

# Macroeconomic and Social Developments in Eastern Africa 2019

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



  
Economic Commission for Africa | Commission économique pour l'Afrique  
1958 - 2018



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## **Acknowledgements**

This report was prepared for the discussion of the 22<sup>nd</sup> Meeting of Intergovernmental Committee of Experts for Eastern Africa in Kigali, Rwanda from 20<sup>th</sup> to 22<sup>nd</sup> November 2018.

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, Daya Bragante, Emelang Leteane, Rodgers Mukwaya, Geoffrey Manyara, Abdoulaye Djido, Laura Naliaka, Rosemary Bagiza and Jackline Ingabire of the Sub-Regional Office for Eastern Africa. Infographics were kindly designed and provided by Ferdos Issa.

## 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

*Reflecting general improvements in living standards, life expectancy 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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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 some countries registering historically unprecedented gains (with Kenya and Rwanda both registering the largest increases of 8.5 years).

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.

*Prospects for regional growth have 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.*

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 – 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.*
- 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.

*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 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 – under the guise of multiple

'preferential market access' schemes – 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.

*Trade deficits in the region are driven almost exclusively by manufactured goods imports. 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.*

*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 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.

*If the AfCFTA is fully implemented, the value of exports of the Eastern Africa to the rest of the continent would increase by almost a third, with processed food and manufacturing products being the main beneficiary sectors.*

*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 – particularly the East African Community, the Intergovernmental Authority on Development, and the Indian Ocean Commission – need to take a protagonistic role in reaching this objective.

# 1. Macroeconomic and Social Developments

## 1.1. Resumed Growth Momentum in Eastern Africa

The world economy continues a steady expansion in 2018, following an annual growth rate of 3.1 per cent in 2017, the fastest pace since 2011. Supported by the revival of global demand, broadly favorable financial conditions and expansionary fiscal policy in the United States, the world economy is forecast to expand by 3.2 per cent in 2018 and 2019 (UNDESA, 2018a). Nevertheless, risks are also mounting, especially the escalating trade tensions between major economies and worries about financial crises in several emerging markets.

The recovery in Africa in 2017 was strong, evidenced by the pickup of GDP growth from 1.6 per cent in 2016 to 3.7 per cent in 2017, partly thanks to the rise in commodity prices. The improvement largely reflects stronger prospects in some of the region's largest economies, such as Nigeria, South Africa and Angola, yet recent statistics suggest weakening growth momentum.<sup>1</sup> While the continent is expected to enjoy a modest growth at 3.6 per cent and 3.9 per cent in 2018 and 2019 respectively (UNDESA, 2018a), structural reforms to tackle macroeconomic imbalances and improve the business environment are required to raise medium- and long-term growth potential.

In Eastern Africa<sup>2</sup>, the economy rebounded in 2017, up to 6.6 per cent from 5.7 per cent in 2016, following a recovery from wide-spread droughts which negatively impacted on the regional growth performance in 2016. As the fastest growing region in Africa, Eastern Africa recorded an annual average growth rate of 6.7 per cent between 2013 and 2017, much higher than the African average of 2.9 per cent. Of a special note, prospects for regional growth have been bolstered by the resolution of the long-standing political conflict between Eritrea and Ethiopia (Box 1). UNECA estimates suggest that robust growth is expected to be sustained in 2018 and 2019 at 6.0 per cent and 6.2 per cent respectively (Figure 1).

*The Eastern African economy rebounded in 2017 following a recovery from wide-spread droughts. Robust growth is expected to be sustained in 2018 and 2019 at 6.0 per cent and 6.2 per cent respectively.*

Regarding the economic performance of individual countries in the region, Ethiopia, Tanzania and Rwanda registered the highest growth rates between 2013 and 2017. Backed by an increase in agricultural production and continued infrastructure investment, most countries are expected to maintain growth momentum in 2018 and 2019 (Table 1). Indeed, the most recent statistics suggest stronger growth in 2018 compared to 2017. For example, the Rwandan economy expanded by 10.6 per cent and 6.7 per cent in the first two quarters of 2018 compared to 1.7 per cent and 4.0 per cent in 2017, largely due to the rapid growth of the agriculture and services sectors underpinned by a much improved food crop harvest and an increase in transport and tourism revenues, boosted by the international events hosted in Kigali<sup>3</sup> (BNR, 2018). In Kenya, economy growth also accelerated to 5.7 per cent and 6.3 per cent in the first two quarters of 2018 from 4.7 per cent observed in 2017, thanks to the notable improvement in agricultural performance (KNBS, 2018a). Having said that, the instability of

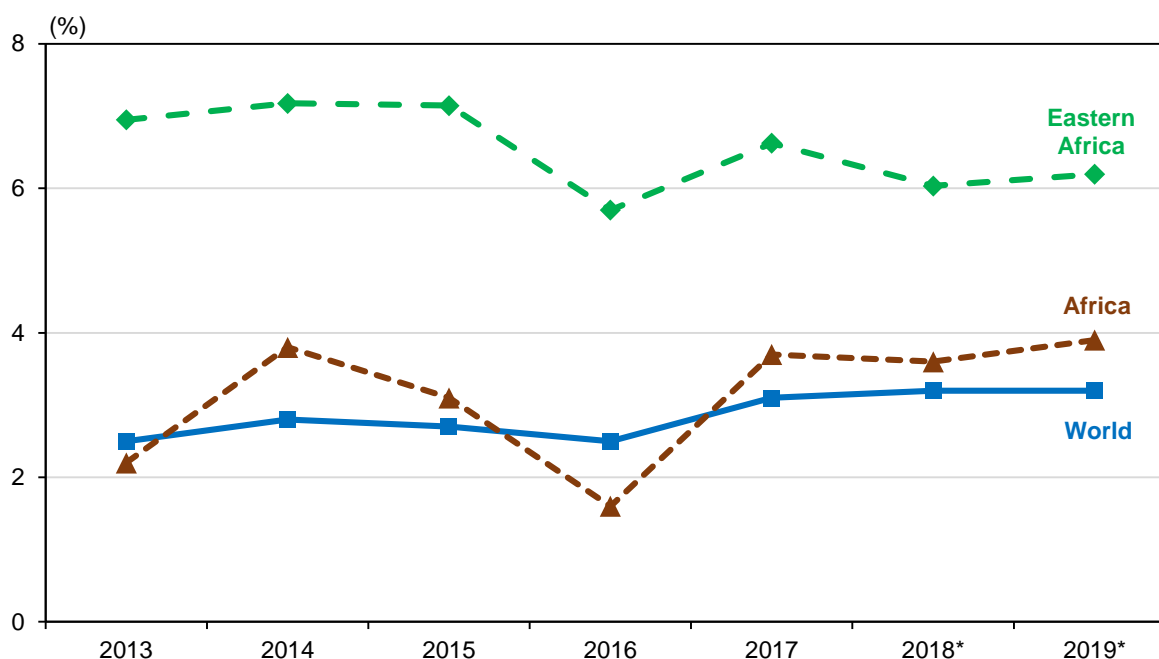
<sup>1</sup> The latest data indicates that the South African economy slipped into recession during the second quarter of 2018, as a result of a fall-off in activity in the agriculture, transport, trade, government and manufacturing industries (Stats SA, 2018).

<sup>2</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>3</sup> Rwanda has been ranked by the International Congress and Convention Association as the third most popular conference and events destinations in Africa (ICCA, 2018). Rwanda recorded around 28,000 delegates in 2017, an increase of 19 per cent compared to that in 2016.

agricultural output and its significant impact on economic growth highlights the vulnerability of the Eastern African countries to weather-related shocks (Box 2).

**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 (2018a), IMF (2018a) and UNECA calculations.

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

	2013	2014	2015	2016	2017	2018*	2019*	Average Growth Rate (2013-2017)
Ethiopia	9.9	10.3	10.4	8.0	10.9	7.3	7.5	9.9
Tanzania	7.3	7.0	7.0	7.0	7.1	6.8	6.9	7.1
Rwanda	4.7	7.6	8.9	6.0	6.1	7.2	7.0	6.7
Djibouti	5.0	6.0	6.5	6.5	7.0	6.8	6.7	6.2
D.R. Congo	8.5	9.5	6.9	2.4	3.7	4.2	4.2	6.2
Kenya	5.9	5.4	5.7	5.9	4.9	5.9	6.0	5.6
Seychelles	6.0	4.5	4.9	4.5	4.2	3.3	3.3	4.8
Uganda	4.7	4.5	5.7	2.6	5.0	5.7	6.0	4.5
Eritrea	3.1	5.0	4.8	3.5	3.2	3.4	3.8	3.9
Madagascar	2.3	3.3	3.1	4.0	4.3	4.5	4.8	3.4
Burundi	4.9	4.2	-0.4	2.8	2.8	0.0	2.9	2.9
Comoros	3.5	2.1	1.0	2.2	3.0	3.0	3.7	2.4

Note: (\*) Forecast.

Data for Ethiopia refer to fiscal years (July/June) and data for 2013 represent fiscal year 2012/13.

Sources: National sources, UNDESA (2018b), IMF (2018b) and UNECA calculations.

### **Box 1: The Economic Implications of the Rapid Rapprochement between Eritrea and Ethiopia**

In June, 2018 the new Ethiopian Prime Minister Abiy Ahmed took the historic decision to recognise the demarcation of the Ethiopian Eritrean border and thereby instigated a peace process between the two countries, culminating in an historic visit to Asmara in July 2018. After years of stalemate, events have subsequently moved at a precipitous rate. Arguably, what binds Eritrea and Ethiopia together has always been stronger than what has divided them. Both countries share deep social, historical and economic ties. Both peoples describe themselves as ‘Habesa’.

Economically, the potential gains from the rapprochement are enormous. The two economies are very different in size, with a nominal GDP of around US\$ 81 billion in Ethiopia versus US\$ 6 billion in Eritrea. Meanwhile, Ethiopia is a country with more than 100 million people, around twenty times that of Eritrea. But the two economies display an important degree of economic complementary, particularly with regard to transport infrastructure.

Despite achieving respectable rates of economic growth over the last decade, Eritrea has suffered significant economic hardship and isolation amid the dispute with Ethiopia. Both the north of Ethiopia and Eritrea now stand to benefit from greater investment and commerce. Eritrea is now an important exporter of minerals, and has a large, active and well-educated diaspora community. Despite the prevailing still low per capita incomes, Ethiopia has been growing very rapidly over the last decade and a half, and has made big strides in terms of the development of its industrial potential. It also has major energy resources (e.g. the Grand Renaissance Dam). From a purely economic perspective, there are enormous potential complementarities between the two countries, if the recent political advances are consolidated.

The granting to Ethiopia of access to Eritrea’s Massawa and Assab ports will represent a major boon for a landlocked nation focused on developing an export-oriented manufacturing sector. The port access is undoubtedly important for Ethiopia, but also for Eritrea which would stand to benefit from facilitating Ethiopian import and export cargo. Eritrean ports require major investment to compete with neighbouring Djibouti. Both countries have already demonstrated keen interest to initiate trade-links through the ports, road transport and opening of telephone lines. Work is also underway to finalize maintenance of the road networks connecting Ethiopia to Eritrea’s border.

Over recent decades, air transport has become crucial for Ethiopian manufacturing – a lot of products are now shipped by air (e.g. textiles and horticultural products). For Eritrea, greater connectivity by air will be a boon too. President Ahmed’s flight to Asmara in June was the first Ethiopian Airways flight to Asmara in many decades. It has recently been announced that Ethiopian Airlines will buy a 20 per cent stake in Eritrean Airlines. Subsequently, regular flights from Addis Ababa to Asmara by both Ethiopian and Eritrean Airlines have resumed, facilitating further economic ties.

UNECA’s Ethiopia STEPs country profile (2018a) highlights the fact that Ethiopia is not currently well integrated into the regional economy – intra-regional trade within the Intergovernmental Authority on Development (IGAD) is very low. Ethiopia could benefit a lot from integrating more into the sub-regional economy – not only with Eritrea, but also with Kenya. The prospect of Eritrea reintegrating into IGAD will hopefully accelerate this process. Simultaneously large investments will be needed to address the poor state of Eritrea's infrastructure, and this will probably come initially from the Gulf States and China, two countries which retained good relations with Eritrea. There is also a need to address the investment climate, economic openness and financing development. To benefit from the economic opening with Ethiopia, Eritrea will be compelled to address necessary structural economic reforms. Trade and tourism will witness immediate impacts from the rapprochement with Ethiopia.

Finally, a major boost to growth will come from the lifting of UN sanctions against Eritrea. Both Ethiopia and Somalia have supported the lifting of sanctions on Eritrea and Ethiopia has offered to negotiate an understanding between Djibouti and Eritrea.

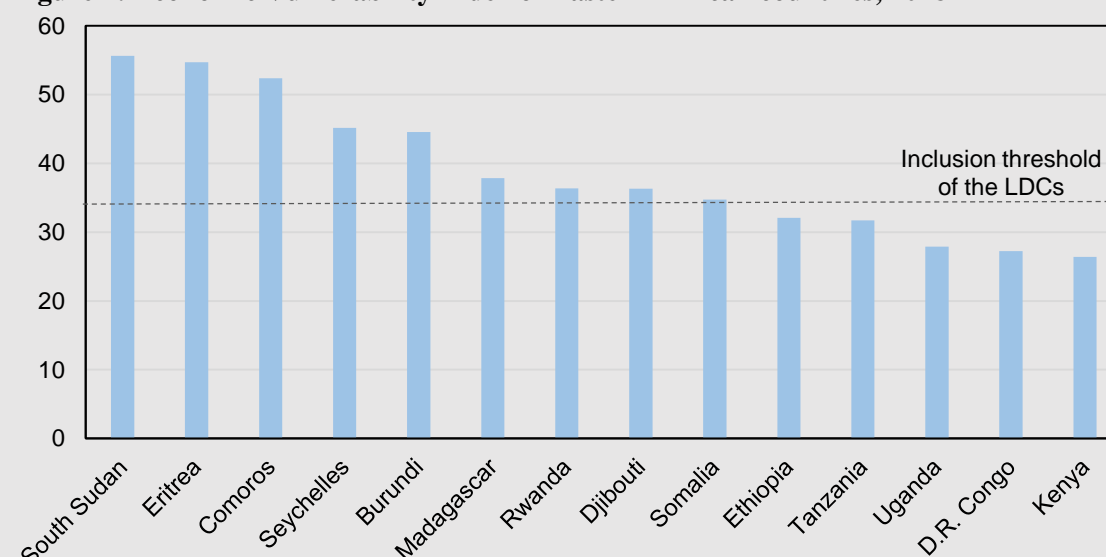
### Box 2: How Vulnerable Are the Eastern African Countries?

Economic vulnerability to exogenous shocks and related instabilities are one of the major structural impediments to sustained growth and poverty reduction in developing countries. To quantify and compare the degree of economic vulnerability across countries, the United Nations Committee for Development Policy established the Economic Vulnerability Index (EVI) and used it as an additional criterion to GDP per capita and human capital for a country to be classified as a Least Developed Countries (LDCs) (Guillaumont, 2009). The economic vulnerability of a country can be defined as the risk of a country’s development being hindered by the natural or external shocks. It can be viewed as a result of the size and frequency of the exogenous shocks, the exposure to shocks, as well as the capacity to react to them. While the capacity to react to a shock relies partially on transitory factors such as the overall state of the economy, the EVI emphasizes the long-term structural vulnerabilities (Guillaumont, 2010).

The EVI is a composition of eight indicators, with five variables measuring the exposure of shocks, including (i) population size, (ii) remoteness (i.e. the minimum average distance for a country to reach half of the world market), (iii) merchandise export concentration, (iv) share of agriculture, forestry, fisheries in GDP, and (v) share of population in low elevated coastal zones, whereas the shocks are captured based on three indicators, namely, (vi) instability of exports of goods and services, (vii) victims of natural disasters and (viii) instability of agricultural production (UNDESA, 2018c). The EVI, ranging from 0 to 100, indicates a higher level of vulnerability with a higher score, with the inclusion threshold of the LDCs being set at 36.

In Eastern Africa, eight countries in 2018 had the EVI higher than the inclusion threshold for the LDC group of countries, with five countries South Sudan, Eritrea, Comoros, Seychelles and Burundi scoring above the LDCs’ average (Figure 2). The most vulnerable countries exhibit different economic and social characteristics – some are small island states, others landlocked – yet they generally have a dependence on a few export products, and suffer from instability in export earnings. Moreover, most of these countries are extremely vulnerable to natural disasters, with large fluctuations in agricultural production and a high reliance on the agriculture sector, e.g. Burundi, Rwanda and Uganda.

**Figure 2: Economic Vulnerability Index of Eastern African countries, 2018**



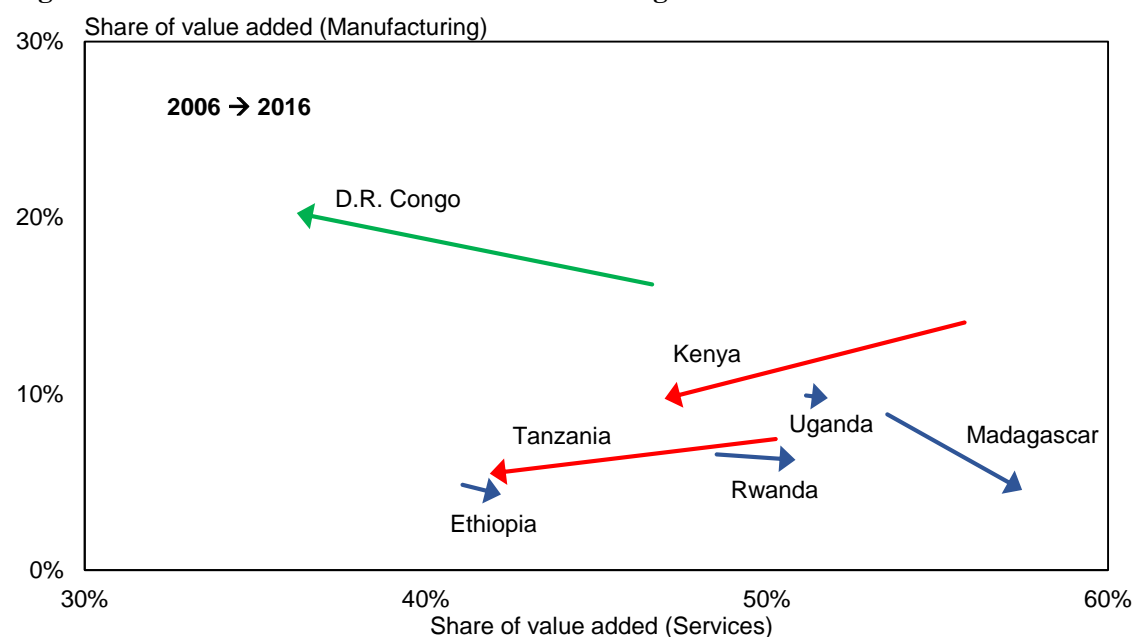
Source: UNDESA, 2018c.

In terms of the key drivers of economic growth, despite sharp fluctuations due to adverse weather conditions, the agriculture sector retains a prominent role. Meanwhile, the mining and manufacturing sectors played an important role in boosting the economy in several countries in 2017, e.g. Ethiopia, Rwanda and Tanzania, whereas the services sector has sustained robust growth. Nonetheless, structural transformation<sup>4</sup> has been taking place only at a slow pace, and the share of value added of the manufacturing sector still stands at below 10 per cent of the economy for most countries in the region. Indeed, with the exception of D.R. Congo,<sup>5</sup> the major economies actually registered a decline in the share of manufacturing value added over the past decade, with Kenya and Tanzania further recording a decrease in the share of value

*Structural transformation has been taking place only at a slow pace, raising the question of sustainability and inclusiveness of economic growth in the region.*

added in the services sector (Figure 3). This raises the question of sustainability and inclusiveness of economic growth in the region.<sup>6</sup>

**Figure 3: Share of value added of the manufacturing and services sectors between 2006 and 2016**



Source: UNdata, 2018.

Another key aspect of inclusive growth is job creation. Figure 4 reveals that over the period between 2006 and 2016, the creation of employment was far below the rate of expansion of the economy for many African countries, implying very low employment growth / elasticities.<sup>7</sup> This gives rise to the worrying phenomena of jobless growth which retards poverty reduction and which may also result in social unrest, in the face of the rapidly growing population. In Eastern Africa, the mismatch between

<sup>4</sup> UNECA defines structural transformation as the fundamental changes in economic and social structures that drive inclusive and sustainable development.

<sup>5</sup> In the case of the D.R. Congo, this may be related to the way that a lot of its mineral exports are classified, as having received a degree of processing, and therefore warranting the label “manufactured”. This may be misleading in terms of the real value-addition to exports.

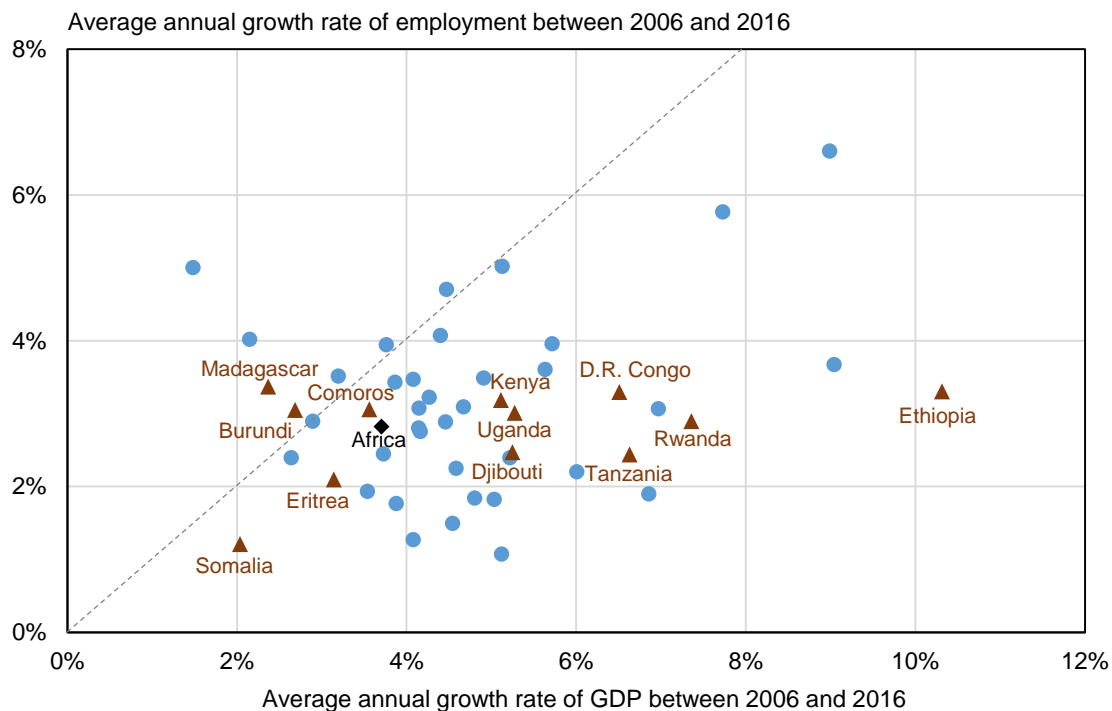
<sup>6</sup> Although the agriculture sector is a natural candidate in many countries to implement pro-poor policies, industrial policies that contribute to economic diversification and sustainable structural change are crucial for poverty reduction (Berardi and Marzo, 2017).

<sup>7</sup> The employment figures refer to estimates by the International Labour Organization which may be different from national statistics. For example, ILO’s estimate of Kenya’s total employment was around 16.6 million in 2016, compared to 17.9 million based on 2015/16 Kenya Integrated Household Budget Survey (KNBS, 2018b).



employment growth and economic growth has been particularly notable in Ethiopia, Tanzania and Rwanda, with a relatively low employment elasticity of around 0.4 (meaning that, for every 1 per cent of economic growth, employment grows by only 0.4 per cent). With an estimated annual labour force growth at around 3 per cent in the coming two decades (UNDESA, 2017), countries in the region would have to sustain GDP growth rates of at least 6 per cent per year in order to absorb the rapidly growing labour force.

**Figure 4: Employment and GDP growth in selected African countries**



Note: Countries in the region are marked in triangle and other African countries are represented by circle.  
Sources: UNdata and ILO (2018).

Apart from employment creation, structural change that promotes more productive jobs is necessary. In this regard, in some countries in the region there has been a gradual shift of employment from low productivity sectors (e.g. agriculture) towards higher productivity sectors over the past decade, yet the process was slow and mainly towards low productivity segments of the services sector rather than into higher productivity manufacturing (UNECA, 2018a).

*With an estimated annual labour force growth at around 3 per cent in the coming two decades, countries in the region would have to sustain GDP growth rates of at least 6 per cent per year in order to absorb the rapidly growing labour force.*

## 1.2. Debt Vulnerabilities Persist Despite Narrowing Fiscal Deficits

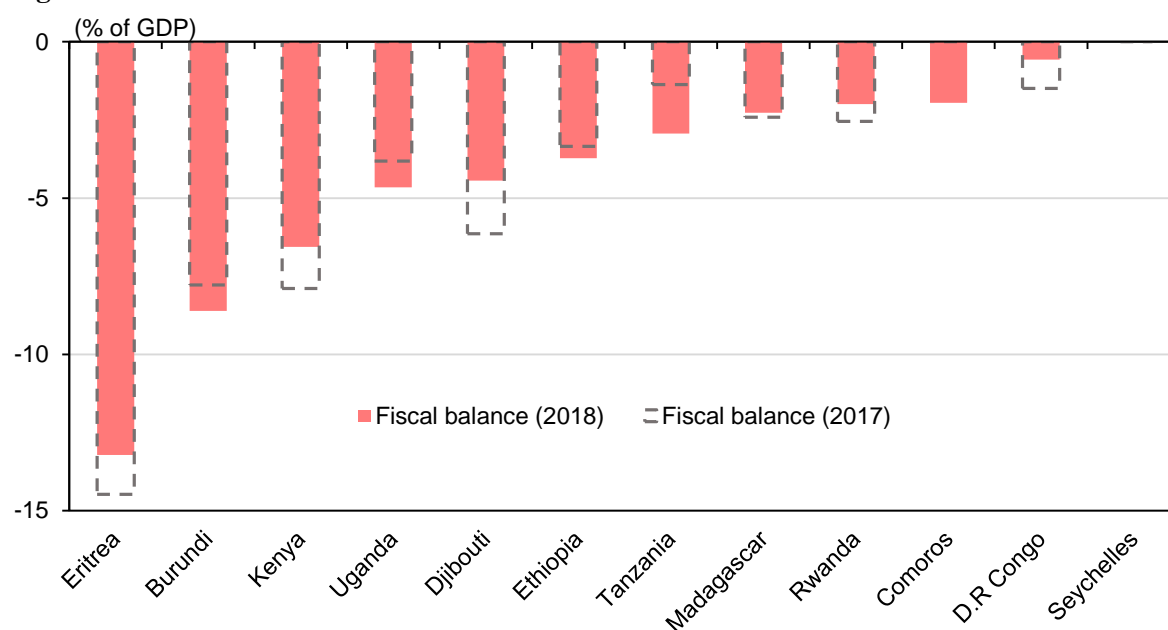
Fiscal balances are generally expected to improve in 2018, especially in Djibouti, partly due to the completion of major infrastructural projects (Figure 5). Fiscal consolidation measures being undertaken by some countries would also help reduce budget deficits. Yet the potential negative impacts warrant attention. Empirical evidence indicates that fiscal consolidations based on cutting public investment have a larger negative effect on output compared to cutting public consumption or raising revenues (Arizala et al., 2017). In fact, the World Bank has cautioned Kenya's style of cutting development budget to reduce budget deficits and borrowing as it may stifle growth in the near future (Daily Nation, 2018). For a more detailed assessment of the government expenditure, Box 3 discusses the budget allocations of Kenya, Rwanda and Uganda and reviews if they align with the development priorities.

On the revenue side, progress on domestic revenue mobilization is much needed. It is estimated that sub-Saharan African countries, on average, could mobilize about 3 to 5 per cent of GDP in additional tax collection through enhancing the efficiency of current systems and institutions (IMF, 2018b). While countries have been improving the management of tax collection and administration, especially with

*Progress on domestic revenue mobilization is much needed. A comprehensive assessment of potential revenue sources and review of tax policy are essential to raise revenues without jeopardizing economic development.*

the help of digital systems, structural factors (e.g. government effectiveness, corruption and inequality) are to be tackled to improve the functioning of tax system (Fenochietto and Pessino, 2010 and 2013). In addition, a comprehensive assessment of potential revenue sources and review of tax policy are essential to raise revenues without jeopardizing economic development.

**Figure 5: Fiscal Balance**



Source: IMF (2018a).

### Box 3: Do Budget Allocations Align with Development Priorities?

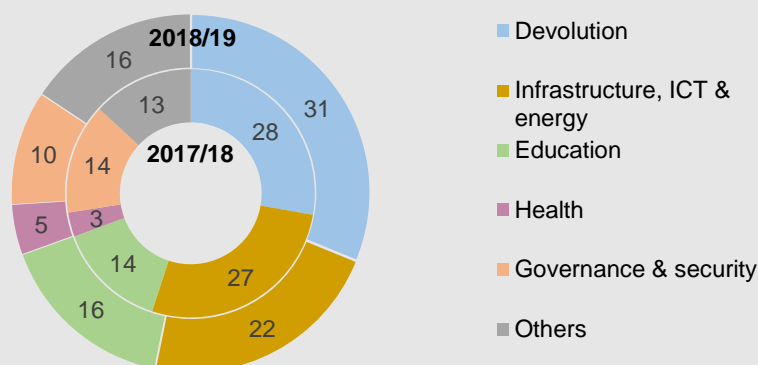
Facilitated by strong economic growth, countries in the region have been able to increase their national budget expenditures in recent years. However, a key question is whether those larger budget allocations are aligned with countries' developmental priorities. For governments in the region, the choices are often very difficult ones – given the still low per capita incomes and hence limited financial resources, there are a lot of contrasting demands placed on their budgets. The situation has been made more difficult by a series of continental wide commitments to reach sectoral spending targets. For instance, the Maputo Declaration of 2003 placed a target spending on agriculture of at least 10 per cent of national budgets (AU, 2003). Similar commitments have been made in the areas education, health, research and development, etc.<sup>8</sup> Individually each of these targets make a lot of sense. But collectively, in a context of limited resources, they make the job of regional Finance Ministers much more difficult.

This box analyses the cases of three Eastern African countries – Kenya, Rwanda and Uganda. Given the fact that the lack of adequate infrastructure is a common challenge, infrastructure development accounts for a significant share of the budget spending in all three countries, concomitant with their development agendas. On the other hand, the budget allocation to other key priority areas (e.g. education and health) varies significantly amongst the countries.

#### Kenya

Kenya's development blueprint 'Vision 2030' aims to transform the country into an industrialized middle-income nation by 2030 (GoK, 2007). The economic, social and political pillars of Vision 2030 mainly focus on infrastructure development, human resource development and governance reforms. Fiscal policy in recent years has been highly expansionary. The total budget expenditure amounted to Ksh 2,287.9 billion (US\$ 22.7 billion) in 2017/18, rising to Ksh 2,556.6 billion (US\$ 25.4 billion) in 2018/19.<sup>9</sup> As a consequence, Kenyan public spending alone accounts for around one-seventh of the EAC GDP. The choices made in terms of budget allocation therefore have regional repercussions. Of a special note, the promulgation of the 2010 constitution led to introduction of county governments. The central government sustains the devolved county governments through allocation of shareable revenues and conditional allocations, with the share of transfers to county governments staying largely stable at approximately 30 per cent of total sectoral expenditure<sup>10</sup> (Figure 6).

**Figure 6: Kenya's sectoral allocations**



Source: The National Treasury and Planning (2017 and 2018).

Vision 2030 identifies investment in infrastructure as a high priority area (GoK, 2007). The sector was allocated 27 per cent of total sectoral expenditure in 2017/18, but the share reduced to 22 per cent in 2018/19. The transport sector<sup>11</sup> represented the largest share of the infrastructure expenditure in both 2017/18 and 2018/19 at about 72 per cent and 85 per cent respectively. Another key sector is

the electrification projects which accounted for around 8 per cent of the infrastructure expenditure in 2017/18 and 14 per cent in 2018/19.

One of the key aspects of Vision 2030 is to provide quality education for the development and enhanced well-being of all its citizens in order to meet the requirements of a rapidly industrializing economy (GoK, 2007). Allocation to education was around 14 per cent of the total sectoral expenditure in 2017/18 and 12 per cent in 2018/19. In line with its goals of improving transition from primary to secondary education and expanding enrollment to public and private universities, a large proportion of the budget allocated to education was on the *free day* secondary education initiative<sup>12</sup> and university education.

In addition, the government aims to provide efficient and high quality health care system.<sup>13</sup> As outlined in the Vision 2030 and the 2010 Kenyan constitution, healthcare is partly devolved to the county governments. Allocation to healthcare has been around 3 to 5 per cent in the past two financial years, with the free maternal healthcare programme and the main referral hospitals having the largest amount of the expenditure on healthcare.

Lastly, security and good governance are identified as enablers for the achievement of the development goals. The allocations to security and good governance declined from 13 per cent in 2017/18 to 8 per cent in 2018/19. The higher expenditure in 2017/18 was attributable to allocations to the Independent Electoral and Boundaries to conduct Kenya's 2017 general elections. Meanwhile, the highest expenditure under improving of national security was police and military modernization, in line with the security strategies outlined in Vision 2030. With regards to good governance, the parliament followed by judiciary received the highest allocation in both financial years.

### Rwanda

Rwanda's sectoral budget allocations are in line with its Vision 2020, which represents an ambitious plan to raise the people out of poverty and transform the country into a middle-income economy by 2020 (MINECOFIN, 2012). Attainment of world class physical infrastructure, skilled human capital and good governance are some of the thematic areas through which the Vision 2020 will be realized. The country's total budget expenditure amounted to Rwf 2,094.9 billion (US\$ 2.47 billion) and Rwf 2,443.5 billion (US\$ 2.8 billion) in 2017/18 and 2018/19 respectively.

The Vision 2020 identifies infrastructure as being key in lowering the costs of doing business in Rwanda, which is essential to attracting domestic and foreign investments. The government allocated about 16 per cent in both financial years to infrastructure projects (Figure 7). Among the infrastructure expenditure, more than 60 per cent was allocated to the transport sector, whereas the energy sector received about 37 per cent.

<sup>8</sup> For instance, the target spending on health is 15 per cent of the national budget (AU, 2003)

<sup>9</sup> The expenditure projections for 2018/19 were revised downwards in September 2018 due to challenges in revenue collection and elevated expenditure pressures.

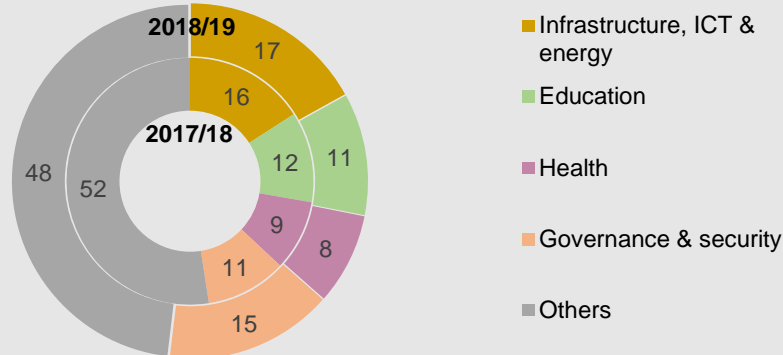
<sup>10</sup> The sectoral expenditure refers to budget allocations to the sectors mentioned in the budget, and thus it may not match the total budget expenditure.

<sup>11</sup> Approximately 30 per cent of Kenya's road network requires rehabilitation or reconstruction and the country's airports, ports and rail reportedly are operating beyond capacity (PSC, 2018).

<sup>12</sup> Under this initiative, the government pays the school fees for student's attending public day secondary schools.

<sup>13</sup> The Kenyan government intends to roll out universal health coverage to all households by 2022, so as to guarantee access to quality and affordable health care (The National Treasury and Planning, 2018).

**Figure 7: Rwanda’s sectoral allocations**



Source: MINECOFIN (2017 and 2018).

With regards to human resource development, the education sector was allocated approximately 12 per cent of the sectoral expenditure in both 2017/18 and 2018/19. The funding was mainly meant for construction and rehabilitation of classrooms and the promotion of Science Technology Engineering and Mathematics (STEM) through construction of laboratories. On the other hand, healthcare was allocated 9 per cent of the total expenditure in 2017/18 and about 8 per cent in 2018/19. The healthcare expenditure was mainly targeted on the construction of hospitals and health centers. As for accountable governance, which aims at strengthening public accountability, ownership and quality service delivery, the share of budget allocation increased from around 11 per cent in 2017/18 to 15 per cent in 2018/19.<sup>14</sup>

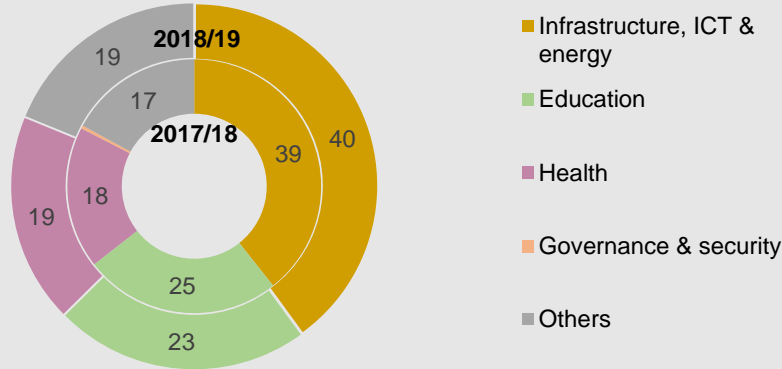
### Uganda

Uganda’s Vision 2040 outlines the development paths and strategies necessary to move the country from a predominantly low income to a competitive middle-income country (NPA, 2007). The government spending focuses on bottlenecks such as infrastructure and human capital development which constrain the country’s socio-economic development. The total budget expenditure amounted to Ush 29,008.5 billion (US\$ 7.7 billion) and Ush 32,702.8 billion (US\$ 8.7 billion) in 2017/18 and 2018/19 respectively.

The government allocated 39 per cent to infrastructure projects in both financial years (Figure 8). In a bid to have an integrated transport network to spur economic growth (NPA, 2007), more than 90 per cent of the infrastructure budget in both financial years was allocated to roads rehabilitation and construction. The Energy and Information and Communication Technology (ICT) sectors received dismal funding in both financial years. ICT, which is poised to improve national productivity by making business and government enterprises more efficient, was allocated only 3 per cent of infrastructure spending in 2018/19. Although Uganda aims to develop and generate modern energy to drive the industry and services sectors, energy was allocated merely 2 per cent of the spending in 2017/18.

<sup>14</sup> Among the categories defined as ‘others’, the public finance management which is instrumental in developing and promoting Rwanda’s service-led and knowledge based economy received the largest allocations.

**Figure 8: Uganda’s sectoral allocations**



Source: Ministry of Finance of Uganda (2017 and 2018).

One persistent criticism has been over the efficiency in the delivery of social services despite the country’s human capital development strategy being anchored on the provision of modern ‘world class’ education and efficient health services delivery system (NPA, 2007). Education was allocated approximately 25 per cent of the total sectoral allocations in 2017/18 and 23 per cent in 2018/19. The expenditure allocated to healthcare was about 18 per cent in both 2017/18 and 2018/19. These funds were mostly for construction and rehabilitation of hospitals and health centers. Having said that, inefficiencies such as drug stock outs and absenteeism of health workers as mentioned in the budget speech (Ministry of Finance, 2017) have to be addressed to improve the healthcare system.

Despite security and governance being identified as a fundamental area in the Vision 2040, it received a paltry 0.4 per cent in 2017/18 and no allocations in 2018/19. The allocation in 2017/18 was geared towards strengthening legal reforms through enhancing legal reforms of the judiciary in line with the Vision 2040. It is important to note that the government had invested heavily in strengthening of the national defense systems in earlier financial years.

Despite narrowing fiscal deficits and strong economic growth, several countries continue to record higher debt to GDP ratios in 2017 and 2018 (e.g. Burundi, Ethiopia, Kenya, Rwanda and Uganda). In the region, there are five countries with debt to GDP ratios<sup>15</sup> exceeding 50 per cent in 2018, compared to only two in 2013, raising concerns on the debt sustainability and debt overhang problems.<sup>16</sup> The IMF debt sustainability assessment indicates that among the countries with debt to GDP ratio exceeding 50

*The shift in the composition of debt portfolio from traditional concessional sources of financing towards emerging bilateral lenders and market based sources exposes the region to new sources of risk.*

per cent, Burundi and Ethiopia were rated as high risk (IMF, 2018c).<sup>17</sup> Since the debt structure is key in determining debt sustainability (Pienkowski, 2017 and Hurley et al., 2018), the shift in the composition of debt portfolio from traditional concessional sources of financing towards emerging bilateral lenders and market based sources exposes the region to new sources of risk.

On the composition of bilateral lenders, most countries have shifted from the Paris Club<sup>18</sup> creditors toward non-Paris Club creditors, with China positioning itself as the major regional bilateral lender. For instance, amongst the bilateral lenders, China accounted for about 72 per cent of Kenya's loans in 2018, compared to just 15 per cent in 2011 (GoK, 2018). Meanwhile, in Djibouti, the total amount of loans from China was almost 77 per cent of its GDP in 2018 (Eom et al., 2018). In the region, loans from China have more than doubled to approximately US\$ 23.2 billion in the period 2013-2017 from US\$ 10.0 billion in the period 2008-2012 (Atkins et al., 2017). The sharp increase in debt was mainly used to finance infrastructure projects<sup>19</sup> in the transport sector which received about 41 per cent of the total Chinese debt, followed by power and communication which were allocated 24 per cent and 13 per cent respectively. Moreover, the debt is concentrated in a few countries, notably Ethiopia and Kenya (Figure 9). Box 4 discusses the economic impact of the China Belt and Road Initiative on the region.

Regarding the associated risks, there are concerns that the short maturity of the debt from China exposes countries to liquidity risks as the returns from infrastructure projects tend to be realized over the long haul. Moreover, although China through its Ministry of Commerce, the China Export-Import (Exim) bank and the China Development bank (CDB) provides interest-free loans and concessional loans, some loans are offered at commercial rates<sup>20</sup>, therefore increasing the debt servicing burden (Brautigam and Jyhjong, 2016 and CARI, 2018). The fact that the loans are not tied to transparency or key governance reforms in the recipient countries also presents challenges. Recently, the seizing of the Sri Lankan port at Hambanota by Chinese investors due to failure to service a loan raised concerns about China's 'debt-

<sup>15</sup> The figures refer to general government gross debt as a share of GDP based on IMF (2018a).

<sup>16</sup> Some scholars argue that debt to GDP ratio is an inconclusive and narrow way to view debt sustainability as it does not take into account other important factors, such as the amount of local revenues and foreign currency that the government can collect for use in servicing the public debt (Fitzgerald, 2009 and Wyplosz, 2009). It is important to assess whether debt effectively contributes to the development process in so far as it does not lead to debt overhang problems (UNCTAD, 2006a).

<sup>17</sup> Although Eritrea is not part of the IMF's debt sustainability assessment, its estimated debt to GDP ratio is around 130 per cent over the past five years, suggesting unsustainable debt burden (IMF, 2018a).

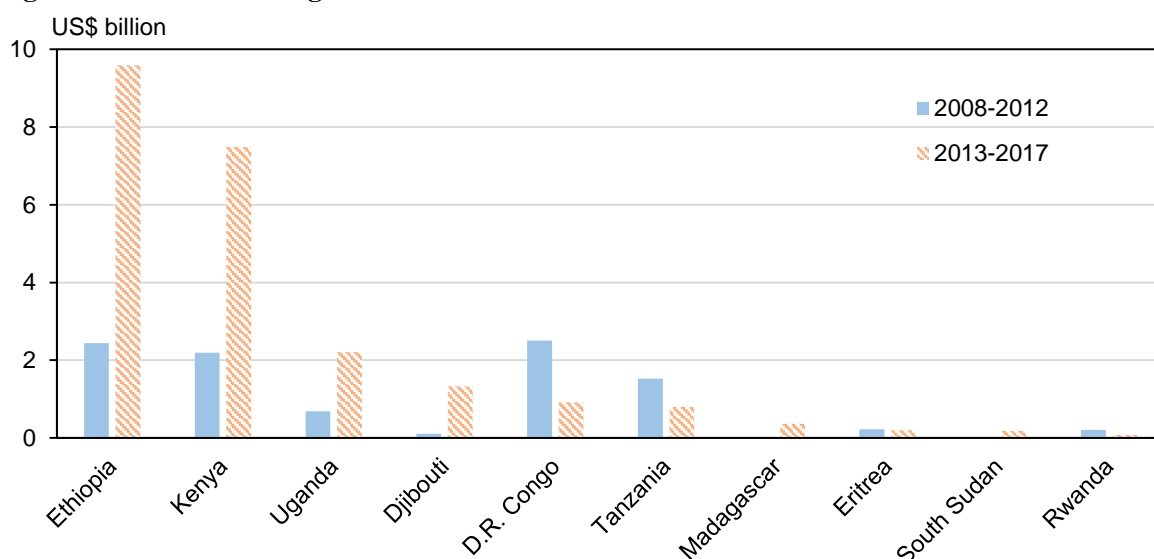
<sup>18</sup> The Paris Club has 19 permanent members, comprising mostly the western European and Scandinavian nations, the United States, the United Kingdom and Japan.

<sup>19</sup> Some of the major infrastructure projects in the region financed by China include the Addis Ababa- Djibouti railway, Entebbe-Kampala expressway and Kenya's Standard Gauge Railway.

<sup>20</sup> For instance, the Addis-Djibouti line, 85 per cent of Ethiopia's portion and 70 per cent of Djibouti's were funded by commercial loans from the China Exim Bank. In the case of the Mombasa-Nairobi line, 42 per cent of the financing was concessional export credit, and 52 per cent came from proprietary trading loans, both provided by the China Exim Bank (Sun, 2017). Meanwhile, countries are also susceptible to exchange rate risks as most of the loans by the CDB and China Exim were denominated in either dollars or renminbi (Hurley et al., 2018).

trap diplomacy’ (Moore, 2018), especially since the region’s Chinese loans are collateralized with long-term strategic assets such as ports.

**Figure 9: Loans to the region from China**



Source: Atkins et al. (2017)

However, it is worth noting that China usually offers debt restructuring. A recent example is the restructuring of the US\$ 4 billion loan to Ethiopia.<sup>21</sup> China has also cancelled the debt of a number of countries in the recent past. One example is the writing off of a small package of Comorian government debt worth Cfr 630 million (US\$ 1.4 million) in 2017 (EIU, 2017 and Hurley, 2018).

With regards to the international capital market, several countries in the region have successfully issued Eurobonds over the last decade.<sup>22</sup> The latest Eurobond issuance was by Kenya in the first quarter of 2018.<sup>23</sup> The dollar has been the currency of choice for the bond issuances and this exposes the issuers to exchange rate risks. Meanwhile, the appreciation of the dollar against local currencies is expected to increase the cost of repaying debt. The short maturity and high interest rates further poses significant repayment risks. Eurobonds are also more difficult to restructure than bank loans as there is a larger number of creditors involved that must coordinate in the event of default (UNCTAD, 2016). In sum, how the respective countries invest and manage their debt levels will be imperative in preventing the rise of another debt crisis.

*How the respective countries invest and manage their debt levels will be imperative in preventing the rise of another debt crisis.*

<sup>21</sup> The loan for the Addis Ababa-Djibouti railway, which was meant to be paid over 10 years, has now been extended to 30 years. (The EastAfrican, 2018a)

<sup>22</sup> Record low interest rates in the advanced economies vis-à-vis high yields of the Eurobond increased investor appetite for the bonds from the region (Presbetiro et al., 2015 and Bloomberg, 2018).

<sup>23</sup> Kenya issued its second US\$ 2 billion sovereign bond to pay off its maturing debts and fund development plans. The bond was issued in two equal tranches of 10 years at a coupon of 7.25 per cent and 30 years at a coupon of 8.25 per cent.



#### **Box 4: Modelling the Economic Impact of the China Belt and Road Initiative on East Africa**

The global infrastructure index prepared by the World Bank shows that countries in the East African region perform poorly regarding infrastructure, highlighting the need for improved infrastructure in the region. The “Silk Road Economic Belt” and a “21<sup>st</sup> Century Maritime Silk Road”, formally known as Belt and Road Initiative (BRI), launched by the Chinese government, represents an opportunity for countries in the East African region to develop the quality of infrastructure.

Mukwaya and Mold (2018) evaluated the effect of People’s Republic of China’s BRI strategy on trade and welfare in Eastern Africa. The BRI routes will run through countries in Asia, Europe and Africa. In East Africa, the countries along the BRI include Djibouti, Ethiopia, Kenya, Rwanda, Uganda and Tanzania. One of the BRI projects in East Africa, the standard gauge railway is already under construction. It will connect the ports of Mombasa and Dar-es-salaam to Kenya, Uganda, Tanzania and Rwanda. The standard gauge railway is expected to reduce transport costs in the region, which has implications for trade and welfare. The study uses the Global Trade Analysis Project (GTAP) computable general equilibrium (CGE) model and the latest GTAP 10 database, based on 2014 data, to analyse the effects of the establishment of the BRI.

This study confirms that the BRI initiative could have a very significant positive impact on East Africa. For instance, reducing the export and imports trade margins by 10 per cent as a result of the BRI could result in increases the GDP growth in East Africa ranging from 0.4 to 1.2 percentage points. It could also contribute to an increase in regional welfare of nearly US\$ 1 billion. Intra-regional exports could be expected to increase by US\$ 278 million, boosting intra-regional trade, another important objective against the backdrop of the recently signed AfCFTA.

As is to be expected in this kind of analysis, however, the distribution of benefits arising from BRI is not equal, with some countries benefiting more than others. Indeed, the larger countries, Ethiopia, Kenya and Tanzania would gain substantially more from the BRI initiatives. It is, therefore, in their best interests to make sure that other regional initiatives to improve infrastructural provisions do not stall.

Particularly interesting is the fact that the simulations suggest that the BRI would actually provide more of an impetus to intra-African exports than to exports to the rest of the world (which actually fall under our modelling scenarios). In this sense, although it was not the original purpose of the BRI, it seems that the infrastructure would facilitate the completion of regional agendas to intensify intra-African trade, as reflected in the AfCFTA that was signed by all but two of the countries (Burundi and Tanzania) in the group of countries studied here.

### 1.3. Moderated Inflation and Exchange Rate Pressures

Inflation has eased across most of the region in 2018, largely due to lower food prices following recovery from droughts (Table 2). Yet some countries still face challenges curbing inflation, partly owing to the political instability. For instance, it is estimated that D.R. Congo will record a 38 per cent inflation in 2018, following the sharp depreciation of the Congolese franc in 2017 (Central Bank of the D.R. Congo, 2018). Having said that, the latest statistics indicate that inflation remains modest in most countries, but has gradually accelerated since mid-2018. In Kenya, the year-on-year inflation stood at 5.7 per cent in September 2018, up from the year low of 3.7 per cent in April 2018, yet still lower than the 7.1 per cent registered in September 2017 (KNBS, 2018c). Similarly, Uganda's headline inflation rate moderated from 5.3 per cent in September 2017 to 3.7 per cent in September 2018, but showed signs of picking up since May 2018 (BOU, 2018).

*Inflation remains modest in most countries, but has gradually accelerated since mid-2018.*

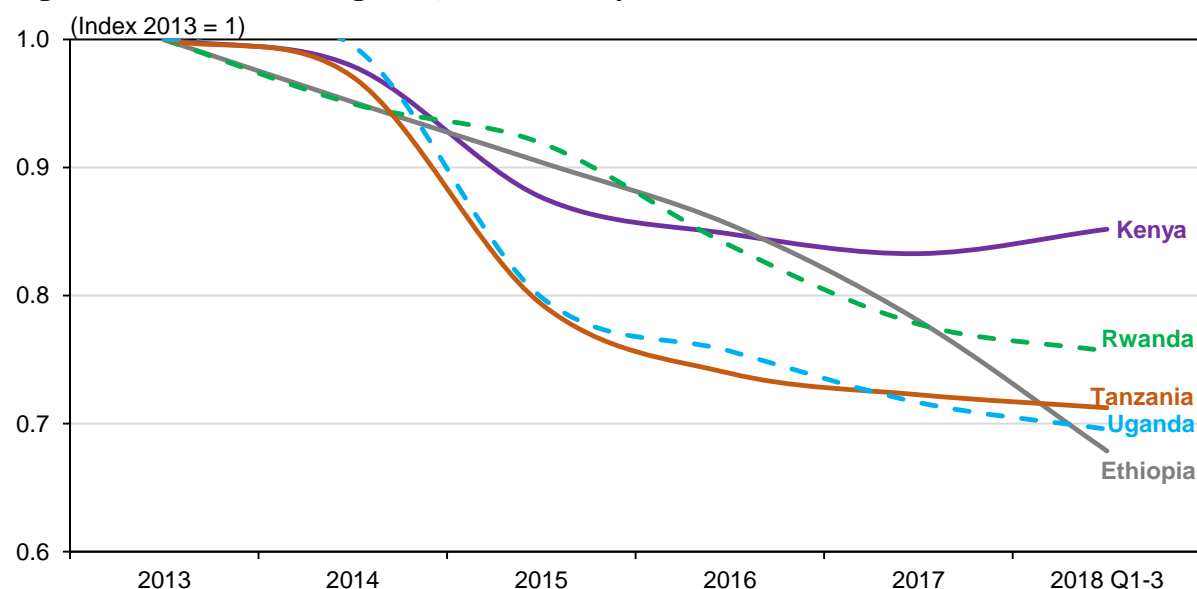
**Table 2: Inflation (% annual change)**

	2013	2014	2015	2016	2017	2018*	Average (2013-2017)
D.R. Congo	1.2	1.2	1.8	5.9	53.5	37.9	12.7
Eritrea	7.3	15.2	9.0	11.5	7.5	5.9	10.1
Ethiopia	8.1	7.4	10.1	7.3	9.0	8.2	8.4
Burundi	7.9	4.4	5.5	5.6	16.1	14.0	7.9
Kenya	5.7	6.9	6.6	6.3	8.0	6.0	6.7
Madagascar	5.8	6.1	7.4	6.7	7.0	6.5	6.6
Tanzania	7.9	6.1	5.6	5.2	5.3	5.4	6.0
Uganda	4.9	3.1	5.4	5.5	5.6	5.6	4.9
Rwanda	4.2	1.8	2.5	5.7	4.8	5.1	3.8
Seychelles	4.3	1.4	4.0	-1.0	2.9	3.8	2.3
Djibouti	2.5	3.0	2.7	2.4	-0.8	4.0	2.0
Comoros	1.6	1.5	1.3	1.8	2.2	0.4	1.7

Note: (\*) Estimates.

Sources: National sources, UNDESA (2018a) and IMF (2018a).

Regarding the recent exchange rate developments, depreciation pressure of most local currency against the US dollar remained moderate in 2018, despite the relative strength of the US dollar. While the Kenyan shilling actually appreciated against the US dollar by around 2 per cent (year-on-year) in the first three quarters of 2018 despite concerns over rising debt level, the Ethiopian birr has not yet stabilized after the 15 per cent devaluation in October 2017 (Figure 10). In addition, South Sudan still faces notable inflationary and exchange rate pressures, following an inflation rate of around 200 per cent and the sharp depreciation of the South Sudanese pound against the US dollar by about 60 per cent in 2017 (IMF, 2018d).

**Figure 10: Nominal exchange rate, local currency versus US dollar**

Source: IMF (2018d).

In terms of monetary policy, central banks generally sustained an accommodative monetary policy in 2018. For example, the Central Bank of Kenya lowered the Central Bank Rate from 10 per cent to 9.5 per cent in March 2018, and then to 9 per cent in July 2018, with the aim of supporting the financing of the economy (CBK, 2018a). Nonetheless, credit growth remains sluggish despite the gradual pick up in the second quarter of 2018. This could be partly attributed to the fact that credit risk could not be factored in the pricing of loans with the interest rates cap in place since September 2016<sup>24</sup>. The interest rate caps were meant to reduce the repayment burden on borrowers and improve financial inclusion, yet banks shifted their lending to the government<sup>25</sup> and large corporate clients at the expense of the ‘perceived to be riskier’ micro and small medium enterprises borrowers (CBK, 2018b, and Safavian and Zia, 2018).<sup>26</sup> Whether this outcome was a result of the application of the interest rate cap itself, or a consequence of action by the banking sector to undermine the Central Bank’s policy itself is of course the moot point.

On the other hand, in view of the tighter global financial conditions, central banks are under pressure to raise interest rates. While the policy rate of Tanzania and Rwanda remained unchanged for the first ten months of 2018, Uganda is the first major economy that increased its interest rates in 2018 to counter inflationary pressures given weakening currency and rising oil prices. Given the different economic structure and macroeconomic adjustments in response to shocks, it is understandable that the monetary policy of central banks is not the same. However, the divergence of monetary policy among the EAC Partner States raises the question of the readiness of the East African Monetary Union (Box 5).

*Central banks generally sustained an accommodative monetary policy in 2018, yet they are under pressure to raise interest rates in view of the tighter global financial conditions.*

<sup>24</sup> The Banking Act was amended in August 2016 to put a cap on lending rates at no more than 4 percentage points above the central bank rate (CBR) and a floor on the deposit rates at 70 per cent of the CBR. On the latest development, the Finance Act 2018 was enacted in 2018 which scrapped the floor on the deposit rates and banks responded by reducing interest rates on savings accounts.

<sup>25</sup> By June 2017, Kenyan banks had invested Ksh 955 billion (US\$ 9.6 billion) in government securities, around 20 per cent higher than the same period in 2016.

<sup>26</sup> Unable to access credit from traditional financial institutions, the riskier borrowers are forced to turn to the unregulated market that charges much higher rates and lacks consumer protection (Safavian and Zia, 2018).

### **Box 5: The East African Monetary Union: Ready or Not?**

EAC Partner States are in the process of implementing the Protocol on the Establishment of the East African Community Monetary Union (EAMU), which was signed in 2013 and will lead to the use of a common currency by 2024. The stated objective of the EAMU is to promote and maintain monetary and financial stability in order to facilitate economic integration for sustainable growth and development of the community. Inherent to a monetary union is the conduct of a single monetary and exchange rate policy in the interest of the single currency area as a whole.

It is suggested that the creation of monetary union could help achieve an efficient single market (Kenen and Meade, 2008), increase trade-integration and credibility of macroeconomic policies (Frankel and Rose, 1998) and create more solidarity among African countries (Masson and Pattillo, 2004). On the other hand, a common currency has its costs, mainly due to the inability of monetary authorities of the individual countries to use country specific monetary and exchange rate policy as an instrument of macroeconomic adjustment in response to external shocks.

The benefits and costs arising from the establishment of monetary union ultimately depend on the structural characteristics of the economies concerned. It is therefore critical to examine how economies are converging before forming a monetary union. Specifically, the assessment includes a headline inflation ceiling, a fiscal deficit ceiling, a gross public debt ceiling and a sufficient level of foreign reserves. Empirical analysis by UNECA (2018b) show that there is only partial convergence among the key macroeconomic variables, suggesting that EAC Partner States need to better align their monetary policies and allow for a period of monetary policy coordination. For instance, fiscal convergence is an area where EAC countries have considerable challenges, particularly given the significant need for investment and development spending. Also, most EAC Partner States have a low level of foreign reserves and are vulnerable to external shocks. Moreover, despite their broader structural similarities, UNECA's analysis indicates that EAC economies remain susceptible to asymmetric (country-specific) shocks.

While drawing from the experiences of other currency unions, EAC Partner States have to align their monetary policies and allow for a period of monetary policy coordination to foster convergence that will improve the chances of a sustainable currency union. It is also important that the EAC continues to direct efforts to designing and putting in place adequate mechanisms that can help member countries adjust to future shocks once the common currency is adopted. This includes the usual measures to mitigate the costs of common monetary policies, such as greater labour and capital mobility, price and wage flexibility, as well as various risk-sharing mechanisms (e.g. compensatory fiscal policy). This will require that EAC Partner States agree to explicit and binding convergence commitments as prerequisites to the establishment of the EAMU.

To achieve these goals, there is a need for the establishment of an institution (or a strong mechanism) for enforcing and ensuring compliance by all countries. To ensure good preparation on the establishment of EAMU, it is advisable for the EAC Partner States to fast track the establishment of the East African Monetary Institute which was initially planned to start operating in 2015. In addition, firm commitment, discipline among members, and reduction of the risk of bad policies are results of a more rule-based framework. These measures should be agreed among member countries before the introduction of the single currency, to reduce risks and signal early commitment to macroeconomic stability.<sup>27</sup>

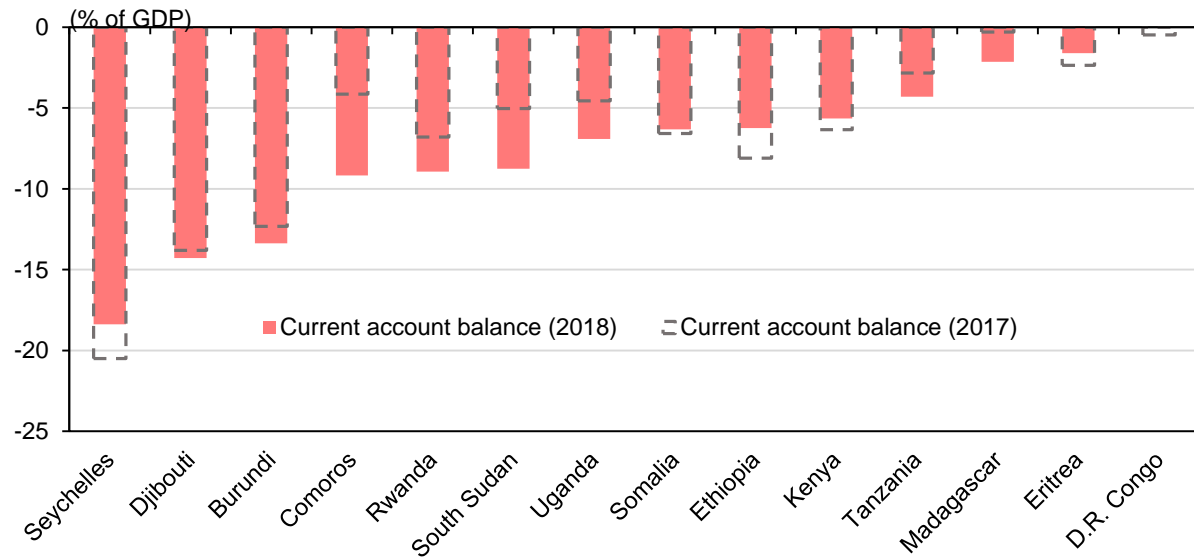
Source: UNECA (2018b).

<sup>27</sup> What happened in Europe at the time of the Greek crisis of 2011 shows that mistakes can be extremely costly and macroeconomically destabilising.

### 1.4. Current Account Deficits Are Constraining Growth

Current account deficits are estimated to widen in 2018, partly due to stronger import growth in some countries as well as higher oil price (Figure 11). Despite the fact that several countries recorded notable increase in exports in first half of 2018 (e.g. Kenya, Rwanda, Tanzania and Uganda), export growth would have to significantly outpace import growth over a sustained period to make a difference to the trade deficit given the much lower value of exports (a regional average of around two-fifths of the imports value). In fact, the scale of these structural current account deficits has been limiting the pace of economic growth – the so-called ‘balance of payment constraint’ (Box 6).

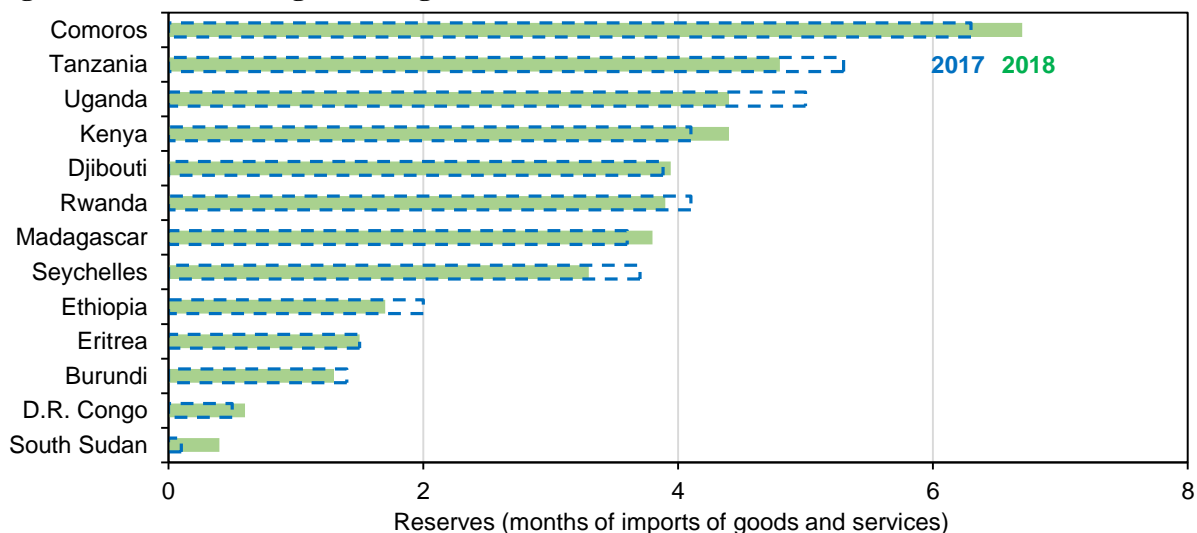
**Figure 11: Current account balance**



Source: IMF (2018a).

Although current account balances have deteriorated, reserve buffers have generally not been increased. While most countries in the region have reserves of around four months of imports in 2018, Ethiopia, Eritrea, Burundi, D.R. Congo and South Sudan are rather vulnerable to external shocks given the low level of reserve buffers (Figure 12). This warrants attention as the mounting risks in the global financial system may put countries under pressure of capital outflows.

**Figure 12: Official foreign exchange reserves**



Sources: IMF (2018b).

### Box 6: Financing Growth in the Context of Balance of Payment Constraint

Since the late-1980s, there has been an outpouring of literature and research into the macro-determinants of economic growth, attempting to understand and explain the differences in the rates of growth and per capita incomes across countries (e.g. Barro, 1991; Barro and Sala-i-Martin, 1995; and Easterly et al., 1997).<sup>28</sup> Much of this work has been carried out within what is known as the ‘endogenous growth theory’. Based on data from the period 1990-2015, Mold and Naliaka (2019, forthcoming) construct an econometric model to help explain growth in Eastern Africa, borrowing from the aforementioned literature, but focusing specifically on the way in which growth has been financed.

There are several reasons for this approach. Firstly, despite still low average per capita incomes, in terms of growth performance, Eastern Africa has been performing strongly since the early 2000s – far above the global and African averages, and not far short of the most dynamic economies of East and South-Eastern Asia (e.g. China and Vietnam). This makes it a good case study of the determinants of sustained economic growth in a low income setting. Secondly, in an important contribution to the literature, Prasad et al. (2007) find that the more a developing country finances its investment through its domestic savings, the faster it grows. Conversely, the more external financing it relies on, the more slowly it grows. While enjoying a strong overall growth trajectory, Eastern Africa has generally struggled to mobilize sufficient resources from domestic sources and has been thus forced to rely quite heavily on foreign inflows to finance that growth process. As a consequence, most countries in the region continue to sustain large current account deficits, indicative of low domestic savings. How this impacts on growth has implications for the sustainability of the growth process in Eastern Africa?

The model used here builds on earlier work by Bosworth and Collins (2003) and Prasad et al. (2007). The pooled regressions include observations for 11 countries in the region over the time period 1990-2015. The empirical specification of the random effects estimator<sup>29</sup> is shown below:

$$y_{it} = B_0 + B_1 ca_{it} + B_2 X'_{it} + (c_i + u_{it}), \quad t = 1, 2, \dots T; i = 1, 2 \dots N$$

where  $y_{it}$  is the annual rate of growth of GDP per capita,  $ca_{it}$  is the current account balance as a percentage of GDP,  $X'_{it}$  is a vector of control variables that comprises initial per capita income, initial life expectancy, openness, fiscal balance, inflation, ODA, population growth, dummy variable for the year 2002<sup>30</sup>, savings and investment<sup>31</sup>.

The results confirm a number of interesting characteristics of growth in the region (Table 3):

**Table 3: Random effects regressions of the determinants of growth in Eastern Africa**

Dependent Variable: Annual rate of growth of GDP per capita	Estimation Period: 1990-2015								
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Current account balance/GDP	-0.14*** (0.05)	-0.06 (0.06)	-0.14*** (0.05)	-0.04 (0.059)	-0.10* (0.06)	-0.01 (0.06)	-0.09* (0.06)	-0.00 (0.05)	-0.08 (0.05)
Log per capita income (1990)	1.35** (0.59)	1.13** (0.53)	1.23*** (0.34)	1.11** (0.52)	1.28*** (0.37)	1.43** (0.67)	1.51*** (0.50)	1.49** (0.68)	1.56*** (0.55)
Life expectancy (1990)	- 0.17*** (0.05)	- -0.15*** (0.04)	- -0.16*** (0.03)	- 0.24** * (0.07)	- - 0.25*** (0.06)	- - 0.25*** (0.06)	- - -0.25*** (0.05)	- - -0.24*** (0.06)	- - -0.24*** (0.06)
Openness	-0.01 (0.02)	-0.01 (0.02)	-0.01 (0.02)	0.00 (0.02)	-0.00 (0.02)	0.00 (0.02)	-0.00 (0.02)	0.00 (0.02)	-0.00 (0.02)
Fiscal balance /GDP	0.26* (0.15)	0.25* (0.14)	0.22* (0.12)	0.21* (0.12)	0.20* (0.11)	0.19* (0.10)	0.19* (0.01)	0.15 (0.10)	0.15 (0.10)

Inflation	-	-	-	0.02**	-	-	-	-	-
	0.02***	-0.02***	-0.02***	*	0.02***	0.02***	-0.02***	-0.02***	-0.02***
	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)
Investments/GDP		0.13*		0.11		0.12		0.11	
		(0.07)		(0.08)		(0.07)		(0.07)	
Savings/GDP			0.15**		0.12*		0.12		0.10
			(0.07)		(0.07)		(0.07)		(0.07)
ODA as a share of GNI				-0.13	-0.14*	-0.13*	-0.13	-0.12	-0.12
				(0.09)	(0.08)	(0.08)	(0.08)	(0.08)	(0.08)
Population growth						0.42	0.33	0.42	0.34
						(0.34)	(0.31)	(0.29)	(0.27)
Dummy 2002								1.28	1.188
								(0.94)	(0.881)
Constant	2.45	0.67	0.64	7.24	6.99	4.37	4.88	2.96	3.551
	(3.15)	(2.72)	(2.39)	(5.17)	(4.95)	(6.33)	(6.10)	(6.84)	(6.568)
R-squared	0.11	0.15	0.16	0.19	0.20	0.20	0.20	0.21	0.211
Wald chi-squared	1335.91	1780.64	1363.77	4749.6	8873.49	8995.82	49693.34	90096.73	191245.83
No. of observations	267	267	267	257	257	257	257	257	257
No. of cross-sections	11	11	11	11	11	11	11	11	11

Note: Robust standard errors in parentheses. \*\*\* p<0.01, \*\* p<0.05 and \* p<0.1.

- a) The first row of the table (1) contains coefficients of the impact of current account deficits on GDP per capita growth. The coefficients are negative and statistically significant at the 1 per cent level, implying that a 10 per cent increase in the current account deficit results to a 0.9 to 1.4 per cent reduction in the GDP per capita growth, *ceteris paribus*. This mirrors findings by Prasad et al (2007) whereby current account deficits are associated with negative growth in developing countries. It also confirms Rodrik's (2009) assertion that when it comes to capital flows, 'more is not necessarily better';
- b) The coefficients of initial income per capita are highly significant and positive. This suggests that the countries in the region are actually growing slower than the richer countries, hence there is no evidence of conditional  $\beta$  convergence. With reference to the Keynesian economists especially Thirlwall and McCombie (2004), Hussain (2006) and Thirlwall (2011), the slow growth of countries in the region partly points to issues in their underlying trade structure vis a vis that of the fast growing economies such as Asian tigers. As a result, the countries are probably running against what Thirlwall (1979) referred to as the 'balance of payment constraint';
- c) All the coefficients of initial life expectancy are statistically significant and negatively correlated to GDP per capita growth. This finding does not necessarily belie the importance of investing in human capital for development outcomes as evidenced in

<sup>28</sup> For summaries and discussion of this earlier work, see Agenor (2004) for an orthodox review, and Thirlwall (2011) for a more heterodox approach.

<sup>29</sup> The GMM estimator is not considered as it is likely to give biased estimates since our data has small N and large T. GMM was originally designed to cope with panels with little depth, but a large cross section.

<sup>30</sup> This variable is meant to capture the sharp improvement in the performance of East African countries since the beginning of the 2000s, related to improvements in the external environment (better financing possibilities – increased ODA, FDI and remittances, and higher commodity prices) (Romily, Prizzon and Rogerson, 2013).

<sup>31</sup> To minimize the risks of multicollinearity and bidirectional causality, savings and investment variables are not included in the same regression.

empirical studies by Bloom and Sachs (1998), Gallup et al. (1998), Bloom et al. (1999) and Lorentzen et al (2008). Rather, it indicates that though improvements in life expectancy may lead to growth in aggregate incomes, it may also trigger faster population growth leading to a negative causal effect of life expectancy on growth of GDP per capita<sup>32</sup> (Acemoglu and Johnson, 2007);

- d) With regards to macroeconomic factors, the fiscal balance has a significant positive influence on GDP per capita growth. On the other hand, the coefficient of inflation (a proxy for macroeconomic uncertainty) is consistently significant and negatively correlated with GDP per capita growth;
- e) Regarding the investment coefficient, in comport with many other previous studies (Levine and Renelt, 1992; Ghura and Hadjimichael, 1996; Easterly, Loayza and Montiel 1997, and Hoeffler ,2002), it is significant and positively correlated to the GDP per capita. Similarly, the savings rate to GDP has a positive impact on the GDP per capita growth. A 10 percent increase in the savings rate to GDP raises the GDP per capita growth by around 1.2 to 1.5 percent. This is in line with predictions from theories of endogenous growth pioneered by Romer (1986) and Lucas (1988), that higher saving and investment rates can permanently raise growth rates; and
- f) Finally, the results suggest that ODA has a negative impact on GDP per capita growth. The empirical results on the aid-growth nexus have been at best, mixed. Clemens et al. (2011) and Askarov and Doucouliagos (2015) attribute this to econometric challenges in estimation. Brautigam and Knack (2004) and Mallick (2008) find a similar negative impact of aid on growth. Aid may actually curtail growth by, inter alia, lowering competitiveness through Dutch disease problems (Rajan and Subramanian, 2005) and limiting the capacity to absorb foreign currency.

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<sup>32</sup> For instance, lower mortality may increase income per capita by increasing the productivity of available resources (most notably human capital). On the other hand, lower mortality may lead to an increase in population size. In the presence of fixed factors of production a larger population tends to reduce income per capita (Cervellati and Sunde, 2009).

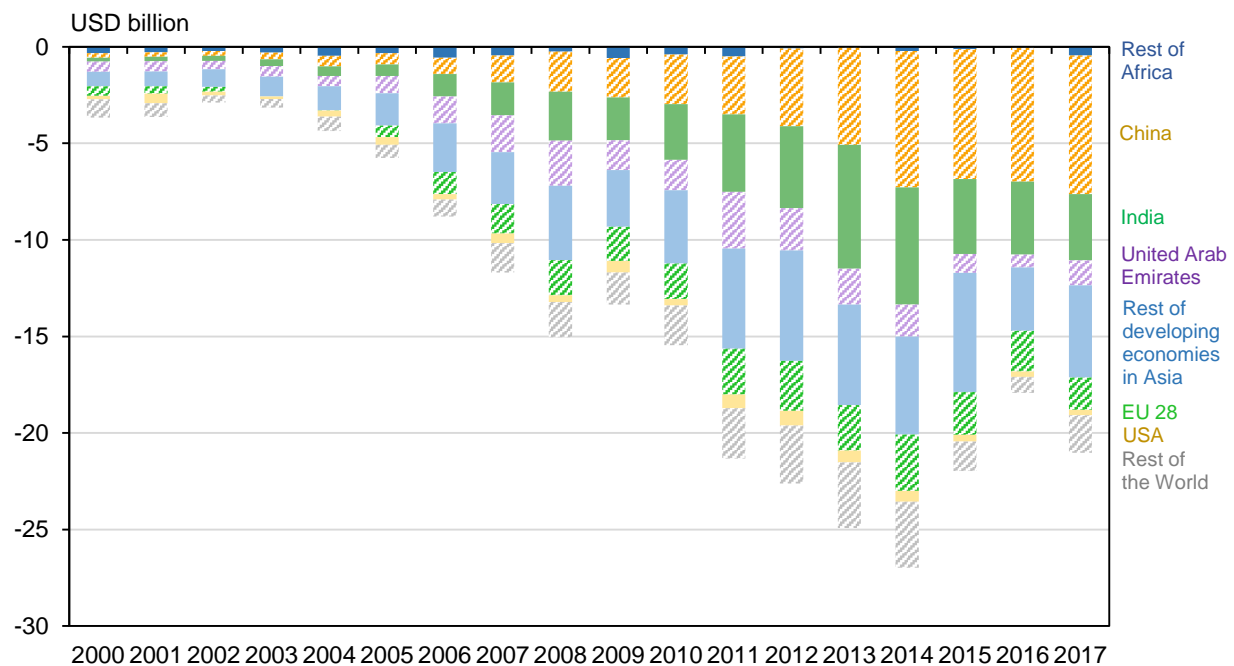


On the analysis of goods trade, countries in the region have been diversifying their trade away from traditional markets (e.g. Europe) towards new trading partners (e.g. Asian countries such as China and India) over the past decade (UNECA, 2018d). While the share of exports to the new trading partners is still low, the increase in importance as imports sources is striking. As an example, the unbalanced growth of trade between the EAC and China and India resulted in an enlarging trade deficits to around US\$ 11 billion in 2017 (i.e. half of the EAC overall trade deficit) (Figure 13). More importantly, the exports composition remains little changed with a high concentration on primary commodities. On a positive note, the exports pattern of intra-regional trade is completely different, with manufactured goods accounting for around half of intra-EAC exports, signifying the importance of intra-regional trade for the development of regional value chains and industrialization (UNECA, 2018d). In this regard, focusing on the intra-regional trade dynamics is crucial, especially given the escalating trade tensions

*Focusing on the intra-regional trade dynamics is crucial, especially given the escalating trade tensions between major economies which threatens to undermine global growth and the rules-based multilateral trading system.*

between major economies which threatens to undermine global growth and the rules-based multilateral trading system. Although the region may benefit marginally from trade diversion in the short term, countries that are more integrated in the global market and the commodity exporters would be affected by the negative effects of trade conflicts on global demand (IMF, 2018e and f).<sup>33</sup>

**Figure 13: Trade balance between the EAC and key trading partners**



Source: UNCTADStat (2018).

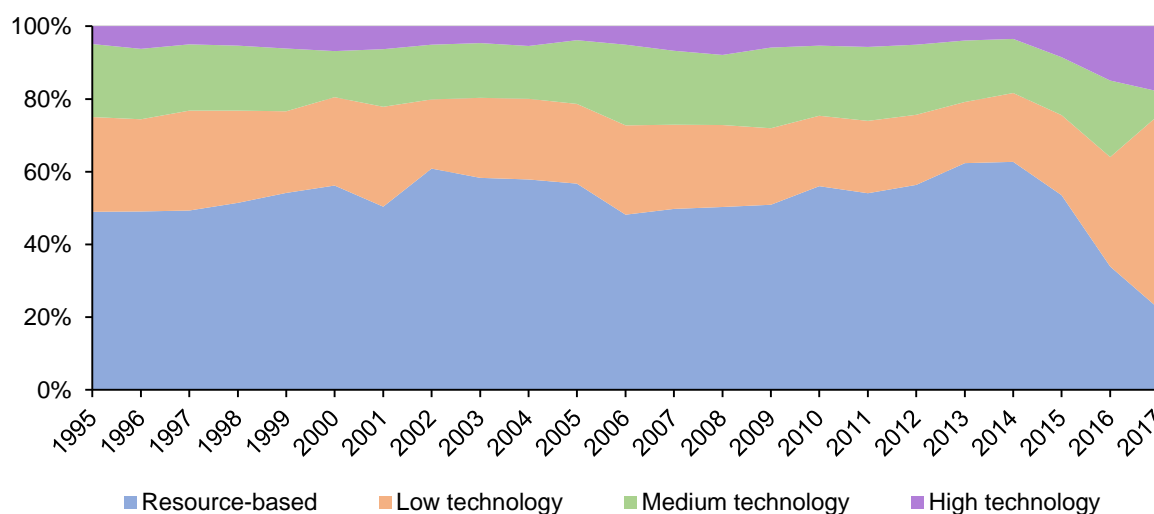
<sup>33</sup> Trade conflicts could have negative impact on China GDP growth. As hard primary commodities (ores and minerals) account for around 42 per cent of Eastern African exports to Asia and 75 per cent of these exports are destined for China, the moderating of China growth has significant implication on the region.

*Trade disputes and reciprocal barriers against each other's goods continue to recur and could undermine intra-African trade.*

Nonetheless, trade disputes and reciprocal barriers against each other's goods continue to recur and could undermine intra-African trade. For instance, manufacturers of confectionery in Kenya<sup>34</sup>, oil and fats in Uganda<sup>35</sup> and a wheat and juice producer from Tanzania have noted that tariff and non-tariff barriers have blocked them from accessing the regional markets (The EastAfrican, 2018b).

With regards to the composition of manufactured exports to Africa, resource based manufactures and low technology manufactures accounted for a major share of total manufactured exports over the years (Figure 14). A striking observation is that the share of resource based manufactures declined sharply from 63 per cent in 2014 to 24 per cent in 2017, while the share of low technology manufactures more than tripled (to around 57 per cent in 2017) during the same period. Having said that, local manufacturers face stiff competition from the global competitors, especially from China. A recent study by Jeanneney and Hua (2015) indicates that manufactured goods imports from both China and other countries have had an adverse effect on African industrialization<sup>36</sup>. Against this backdrop, countries in the region that shift to production of sophisticated and high technology manufactures stand to accrue better benefits from the intra-African trade. This is premised on the fact that high quality products with greater technological content are more difficult to produce or imitate and are therefore subject to less squeeze on the price and profit margins due to the high barriers of entry (Kaplinsky, 2006). It is worth noting that some multinationals involved in production of medium and high technology manufactures are setting up base in the region. A recent example is the launch of the Volkswagen car assembling plant in Rwanda at the Kigali Special Economic Zone (Minifra, 2018).

**Figure 14: Composition of Eastern Africa's manufactured exports to Africa**



Note: Based on Lall classification, resource based manufactures consist of agro-based and other products, low technology manufactures comprise textile, garments and footwear and other products, medium technology

<sup>34</sup> In 2017, Kenya faced a sugar crisis that prompted importation of sugar at a zero tariff. According to the EAC regulations, this rate should have been 100 per cent as sugar is a sensitive product that needs protection from dumping. Thus, customs officials in Tanzania have blocked Kenyan confectionery products unless a 25 per cent import duty is paid as they were allegedly manufactured using sugar that was imported at zero rate (The EastAfrican, 2018b).

<sup>35</sup> Uganda's cooking oils and fats cannot enter the Tanzanian market because of alleged failure to meet the EAC Rules of Origin (The EastAfrican, 2018b).

<sup>36</sup> For instance, Eveready East Africa was Kenya's main battery producer and the company had to shut down its dry cell plant due to increased competition from cheap imports (Nation, 2016). Sameer Africa also closed its Yana tyres manufacturing factory in Nairobi citing increased competition from cheaper imports, dealing yet another blow to Kenya's ambition to industrialise (Nation, 2017).

manufactures comprise of process, engineering and automotive products, and high technology manufactures comprise electronic and electrical and other products.

Source: UNCTADStat (2018).

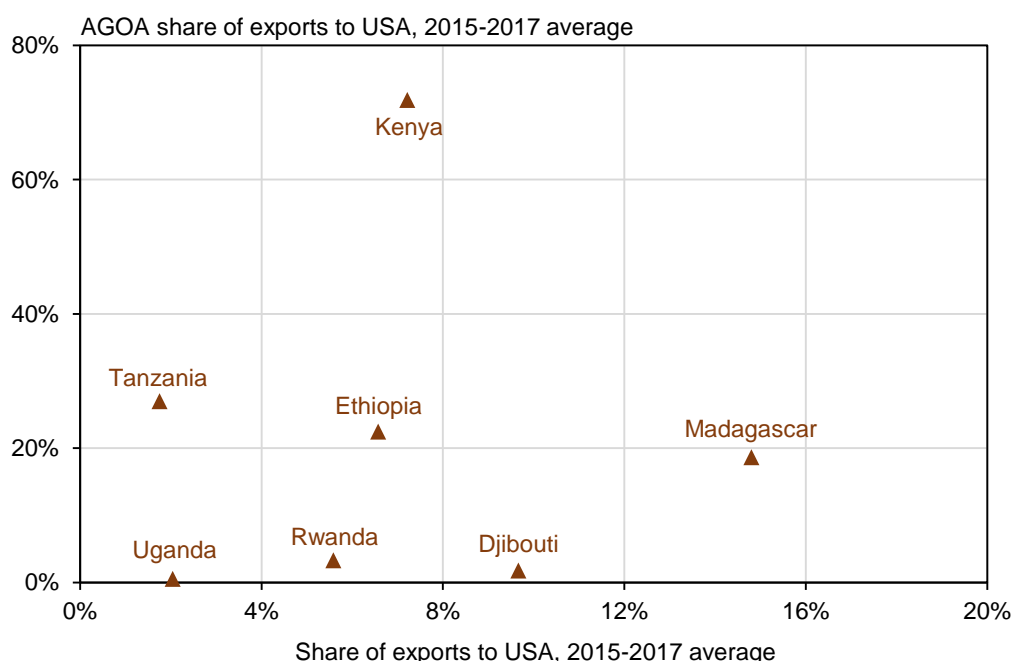
Another recent development in trading relations has been the temporary suspension of duty-free treatment for all AGOA-eligible goods in the apparel sector from Rwanda in July 2018 due to a disagreement over its policy to reduce the imports of second-hand clothing.<sup>37</sup> Indeed, the US administration envisages pursue a bilateral free trade agreement with African countries but not renews AGOA. While the benefits of AGOA for East African countries has been marginal with the exception

*It is highly advisable that Africa negotiates collectively with external trading partners as it helps rebalance an uneven negotiating power and contributes to guarantee policy coherence.*

of Kenya (Figure 15), such shift in the Africa-US trade and investment relationship could have significant consequences, particularly on Africa’s ongoing efforts to deepen its own continental integration process. Given that US free trade deals are usually demanding in terms of the content of the agreements (e.g. removal of public procurement restrictions to non-nationals, financial services liberalization and intellectual property protection), it has to be questioned

whether the potential loss of policy space for African countries is worth the relatively marginal gain in market access. Meanwhile, the prime consideration is how the proposal might affect the implementation of the AfCFTA. Specifically, how the bilateral agreements may impact on AfCFTA rules of origin, and how the provisions of any agreements with the US may impinge on African policies to promote intra-African trade in goods and services. From the experience of the Economic Partnership Agreements, it is highly advisable that Africa negotiates collectively with external trading partners as it helps rebalance an uneven negotiating power and contributes to guarantee policy coherence.

**Figure 15: AGOA share of exports to USA Vs share of exports to USA, 2015-2017 average**



Sources: UNCTADStat (2018) and United States Department of Commerce (2018).

<sup>37</sup> Yet the trade under AGOA is very limited in any case for Rwanda as illustrated in Figure 15.

### Box 7: The Impact of Brexit on the African Continent – Some New Opportunities May Open up for Eastern Africa

On the 23<sup>rd</sup> June 2016, the British electorate delivered a largely unanticipated vote to leave the EU. Speculation has continued ever since about its impact on the UK economy, in Europe and the rest of the world. Africa has not been immune to these concerns (e.g. Luke and Macleod, 2017; Sow and Sy, 2016). This is understandable given the fact that the United Kingdom, as well as the EU, continue to maintain important investment and trading links with Africa and are major donors. Some of the initial evaluations were quite alarmist. For instance, Tan (2016,18) declared that ‘African economies may be severely affected by Britain’s exit.’

Most of the subsequent academic literature discussing the implications of Brexit for Africa has focused on the terms of post-Brexit trading arrangements with both the UK and the European Union (see, inter alia, ODI, 2016; Mendez-Parra et. al., 2016; Holmes et. al., 2016). Mold (forthcoming, 2018) takes a different approach by providing a first quantitative assessment of the potential impact of Brexit on trading relations with the African Continent Using GTAP, a Computable General Equilibrium model based on 2014 data, Mold simulates the impact of a ‘hard Brexit’ (i.e. the return to Most-Favoured-Nation Tariffs on EU-UK trade), focusing particularly on the prospects for the EAC. For the EAC a hard Brexit would entail an increase in exports to the UK of US\$ 115 million, with a small decrease of US\$ 17 million towards the EU-27, leaving a total increase of exports to Europe of US\$ 98 million. The rest of Africa would see increases of exports of nearly US\$ 1.5 billion to both the UK and the EU-27 post-Brexit. Summary results of the simulation are shown in the table below.

**Table 4: Simulation of the impact of Brexit on Africa, 2014**

	Welfare	Terms of Trade	Terms of Trade	GDP	Value of Exports	Value of Imports
	(Millions USD)	(Millions USD)	(% Change)	(% Change)	(% Change)	(% Change)
EAC	156	36.4	0.19	0.36	0.08	0.37
Rest of Africa	1558	899	0.14	0.21	0.15	0.33
UK	-21995	-12767	-1.86	-2.43	-4.65	-7.75
EU-27	-6838	-2276	-0.03	-0.16	-0.51	-0.63
China	3144	2331	0.08	0.18	-0.01	0.26
US	4759	2906	0.17	0.25	-0.16	0.42
Middle East	1464	1581	0.11	0.16	0.13	0.26
Rest of East Asia	2135	1913	0.05	0.17	0.04	0.2
Oceania	810	562	0.17	0.29	0.08	0.43
Rest of SouthAsia	872	531	0.14	0.24	0.02	0.28
Rest of North America	657	379	0.05	0.19	0.02	0.23
Latin America	1549	1023	0.13	0.25	0.06	0.38
Rest of World	2760	2757	0.21	0.18	0.14	0.33

Source: Author’s simulation.

It should, however, be noted that Brexit promises to do nothing to improve the continental trade balance. Exports of both the UK and the EU-27 to the African continent would increase by US\$ 3.8 billion, more than double the expansion of African trade towards Europe. However, this expansion of trade opportunities are mainly in resource-intensive sectors that are not considered a priority for the development agendas of most African countries – for the EAC, grain and crops, meat and livestock would experience the largest increases in exports, while there would actually be small declines in textiles and apparel, light and heavy manufacturing.

In any case, Mold stresses that the indirect consequences, through Brexit’s impact on the global economy, or a potential reduction in UK development cooperation, are likely to be equally important

over the longer run. Finally, one overlooked consequence of Brexit for Africa is that it could undermine confidence in 'deep' regional integration processes like the EAC. To mitigate these risks, Mold recommends the implementation of the recently-signed AfCFTA, to give a new impetus to regional integration on the continent.

## 1.5. Leveraging External Financial Flows

In 2017, total external financial flows to Eastern Africa were estimated at US\$ 33.1 billion, up by 2 per cent from 2016. While official development assistance (ODA) remained the most important component of external finance for most countries in the region despite the stagnant levels, private external flows including remittances and FDI continued to drive growth in external finance (Table 5).

**Table 5: Selected external financial flows to Eastern Africa, 2013-2017**

(USD billion)	2013	2014	2015	2016	2017	Average (2013-2017)
Official Development Assistance	19.8	18.5	17.9	18.0	18.6	18.6
Remittances	4.2	5.2	5.5	5.5	5.4	5.2
Foreign Direct Investment	8.5	8.6	8.6	9.1	9.1	8.8
<i>Total</i>	<i>32.5</i>	<i>32.3</i>	<i>32.1</i>	<i>32.5</i>	<i>33.1</i>	<i>32.5</i>

Note: The 2017 ODA figure is based on the latest estimates.

Sources: OECD (2018a and b), World Bank (2018b) and UNCTAD (2018a).

Eastern African countries have traditionally been major ODA recipients, with Ethiopia, Tanzania, Kenya, D.R. Congo, Uganda and South Sudan ranking among the top 10 recipients in Africa, representing 28 per cent of total ODA to Africa in 2016. Burundi, Somalia and South Sudan are especially dependent on ODA, with ODA accounting for more than 80 per cent of the total external financial flows. A breakdown of sectoral allocations reveals that most of the ODA receipts are used for social and economic development, as well as humanitarian assistance (OECD, 2018c). Given its relatively volatility and the lack of commitments by members of the OECD Development Assistance Committee, countries have been actively exploring new financial sources to reduce aid dependency.

One of the growing sources of financing are remittances, which more than doubled from US\$ 2.3 billion in 2008 to US\$ 5.4 billion in 2017. In term of remittances per capita, Seychelles and Comoros stand out at US\$ 230 and US\$ 170 in 2017, respectively. Remittances provide a more stable financial flow and can have a countercyclical impact (there is evidence that migrants tend to send home more money when difficult situations arise in their country of origin), helping sustain domestic consumption and investment during headwinds. Also, remittances are usually well targeted to the needs of their recipients and can have a positive effect on poverty reduction (Kapur, 2004 and Ratha, 2007). Yet the high cost

*Remittances provide a stable fund flow with countercyclical nature, helping sustain domestic consumption and investment during headwinds.*

of transferring remittances to Africa (at 9 per cent in Q2 2018) is a major constraint. In this regard, mobile money provides the cheapest method for funding a remittance transaction at 4.4 per cent in Q2 2018 (World Bank, 2018c). More importantly, it presents an opportunity to boost financial inclusion and facilitate the flows and allocation of capital (Box 8).

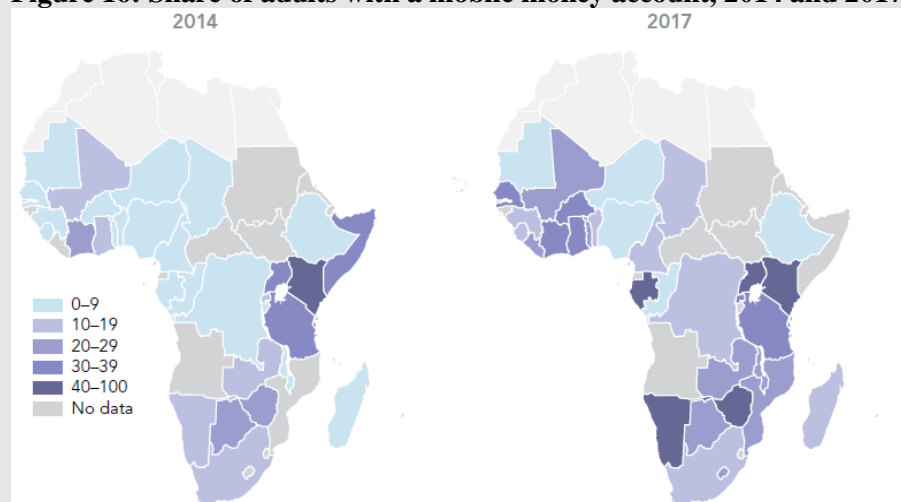
Countries in Eastern Africa have been undertaking various initiatives to leverage remittances for development. For instance, in 2008 the Government of Ethiopia issued Africa's first diaspora bond through the Ethiopian Electric Power Cooperation and a second diaspora 'Grand Renaissance Dam Bond' in 2011. To foster relationships with the diaspora, the Diaspora Engagement Affairs General Directorate was established in 2002. Similarly, the Government of Rwanda has maintained close contacts with its diaspora members. The Rwanda Day Initiative, which provides an important platform for the interaction between diaspora and government officials on the national development plans, is a good example, whereas the annual National Dialogue is another.

### Box 8: Enhancing Financial Inclusion via Mobile Money

Financial inclusion is often considered a key lever to achieve inclusive and sustainable development. It facilitates trade, businesses operation and expansion, as well as risk management. Yet around 31 per cent of adults (or 1.7 billion people) in the world did not own an account at a financial institution nor through a mobile money provider in 2017, with women, the poor and people with low educational attainment accounting for a disproportionate share of the unbanked. In Sub-Saharan Africa, around 57 per cent of adults remained unbanked. In Eastern Africa, the corresponding share ranged from 18 per cent in Kenya to 93 per cent in Burundi. Regarding the reasons behind, more than 80 per cent of the unbanked cited having too little money to use an account, largely due to high minimum balance requirements, whereas one-third said financial institutions are too far away and the services are too expensive respectively (Demirgüç-Kunt et al., 2018).

Against this backdrop, mobile money is a transforming technology that connects the unbanked to the use of financial services via a mobile device.<sup>38</sup> After the launch of the payment system ‘M-PESA’ in Kenya in 2007, mobile money account has been spreading rapidly from the epicenter of mobile innovation in Eastern Africa to the continent, making it the leading region with more than one-fifth of the adults having a mobile money account (Figure 16). Given the fact that two-thirds of unbanked adults have a mobile phone in 2017, mobile money presents an unprecedented opportunity to boost financial inclusion and shrink the gaps in account ownership between richer and poorer as well as men and women, especially in developing countries.<sup>39</sup> By offering financial services to excluded groups, mobile money could contribute to the Sustainable Development Goals (SDGs), through helping to reduce poverty and empower women with employment opportunities.<sup>40</sup>

**Figure 16: Share of adults with a mobile money account, 2014 and 2017**



Note: Data are displayed only for economies in Sub-Saharan Africa.

Source: Demirgüç-Kunt et al. (2018).

Among various financial services, e.g. payment, foreign exchange, savings, loans and insurance, mobile money has been mainly used for peer-to-peer (P2P) transfers and remittances in Africa.<sup>41</sup> Digitizing governments and businesses payments (e.g. wages, tax collection, social transfers and humanitarian assistance) could help increase account ownership and at the same time reduce corruption and transaction cost.<sup>42</sup> In addition, digitizing payments for agricultural sales could enable farmers to build credit history, allowing them to have better access to credit and insurance. AliFinance of the Alibaba Group in China, as an example, overturned traditional banking models by providing loans to millions of vendors on Alibaba’s online shopping platforms based on an internal credit rating system that analyses clients’ online activity.

The extension of the use of mobile money from payment to other financial services entails enormous potential to enhance financial inclusion. For example, Musoni in Kenya is a collaboration between

mobile money and microfinance institutions which enables better credit assessment as well as efficient delivery and repayment of loans (Vizcarra et al., 2017). M-Pawa, a mobile credit and savings product in Tanzania, is another example, with more than one million customers after launching for just five months. In fact, mobile money also facilitates P2P lending without the use of a formal financial institution as an intermediary, which could help address the issue of difficult access and high cost of credit in Africa if proper regulations are in place.

Apart from credit, insurance, in particular agricultural insurance, is inadequate in Africa. Despite the vulnerability to weather-related shocks, most farmers do not have protection against loss of yield. In this regard, companies such as MicroEnsure, ACRE Africa and WorldCover have been leveraging the advancements in mobile money to provide insurance products to customers. Mobile money is not only a more convenient and effective platform for the provision of services (e.g. pay for premiums and settle claims), but it also facilitates data analysis for the design and pricing of new products.

Furthermore, mobile money offers new financial instruments to address people's saving needs and enable the channeling of domestic savings into productive investment. In Africa, the large informal sector holds sizeable financial resources that do not pass through formal financial channels and are simply saved in cash at home or in form of livestock, jewelry, or real estate. Mobile money which allows easy access and small transactions could thus help households manage and even increase their savings.<sup>43</sup> The innovative products built on mobile money demonstrate the tremendous potential benefits. For instance, as the world's top money market fund with around a quarter trillion dollars in assets under management in 2017, Alibaba's Yu'eBao enables small investors to enjoy higher return via pooling individual savers together to bargain with banks.<sup>44</sup>

In sum, although the region has been among one of the pioneers of mobile money, the full potential is far from being reached in Eastern Africa. While the coverage of mobile money is expanding rapidly, the vast amount of transaction data could fuel financial innovation, thereby offering better services to the users and facilitating the flows and allocation of capital.<sup>45</sup> Moreover, with the expected increase in smartphone adoption from one-third in 2017 to two-thirds in 2025 (GSMA, 2018), mobile money in Africa will no longer be bound to mobile network operators and more diversified digital financial services could be supported by third-party payment service providers via smartphone apps.

<sup>38</sup> In 2017, there were 690 million registered accounts worldwide, processing a billion dollars a day (GSMA, 2017).

<sup>39</sup> It is estimated that half the population of Sub-Saharan Africa will be subscribed to a mobile service by 2023 (GSMA, 2018).

<sup>40</sup> A study estimated that access to M-PESA increased per capita consumption levels and lifted 194,000 households out of poverty, with more pronounced impacts for female-headed households (Suri and Jack, 2016).

<sup>41</sup> Apart from the direct benefit of the reduction in transaction cost, the improved risk sharing helps smoothen consumption in case of an unexpected drop in income (Jack and Suri, 2014).

<sup>42</sup> Compared to manual cash payment, the leakage of pension payments decreased by 47 per cent (or 2.8 percentage points) when the payments were made through biometric smart cards in India (Muralidharan et al., 2016). In addition, based on a randomized experiment of a cash transfer program in Niger, it was found that the per-transfer costs of the mobile transfer program were approximately 20 per cent lower than per-transfer cost of the manual cash distribution, despite the higher initial costs due to the purchase of mobile phones (Aker et al., 2016).

<sup>43</sup> It was found that the availability and usage of mobile phones to provide financial services promotes the likelihood and amount of saving at the household level in Africa (Ouma et al., 2017 and GSMA, 2015).

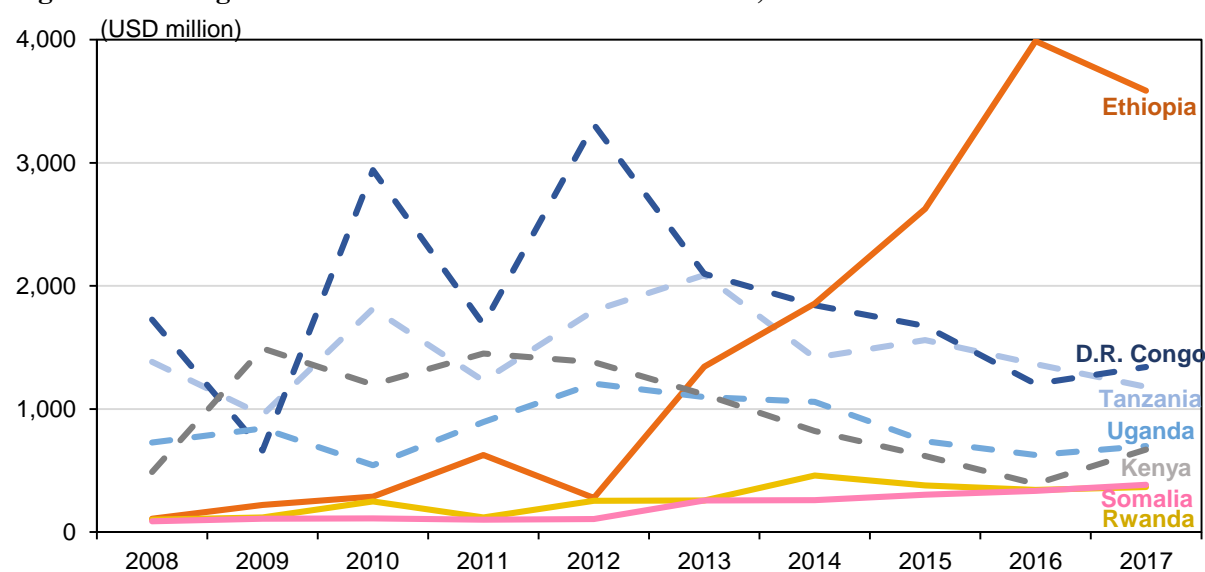
<sup>44</sup> For example, a small investor with US\$ 1 may get an annual deposit rate at 1 per cent. If 100,000 of them pool the money together, they may get an annual deposit rate at above 3 per cent.

<sup>45</sup> The regulatory environment is key to the development of mobile money, especially on the supervision of shadow banking, data security, personal privacy and anti-money-laundering issues.



Another important source of external finance for Eastern Africa is FDI, which increased by more than 40 per cent from 2008 to 2017, from US\$ 6.5 billion to US\$ 9.1 billion. Despite the remarkable decline in both global FDI flow<sup>46</sup> and FDI flow to Africa, FDI flow to Eastern Africa remained stable in 2017. Over the past decade, FDI flow to the region experienced a notable degree of volatility, with the four major FDI recipients (i.e. D.R. Congo, Tanzania, Kenya<sup>47</sup> and Uganda) recording visible declines in FDI inflow, in contrast to the marked increase to Ethiopia, Somalia and Rwanda (Figure 17). This trend is a reflection of the shift from investments in the extractive industry in resource-rich countries to more diversified investments in countries with an improved political and business environment. For instance, between January 2016 to July 2018, most announced greenfield projects in Ethiopia were related to the textiles sector, whereas there were several large investment projects in Rwanda in the chemicals, real estate, and hotels and tourism industries (fDi Markets, 2018).

**Figure 17: Foreign direct investment flow to Eastern Africa, 2008-2017**



Source: UNCATD (2018b).

As for the source of FDI inflows, there has been a shift from advanced economies (e.g. EU and the US) to developing economies (e.g. China and India). In particular, Chinese investment in Africa has increased rapidly, being the single largest contributor of FDI capital and jobs in 2016 (EY, 2017). The surge of China's FDI flow to Eastern Africa has also been remarkable, from less than US\$ 100 million in 2007 to around US\$ 1.2 billion in 2015, accounting for around one-seventh of the total FDI inflow to the region in 2015 (MOFCOM, 2016). From the latest Forum on China-Africa Cooperation (FOCAC) in September 2018, the cooperation plans, which include China pledge of US\$ 60 billion in financing projects in Africa in the form of assistance, investment and loans, pave the way for closer partnership between China and Africa, especially under the Belt and Road Initiative (FOCAC, 2018).

*FDI flows to Africa is expected to be stronger given the advances in interregional cooperation, particularly with the signing of the AfCFTA.*

Looking forward, FDI flows to Africa are expected to be stronger given the advances in interregional cooperation, particularly with the signing of the AfCFTA. While Africa's commodity dependence will cause FDI to remain cyclical, deeper integration of product and consumption markets as well as reductions in the price of goods and services will stimulate both market-seeking FDI and efficiency-seeking FDI for value chains (UNCTAD, 2018a).

<sup>46</sup> Global FDI fell by 41 per cent in the first half of 2018, mainly due to large repatriations by the US parent companies of foreign earnings from their affiliates abroad following tax reforms (UNCTAD, 2018b).

<sup>47</sup> FDI flows to Kenya rebounded to US\$ 672 million in 2017, thanks to buoyant domestic demand, additional tax incentives to foreign investors and strong inflows into information and communication technology industry.

## 1.6. Social Development

The previous sections provide evidence of the general improvement in economic conditions in Eastern Africa despite some structural and emerging challenges. This section looks at the social developments, starting with the update of the Human Development Index (HDI).

*Most countries have made notable progress on the three basic dimensions of human development (i.e. health, education and standard of living) in recent years, but remain in the low human development category.*

albeit from a low base. Despite the notable progress, most countries remain in the low human development category (Table 6).

The latest statistics show that most countries in the region have made notable progress on the three basic dimensions of human development (i.e. health, education and standard of living) in recent years. In particular, D.R. Congo, Ethiopia and Tanzania recorded the largest increase in HDI value since 2013, mainly thanks to the robust economic growth and improvement in education,

**Table 6: 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\$)	
		2013	2017	2013	2017	2013	2017	2013	2017	2013	2017
62	Seychelles	0.779	0.797	73.0	73.7	9.1	9.5	14.4	14.8	23,851	26,077
142	Kenya	0.566	0.590	65.7	67.3	6.3	6.5	11.3	12.1	2,654	2,961
154	Tanzania	0.507	0.538	63.3	66.3	5.5	5.8	8.2	8.9	2,295	2,655
158	Rwanda	0.503	0.524	65.6	67.5	3.8	4.1	11.3	11.2	1,525	1,811
161	Madagascar	0.509	0.519	64.7	66.3	6.1	6.1	10.4	10.6	1,320	1,358
162	Uganda	0.496	0.516	58.8	60.2	5.4	6.1	11.1	11.6	1,576	1,658
165	Comoros	0.499	0.503	62.9	63.9	4.7	4.8	11.2	11.2	1,437	1,399
172	Djibouti	0.463	0.476	61.7	62.6	4.0	4.1	6.2	6.2	2,862	3,392
173	Ethiopia	0.438	0.463	64.0	65.9	2.5	2.7	8.5	8.5	1,323	1,719
176	D.R. Congo	0.426	0.457	58.3	60.0	6.0	6.8	9.2	9.8	669	796
179	Eritrea	0.425	0.440	63.7	65.5	3.9	4.0	5.2	5.4	1,588	1,750
185	Burundi	0.414	0.417	56.3	57.9	2.8	3.0	11.4	11.7	792	702
187	South Sudan	0.392	0.388	55.3	57.3	4.8	4.8	4.9	4.9	1,177	963

Source: UNDP (2018).

To supplement the analysis from the perspectives of inequality and disparities by gender, the Inequality-adjusted HDI (IHDI) and the Gender Development Index (GDI) provide a more comprehensive picture of a country's human development. When inequality is accounted for, the IHDI is significantly lower (on average 30 per cent) than the HDI value in the region, largely due to the high inequality in health and education. The losses in ranking due to inequality in income and education is particularly elevated in the cases of Comoros, Djibouti and South Sudan. Regarding the gender gap, the GDI measures the ratio of female HDI to male HDI. Compared to other regions with low levels of human development, Eastern Africa has a much better gender parity in HDI. Specifically, Burundi stands out with gender equality given the higher income and longer life expectancy of women, yet women are seriously lagging behind their male counterparts in South Sudan, Ethiopia and D.R. Congo, especially in terms of income and education. Furthermore, to highlight women's empowerment, the Gender Inequality Index (GII) presents a composite measure of gender inequality using three dimensions, namely, reproductive health, empowerment and labour market participation. Given the high share of seats in parliament held by

women and female labour force participation rate, Rwanda records remarkable performance in GII. In fact, countries in the region have a much higher ranking in GII compared to HDI (Table 7).<sup>48</sup>

**Table 7: Inequality and gender aspects of human development**

HDI Rank	Country	HDI Value	Inequality-adjusted HDI		Gender Development Index	Gender Inequality Index, 2017	
			2017	Loss (%)		Value	Rank
62	Seychelles	0.797					
142	Kenya	0.590	0.434	26.4	0.931	0.549	137
154	Tanzania	0.538	0.404	24.8	0.928	0.537	130
158	Rwanda	0.524	0.367	30.0	0.941	0.381	85
161	Madagascar	0.519	0.385	25.9	0.962		
162	Uganda	0.516	0.370	28.3	0.865	0.523	126
165	Comoros	0.503	0.275	45.3	0.876		
172	Djibouti	0.476	0.306	35.8			
173	Ethiopia	0.463	0.331	28.4	0.846	0.502	121
176	D.R. Congo	0.457	0.319	30.4	0.852	0.652	152
179	Eritrea	0.440					
185	Burundi	0.417	0.278	33.3	1.002	0.471	114
187	South Sudan	0.388	0.247	36.3	0.826		

Source: UNDP (2018).

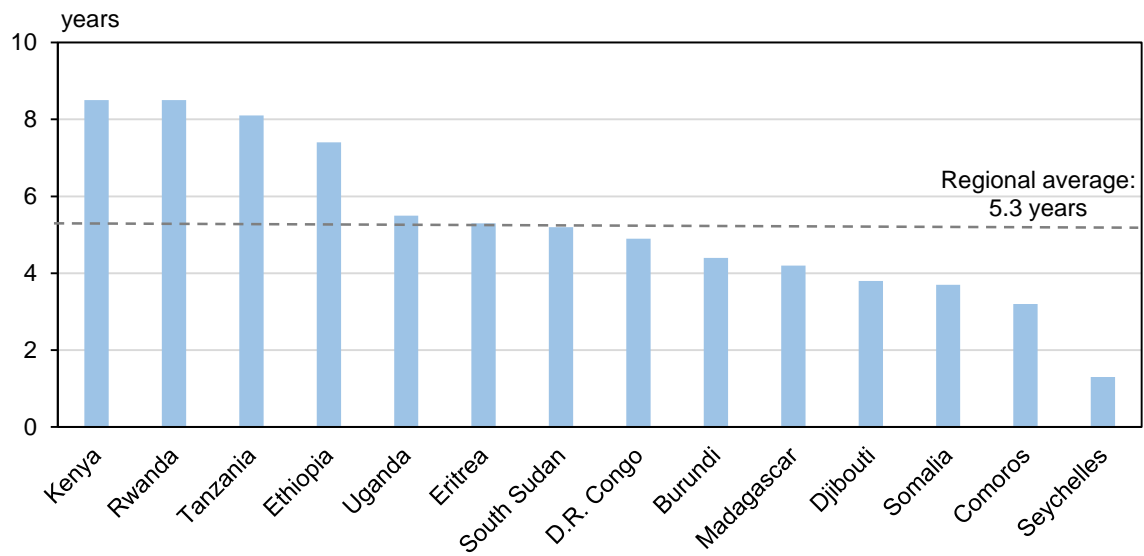
### 1.6.1. Improvements in Life Expectancy

Life expectancy, often considered to be the broadest measure of living standards, has been increasing in Eastern Africa at a pace which, by historic standards, is almost unprecedented (Figure 18). This is underpinned by increased immunization and improved access to healthcare. The WHO (2018) notes that healthy life expectancy<sup>49</sup> in Africa rose from 50.9 years in 2012 to 53.8 years in 2015, representing the largest improvement of all regions. People in countries with high GDP per capita live longer lives on averages but there are also large differences in life expectancy between countries with the same level of income, as a result of how the income is distributed and used. Strong public healthcare systems are clearly a major determinant (Deaton, 2004 and Rosling, 2015).

<sup>48</sup> In terms of political influence, for instance, there are currently only three countries in Africa with more than 50 per cent of Cabinet members who are women – and they are all in Eastern Africa, namely, Ethiopia, Rwanda and Seychelles.

<sup>49</sup> Adjusted for years spent without disability.

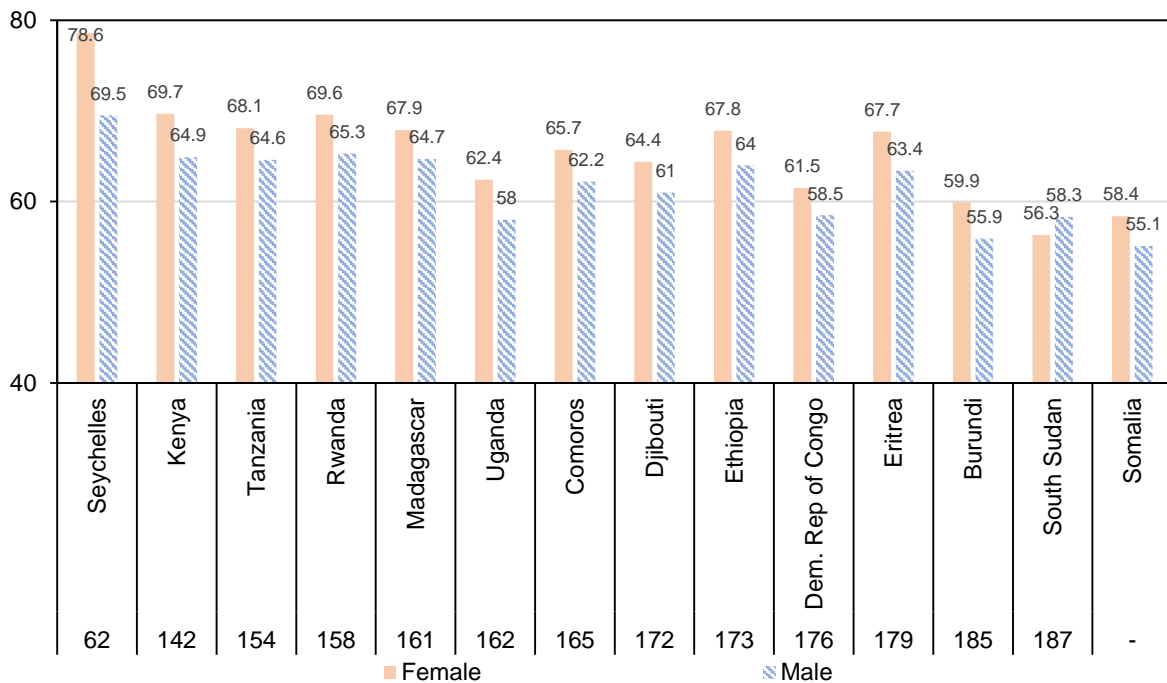
**Figure 18: Improvements in life expectancy, 2007-2017**



Source: UNDP (2018).

Figure 19 shows the life expectancy of individual countries, disaggregated into female and male and ranked by their HDI score. There is some considerable intra-regional variation and some countries are underperforming, for different reasons, in terms of life expectancy relative to the other components of the HDI. One particularly striking case is South Sudan, which is currently the only country in the world where female life expectancy is actually lower than male's.<sup>50</sup>

**Figure 19: Life expectancy at birth (plotted according to HDR rank), 2017**



Source: UNDP (2018).

<sup>50</sup> Biological differences explain partially why females have a longer life expectancy than men, but it is also the product of behavioural and environmental factors (Ortiz-Ospina and Beltekian, 2008).

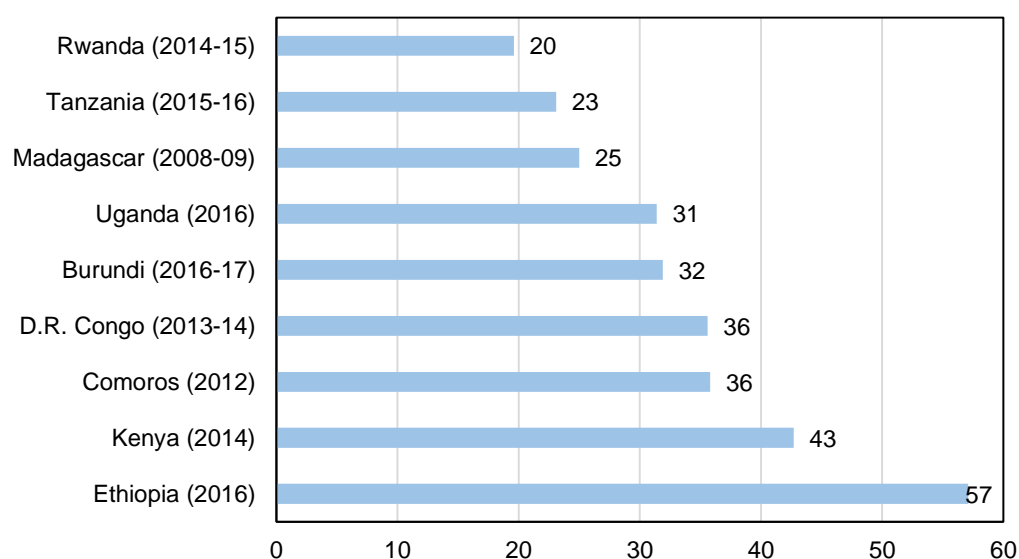
### 1.6.2. Building a Literate Workforce

The definition of literacy has evolved over time to reflect current requisite skills – from the ability to read and write to wider definition of “*the ability to identify, understand, interpret, create, communicate and compute, using printed and written materials associated with various contexts. Literacy involves a continuum of learning in enabling individuals to achieve his or her goals, develop his or her knowledge and potential, and participate fully in community and wider society*” (UNESCO, 2015).

In agriculture – the mainstay of many communities in Eastern Africa – the difference between the literates and illiterates has become more pronounced as technology has evolved. Who gets higher profits and improves productivity most is closely tied to literacy. Farmers’ uptake of mobile technologies is highly dependent on their ability to read and understand at the minimum level. Fu and Akhter (2016) found that service delivery speed and quality in agricultural extension services improved when technology was used.

Economic migrants are on the rise (Porter and Russell, 2018), bringing with them skills that may be needed at their destinations. It is important that citizens are able to compete for available economic opportunities. DHS studies point to deficiencies that need to be addressed to ensure that women compete on an equal footing with men (Figure 20). Universal primary education during the MDGs period focused more on quantity rather than quality. It would seem there is a gap between policy and desired outcomes. Ethiopia and Kenya - the two largest economies in the region - are faced with high illiteracy rates among women while Rwanda has the lowest rate.

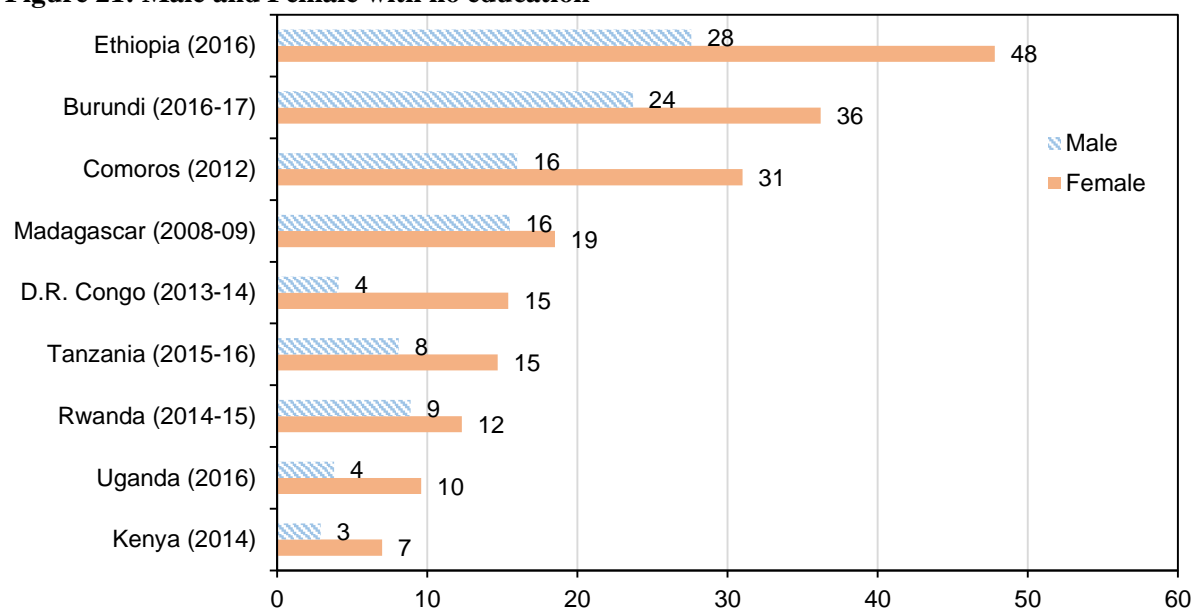
**Figure 20: Percentage of women who cannot read at all**



Source: Demographic Household Surveys.

These disappointing outcomes the persistence in gender gaps in education (Figure 21). Attainment of the SDGs relies on education and targeted investments to alleviate the problem. The challenge is not new and community involvement is required. The Uwezo initiative is such an example which aims to improve literacy and numeracy levels among 5-16 years old children in Kenya, Tanzania and Uganda. It goes beyond access and focuses on content and shares findings broadly. Because the assessment is a yearly exercise, it allows stakeholders to track progress over time.<sup>51</sup>

<sup>51</sup> Uwezo aims for change that is community driven. Assessments are done in learners’ homes. In the 3 countries, Uwezo partner with Ministries of Planning and Education. For more information, visit <http://www.uwezo.net>.

**Figure 21: Male and Female with no education**


Source: Demographic Household Surveys.

### 1.6.3. The Costs of Gender-Based Violence

Gender-based violence (GBV) continues to blight a lot of communities across the region. Some Eastern African countries have passed laws to tackle GBV. Uganda has several pieces of legislation to address GBV, domestic violence and FGM. Rwanda goes a step further with a law that not just punishes but tries to prevent GBV in all its forms. Similarly, there is recognition of the need to tackle GBV to achieve development aspirations.<sup>52</sup>

Because more women than men are affected, the following analysis focuses on violence against women and girls (VAWG), even while acknowledging that men and boys do suffer GBV. VAWG is a form of women's human rights violation that is perpetuated by cultural acceptance and tolerance and is fueled by cultural norms and practices that relegate women to lower classes. It comes at a high social and economic cost, ranging from money spent in response to VAWG incidences to the pain and suffering due to family members providing support to victims. In 2016, UN Women estimated the global cost of violence against women was estimated by the UN to be US\$ 1.5 trillion, equivalent to approximately 2 per cent of the global GDP. In Uganda about 9 per cent of VAW incidents in the country resulted in their loss of half-a-month's salary (UNWomen, 2016).

As a public health issue, VAWG has increasingly gained prominence due to its detrimental to women's health and well-being. It leads to increased cost of health care and erodes from attainment of other gender equality targets. At the micro-level, it affects women and their children, their education and overall psychosocial well-being and can result in income loss, absenteeism and premature death. At the macro-level, VAWG affects human capital development and productivity, resulting in the negative impact on economic growth. For girls, missing school implies slow or no human capital development, which affects them in their current and future states. All women are susceptible, whether single, married, divorced or widowed. The prevalence of occasional physical assault ("sometimes") varies between 3.5 per cent in Comoros to 21.0 per cent in Tanzania (Table 8). The figures are even more alarming when accounting for frequent and occasional assaults altogether. Evidence shows that about a third of married

<sup>52</sup> For example, the Uganda National Action Plan on Elimination of Gender Based Violence in Uganda (2016-2020) describes GBV as an urgent development priority that should be addressed in order to achieve Uganda's development goals for 2020.

women are either frequently or occasionally assaulted by her partner in D.R. Congo compared to about a fifth in Kenya and Burundi. Women who have never married or are divorced or separated or widowed also face situations of physical violence, the percentage of these women going through some form of physical violence being highest in D.R. Congo, Uganda and Tanzania. Half of the assaulted women are youth and young women aged between 15-49. In South Sudan, up to 33 per cent of women reported experiencing non-partner sexual violence (including rape, attempted rape or any other unwanted sexual acts) during their lifetime.

**Table 8: Percentage of women who have experienced physical violence, by marital status**

	Never married		Married or living together		Divorced/separated/widowed		Women aged 15-49
	Often	Sometimes	Often	Sometimes	Often	Sometimes	
Burundi (2016-17)	0.5	4.2	4.1	15.4	3.9	8.7	-
Comoros (2012)	2.7	2.3	2.4	3.5	4.3	4.3	14.0
D.R. Congo (2013-14)	3.6	10.0	12.9	18.4	18.1	16.9	51.8
Eritrea (2002)	-	-	-	-	-	-	-
Ethiopia (2016)	0.3	3.2	4.1	14.0	5.3	14.8	23.3
Kenya (2014)	0.6	11.0	5.9	17.6	10.9	13.5	44.8
Madagascar (2008-09)	-	-	-	-	-	-	-
Rwanda (2014-15)	0.9	4.5	3.5	14.9	7.9	10.1	34.5
Tanzania (2015-16)	0.8	5.2	5.9	21.0	13.8	15.2	39.5
Uganda (2016)	2.4	14.1	4.7	19.3	6.6	15.7	51.1

Source: Demographic Household Surveys.

Studies have looked at costs at both the macro and micro-levels. NGEC (2016) estimated the economic burden of gender based violence in Kenya is approximately Kenya Shillings 46 billion per year. Prevention is clearly better than cure. Care International (2018) notes that implementing the Uganda Domestic Violence Act of 2010 for both prevention and response cost just US\$ 8 million over three years, while the cost of addressing the violence after it occurred exceeded an estimated US \$30.7 million in a single year.

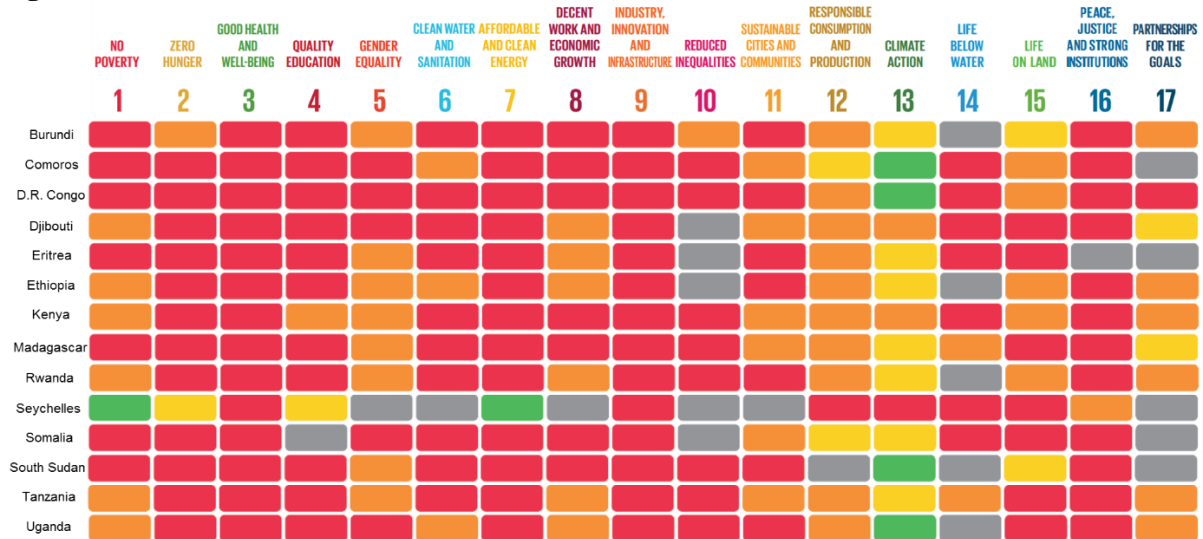
VAWG is not strictly confined to homes. Studies have however documented occurrence of VAWG outside the home. Flone Initiative's (2018) study on VAWG in public road transport found that victims were blamed for their clothing in 25 per cent of cases. In relation to trade, women traders have frequently expressed VAWG experiences, especially at border posts. When implemented, the AfCFTA should present African women with the opportunity to trade without fear of intimidation and harassment.

#### 1.6.4. Progress on The Sustainable Development Goals

For the long-term targets, Agenda 2030 and the Sustainable Development Goals (SDGs), adopted by all member States of the United Nations in 2015, describe a universal agenda of sustainable development combining economic development, social inclusion and environmental sustainability. The SDG dashboard presents a clear visualization on the achievements and challenges of countries, thereby highlighting the areas that require focused actions (Figure 22). East African countries perform relatively well on responsible consumption and production (SDG 12) and climate action (SDG 13). Yet the region faces major challenges in ending poverty and undernourishment (SDGs 1 and 2), improving access and

quality of health and education services as well as infrastructure (SDGs 3, 4 and 9), and strengthening institutions (SDG 16). Given that population trends and dynamics have significant effects on the prospects for poverty reduction and sustainable development, Box 9 provides an assessment on the demographic dividend in the region.

**Figure 22: SDG Dashboard for Eastern Africa**



Note: Green denotes SGD achievement, red highlights major challenges, while yellow and orange indicate that significant challenges remain. Grey refers to the lack of data for assessment.

Source: Bertelsmann Stiftung and Sustainable Development Solutions Network (2018).

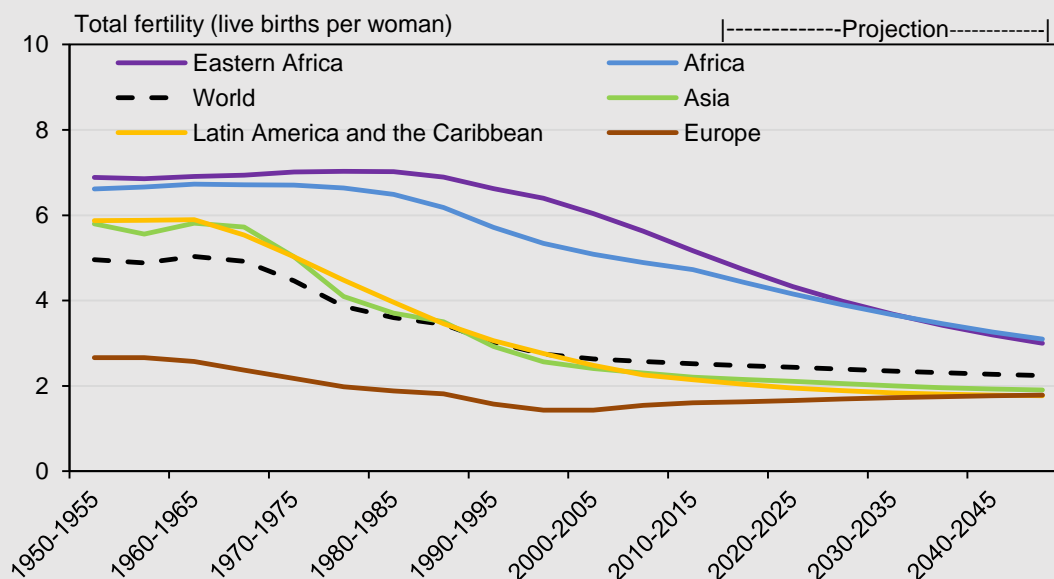


### Box 9: Wishful thinking? – The Demographic Dividend in Eastern Africa

Africa's population grew at an annual average of 2.5 per cent between 1995 and 2015, more than twice the world average. Meanwhile, following years of high fertility and significant decline in child mortality, Africa has a young population with median age below 20 years in 2015 (similar for most Eastern African countries, except Djibouti and Seychelles), compared to the world average of around 30 years. It is estimated that Africa will continue to be the main driver of population growth in the decades ahead. From 2015 to 2050, Africa's population will account for 1.3 billion of the projected 2.4 billion increase in global population. Its working age population (i.e. those aged between 15 and 64) will more than double from 0.7 billion to 1.6 billion over the same period, representing around 70 per cent of the global increase (UNDESA, 2017). In contrast to the ageing population in most advanced economies, the rapid increase in workforce presents an opportunity for accelerated economic growth for Africa.

The economic growth potential due to the shift in a population age structure, specifically growing share of the working age population, is often referred to 'demographic dividend'. Research suggests that the demographic dividend could account for 11 to 15 per cent of African GDP growth by 2030 and reduce poverty by 40 to 60 million people (Ahmed et al., 2014).<sup>53</sup> While the declines in mortality and fertility jointly drive demographic transition, Africa is at an early stage of the transition given the high fertility rate, partly due to early onset of childbearing and marriage, low socio-economic status of women, poor access to contraception and lack of family planning (UNECA, 2012 and AFIDEP, 2018). With the total fertility of around five live births per woman, the current situation in Africa and Eastern Africa is largely similar to that of Asia and Latin America in 1970s. It will take about fifty years for Africa to half the fertility rate to reach the world average nowadays, suggesting a slow and gradual demographic transition (Figure 23).

**Figure 23: Total fertility by region, 1950-2050**



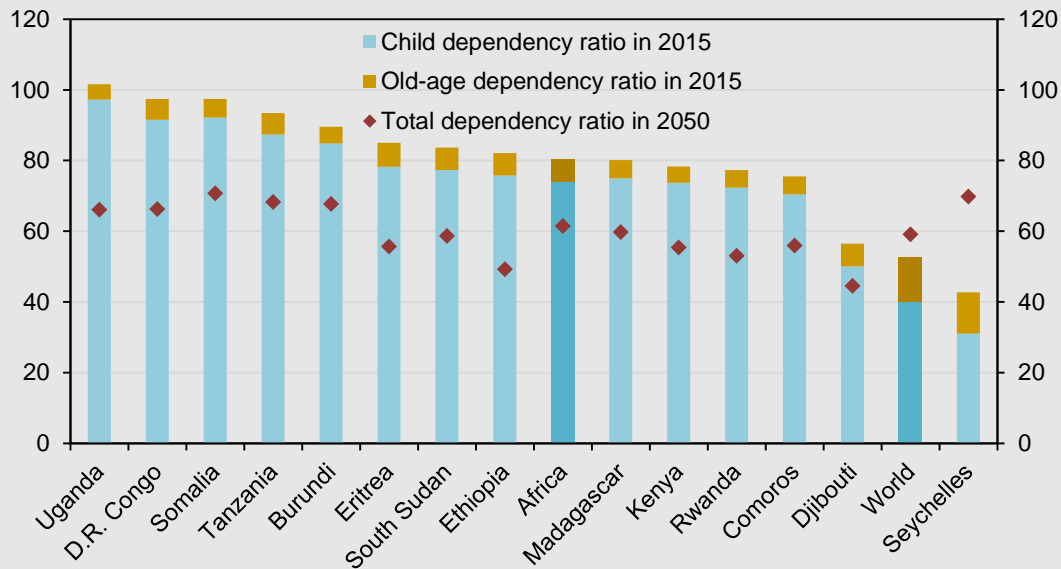
Note: Data for Eastern Africa is the weighted average (based on the number of women aged between 15 and 49) of the 14 countries.

Source: UNDESA, 2017.

The concept of demographic dividend highlights the window of opportunity when the workforce outnumbers the population dependent on it, thereby freeing up resources for economic development. In the region, the average child dependency ratio was around 80 (i.e. four child per five working age population) in 2015, with the highest in Uganda and lowest in Seychelles, whereas the average old-age dependency ratio was around 6, indicating a small demographic dividend given the large young dependent population.<sup>54</sup> While the total dependency ratio of most countries in the region is expected

to decline gradually to around 60 by 2050, Seychelles has already completed demographic transition and is going to face the challenges of ageing population (Figure 24). Indeed, there is significant heterogeneity across African countries in terms of when they start the transition and where they reach the lowest dependency ratio. On average, Africa has just embarked on the transition and it will take sixty years to reach the lowest level of dependency ratio at around 55 in 2075. Compared to Asia and Latin America which completed demographic transition in around forty years, Africa will have a much longer and steadier window of opportunity to harness the dividend (UNDESA, 2017)

**Figure 24: Dependency ratio, 2015 and 2050**



Source: UNDESA, 2017.

Yet the so-called dividend is not guaranteed and can only be realized with the right economic and social conditions. In fact, without appropriate policies in place, the dividend could become a barrier (e.g. high unemployment) to growth, especially with the advancement of robotics technology which makes the traditional manufacturing job creation story less promising. In order to nurture the young population into agents of sustainable development, investments in education and health are crucial (Drummond et al., 2014). Research also suggests that good quality of governmental institutions, flexible labor market and sufficient employment opportunity are the key factors to capitalize the demographic dividend (Mason, 2001 and Bloom et al., 2003 and 2007). With a large young dependent population, Africa stands at a crossroads of demographic dividend and burden where only substantial investments in education and health combined with effective implementation of supporting policies could lead to the road of prosperity. The much longer and gradual demographic transition in Africa demands a stronger and sustained commitment to seize the opportunity.

<sup>53</sup> Research indicates that the demographic dividend accounts for between one-fourth and two-fifths of East Asia’s ‘economic miracle’ (Bloom et al., 2003).

<sup>54</sup> The child dependency ratio refers to the ratio of population aged between 0 to 14 per 100 population aged between 15 and 64, whereas the old-age dependency ratio is defined as the ratio of population aged 65 and above per 100 population aged between 15 and 64.

## 2. Special Thematic Study: The Implementation of the African Continental Free Trade Area in Eastern Africa

### Introduction – The Historical Context

The signing of the AfCFTA on 21<sup>st</sup> March 2018 in Kigali by 44 countries represented a milestone towards achieving the long-standing goal of creating a unified African market. The elimination of tariffs and non-tariff barriers called for by the AfCFTA offers African countries a long-term opportunity to improve developmental prospects and provide goods and services for the rapid growing consumer markets in Africa. With a combined GDP of \$6.4 trillion (measured in Purchasing Power Parities) and a population of 1.2 billion, the creation of a continental market presents an enormous opportunity to boost intra-African trade, thereby fostering a competitive manufacturing sector and promoting economic diversification.

Yet we are only half-way there as 22 ratifications are required by March 2019 for the agreement to go into force. Also, it is not enough to have political agreement – we still need to win the hearts and minds of the private sector and civil society, who will be the true implementers of the AfCFTA. As an interesting parallel, in the late 1980s, the European Commission was confronted with an uphill struggle to convince citizens and member states to support fully the implementation of their *Single Market Programme*. There were plenty of naysayers at the time – many Europeans, particularly in the ‘periphery’ (e.g. Greece, Spain, Portugal and Ireland) – were worried about the consequences of opening their markets to the high productivity firms of northern Europe. In an effort to allay those fears, European researchers published a series of in-depth research papers into the costs of ‘Non-Europe’, trying to make clear what was at stake. The resulting ‘Checcini Report’, published in 1988, made a strong case for the Single Market, paving the way to its eventual implementation in January 1993. Overnight, the border posts between member states disappeared and goods, services, investment and workers flowed freely across those frontiers. Subsequent research suggested that it raised intra-European trade by more than 100 per cent, and member states’ GDP by an average of 4.4 per cent (Mayer et al, 2018).

The AfCFTA has been a long-standing aspiration of African countries. Those aspirations were expressed by Dr. Kwame Nkrumah, the first President of Ghana, in 1963 during a meeting of 32 African Heads of State and Government. He asserted that: “*Only on a continental basis shall we be able to plan the proper utilization of all our resources for the full development of our continent... How else will we retain our own capital for own development? How else will we establish an internal market for our own industries? By belonging to different economic zones, how will we break down the currency and trading barriers between African states, and how will the economically stronger amongst us be able to assist the weaker and less developed states?*” (African Globe, 2013).

These themes were also reiterated at the inauguration of the first session of the then recently-founded UNECA, held in December 1958 in Addis Ababa by His Imperial Majesty Haile Selassie I who emphasized that “*...African people must work and cooperate together if the economic development of the continent is to be furthered... concerted action, cooperation, and coordinated policies to improve the economic lot of all African peoples to a standard comparable to that enjoyed in the most highly developed regions of the world...* ” (Ministry of Information, 1960). This was further echoed by Julius Nyerere who recognized that “*...we should all encourage Africa to get that realisation more and more that we have to depend upon ourselves, both at national level and at the collective level...we all enhance our capacity to develop if we work together...*” (SARDC, 2014).

Africa’s commitment to regional integration continued to take centre stage in subsequent years, and this was manifested in a series of agreements. Notable examples include the historic UNECA declaration on the Lagos Plan of Action where Africa countries declared commitment to the promotion of regional economic cooperation for the economic integration of the continent (Adedeji, 2004). The Lagos framework was given further momentum by the Abuja declaration which established the African

Economic Community. But the timing was bad – from 1980, the continent entered into a period of the ‘two lost developmental decades’ whereby economic integration was ineffective with massive debt building up and anaemic growth.

Times have changed. The frustrations over the non-implementation of previous agreements to deepen regional integration and cooperation do not need to repeat themselves. This time, Africa is working with favourable headwinds. And it is also at a juncture when the global economy is looking decisively less secure. Globalisation seems to have reached a pause and could even go in reverse.

Against such a backdrop, and at a time of great global uncertainty and waning faith in the global trading system and multilateralism, it is logical, as Fosu and Ogunleye (2018) acknowledge, that African countries will adopt growth strategies that are more regionally inward-looking and self-reliant in their conceptualization. The signing of the AfCFTA in March 2018 by no less than 44 member States of the AU reflects how strongly embedded this realization is.

The point of departure for the case in favour of creating an African continental-wide market should be the recognition that Africa’s trading relations with the rest of the world over the last several decades have not delivered the promised benefits. Since the early 1970s, African countries have been beneficiaries of ‘preferential trading agreements’, whereby they were granted reduced tariffs to high-income countries’ markets. The various preferential schemes have had disappointing results and have not led to a notably stronger export performance nor more diversified economies. The design of those preferential agreements is partly to blame, with strict rules of origin and unnecessarily tough phytosanitary and product standards, but so too has been the lacklustre response of African firms to the new opportunities opened up.

*Africa’s trading relations with the rest of the world over the last several decades have not delivered the promised benefits.*

In addition, most of these agreements were signed on a concessional basis, and could therefore be suspended, or simply not be renewed. The recent suspension of Rwanda from certain provisions of the AGOA because of a disagreement over its policy to reduce the imports of second-hand clothing is an example. But it is not the only case – Madagascar, for instance, was suspended from AGOA in 2008, and Kenya has been threatened in the past with suspension due to an alleged rules of origin violations in its textile sector. The temporary nature of preferential market access essentially makes businesses difficult to take a long-term view and make investments in a beneficiary sector.

With the shift of geographic partners away from traditional markets (e.g. Europe) towards other trading partners (especially developing countries in Asia), the new trading relations may not have brought better results either. For instance, the EAC sustained a trade deficit of around US\$ 11 billion a year with China and India between 2013 and 2017 (i.e. half of the EAC overall trade deficits), despite the fact that China and India have had in place their own preferential market access schemes for developing countries for the last decade. Around one-third of the manufactured goods imports into the EAC are from China and another one-tenth from India in 2017. Strikingly, around 97 per cent of EAC imports from China are classified as manufactured goods (UNCTADStat, 2018). The rise of China and India as a source of imports may be good news for consumers, who are now paying lower prices for the consumption goods coming from Asia, but it also implies greater competition in domestic markets, especially for local manufacturers (Mold, 2017).

*The AfCFTA puts trading relations among African countries on a much firmer footing.*

Against this background, the AfCFTA is fundamentally different in the sense that the market access it provides is not concessional nor one-sided and it puts trading relations among African countries on a much firmer footing, especially

during the time of increased trade protectionism in some developed countries nowadays. An integrated continental market could provide Africa with the strengthened voice of 1.2 billion people in future negotiations, fostering a common position on evolving trade policy issues, and ensuring that individual bilateral arrangements do not unravel the objectives of continental integration.

This section of the report looks at the empirical evidence on the potential impact of the AfCFTA from the perspective of Eastern Africa. It is divided in two sections. While policy advice on economic development has been dominated by supply-side thinking in recent decades (e.g. McCombie and Thirlwall, 2004 and Thirlwall, 2018), the first part of the thematic study looks into under-explored demand-side perspectives on regional growth so as to complement the existing analytical framework of the AfCFTA and provide a richer analysis. It highlights the massive opportunities represented by more open domestic and regional markets.

Part two of this section provides an overview of the empirical studies into the benefits of regional integration in Africa, contextualizing it in the case of the AfCFTA.

## Part I: Demand-side Perspectives on Regional Development

Economic development cannot take place if there is not sufficient demand for products and services, and for macroeconomic reasons it is also not sustainable if the demand is met mainly via the import of goods and services. This section provides a demand-decomposition of existing patterns of economic growth, patterns of household consumption, and market opportunities in Eastern Africa. In terms of the policy implications, the section stresses the importance of recapturing domestic and regional markets through the implementation of the AfCFTA.

### I.1. A Demand-Decomposition Analysis of Regional Growth

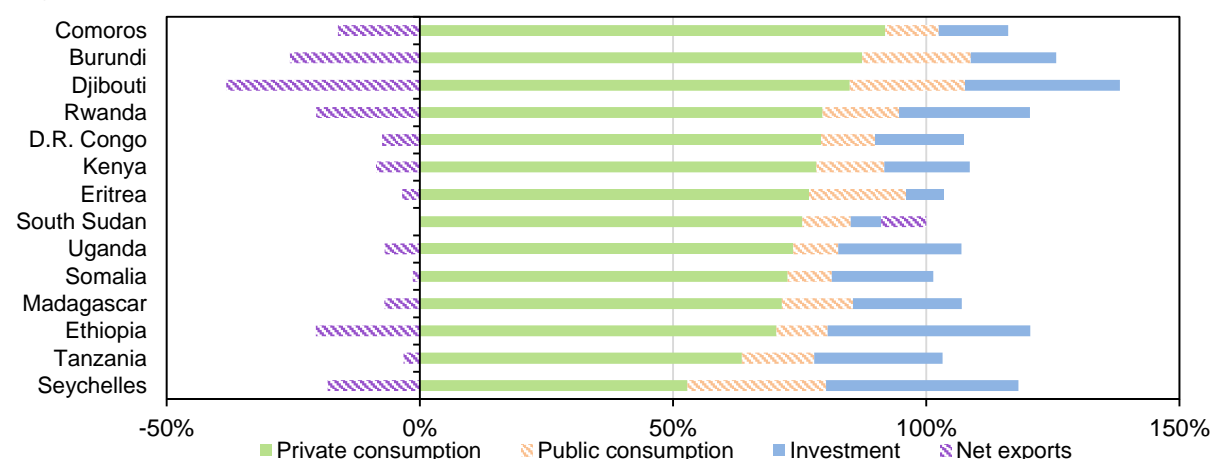
Analysis of the expenditure components of GDP helps inform the sources of economic growth from the demand perspective. In Eastern Africa, private consumption accounts for a significant share of total aggregate demand (at over 70 per cent), with an annual growth rate of around 6 per cent over the past decade, on

*In Eastern Africa, private consumption accounts for over 70 per cent of total aggregate demand.*

par with regional GDP growth. A similar rate of expansion is observed in public consumption, with a relatively stable share of GDP (at around 13 per cent). Over the last decade, economic activities have been boosted by investment (particularly infrastructure projects), which expanded by around 11 per cent per year, representing around a quarter of the regional GDP in 2016.<sup>55</sup> These three components, together constituting total domestic demand, accounted for more than 110 per cent of GDP, while net exports have been a constant drag due to the large import demand especially on manufactured goods (Mold and Naliaka. 2019 forthcoming). Although the share of exports rose to account for more than 25 per cent of GDP during the 2000s commodities boom, it was not high enough to offset the high import demand, signifying the need to address a major structural imbalance.

Figure 25 shows the structure of demand for Eastern African countries in 2016. Private consumption accounts for the major share of GDP in all cases, ranging from 53 to 92 per cent, whereas public consumption represented another 9 to 27 per cent of GDP. The investment share has a larger variation across countries and is particularly high in Ethiopia and Djibouti in recent years, given the large-scale infrastructure projects such as the Grand Ethiopian Renaissance Dam and the Addis Ababa–Djibouti railway. Despite the efforts in exports promotion, the large negative trade balances continue to constrain economic growth.

**Figure 25: Demand shares, 2016**



Source: UNdata (2018).

<sup>55</sup> Yet the figures are far below the scale of investment to GDP ratio reached by China in its growth spurt from the 1980s to 2010s (World Bank, 2008).

Analysis on the main contributor to growth over a longer time horizon provides insights into growth processes. Based on the decomposition method proposed by Chenery (1979), growth in a country can be classified as either domestic demand-led (DD), export-led (EE) or import substitution-led (IS) according to whichever contributes the largest share to GDP growth.<sup>56</sup> For the domestic demand-led countries, it can be further classified into countries where export expansion contributes to over 20 per cent of GDP change (DD1) and otherwise as ‘highly domestic-demand led countries’ (DD2). Figure 26 summarises the results of the analysis for 13 countries of Eastern Africa between 1990 and 2015.

**Figure 26: Growth decomposition, 1990-2015**

	1990-1995	1995-2000	2000-2005	2005-2010	2010-2015
Burundi	--	--	DD2	DD2	DD2
Comoros	EE	IS	DD2	DD2	DD2
D.R. Congo	--	--	EE	DD1	DD1
Djibouti	IS	IS	DD1	DD1	DD2
Eritrea	DD2	DD2	--	--	DD1
Ethiopia	DD2	DD1	DD1	DD2	DD2
Kenya	DD1	DD2	DD1	DD2	DD2
Madagascar	--	DD2	DD2	DD1	EE
Rwanda	--	DD2	DD2	DD2	DD2
Seychelles	DD2	EE	--	DD1	DD2
Somalia	--	DD2	DD2	DD2	DD2
Tanzania	DD1	DD2	DD1	DD1	DD1
Uganda	DD2	DD2	DD2	DD1	DD2

Note: DD, EE and IS refer to countries in which domestic demand expansion, export expansion and import substitution are the major demand-side components of economic growth respectively. In DD1 countries, export expansion contributes to over 20 per cent of GDP change and domestic demand remains the major source of GDP growth. DD2 countries are the remaining DD countries which could be considered as ‘highly domestic demand led’. Country with negative GDP growth is not classified and is represented by ‘--’.

Source: UNdata (2018).

*Between 1990 to 2015, domestic demand expansion was the major source of economic growth in the region.*

by Chenery et al. (1986) which shows the importance of domestic demand for countries in the early stages of development.<sup>57</sup> In contrast, there are only four incidents of export-led growth and three incidents of import substitution-led growth.

The results are enlightening about patterns of regional growth. Between 1990 to 2015, domestic demand expansion was the major source of economic growth in the region (16 classified as DD1 and 32 classified as DD2, accounting for around 90 per cent of all observations). The results are in line with the work

<sup>56</sup> These three components are identified through the following equation:

$$(Y_t - Y_{t-1}) = \alpha_{t-1}(D_t - D_{t-1}) + (\alpha_t - \alpha_{t-1})S_t + \alpha_{t-1}(X_t - X_{t-1})$$

GDP increase    Domestic demand    Import substitution    Export effect

where Y = GDP, D = domestic demand (i.e. Y+M-X), S = total supply (i.e. Y+M), X = total exports of goods and services (fob), M = total imports of goods and services (cif),  $\alpha$  = GDP as share of total supply (i.e. Y/S), t = final year of period and t-1 = initial year of period.

<sup>57</sup> In the Republic of Korea (1955 – 1971) and Taiwan Province of China (1956 – 1971), the role models of ‘export-led growth’, expansion of domestic demand actually contributed to 68 per cent and 55 per cent of economic growth respectively, compared to the contribution of export expansion of 35 per cent and 43 per cent respectively (Chenery et al., 1986).

The relative contribution of domestic demand, export expansion and import substitution has implications for both economic growth and poverty reduction. According to an analysis (UNCTAD, 2004) of a group of Least Developed Countries (LDCs) between 1990 and 2000, it was found that countries in which domestic demand was the major demand-side component of economic growth had the highest growth rate of real GDP and private consumption per capita.<sup>58</sup> While higher private consumption in domestic demand-led countries may seem to some degree tautological, it does reinforce the idea that domestic demand is more important for overall economic growth in the LDCs compared to the contemporary policy emphasis on improving external competitiveness. Despite the fact that an improved export performance is a necessary condition for more resilient growth - especially for countries afflicted by persistent and large current account deficits - the analysis highlights that the nexus between export growth and inclusive and sustainable economic growth is far from automatic, particularly if export expansion concentrates within an externally oriented enclave with few linkages with the rest of the economy. It is crucial that export dynamism helps strengthen domestic linkages and development complementarities between sectors, as well as ensure positive synergies between exporting enterprises and local suppliers. Moreover, it has become evident that developing countries will not be able to depend on exports to developed countries as much as in the past given the moderated growth, and must therefore focus more on domestic and regional markets (UNCTAD, 2012). This again brings us back to the importance of recapturing domestic markets and creating a continental market.

*Countries in which domestic demand was the major demand-side component of economic growth had the highest growth rate of real GDP and private consumption per capita.*

## I.2. Patterns of Household Consumption

A way of extending the analysis to get a better understanding of patterns of domestic demand is through using the International Comparison Program and the Global Consumption Database of the World Bank. Although the data dates back to 2011 and 2010 respectively, the detailed breakdowns provide insights on the general patterns of consumption.

Similar to Figure 25, the table below presents the selected economy's nominal expenditures as a percentage of its GDP. While the composition of Africa and the World was alike, the shares of actual individual consumption<sup>59</sup> and gross fixed capital formation between Africa and Asia Pacific were different, with much higher consumption and lower investment shares in Africa. As for Eastern African countries, the consumption share was strikingly high, coupled with large trade deficits. Zooming into

*The consumption share of Eastern African countries was strikingly high compared to that of Africa and the World.*

the detailed category of individual consumption, Figure 27 shows that food and nonalcoholic beverages as well as housing, water, electricity, gas and other fuels accounted for the largest portion in Africa, and more notable in Eastern Africa.

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<sup>58</sup> Growth in private consumption per capita could be taken as a proxy for poverty reduction.

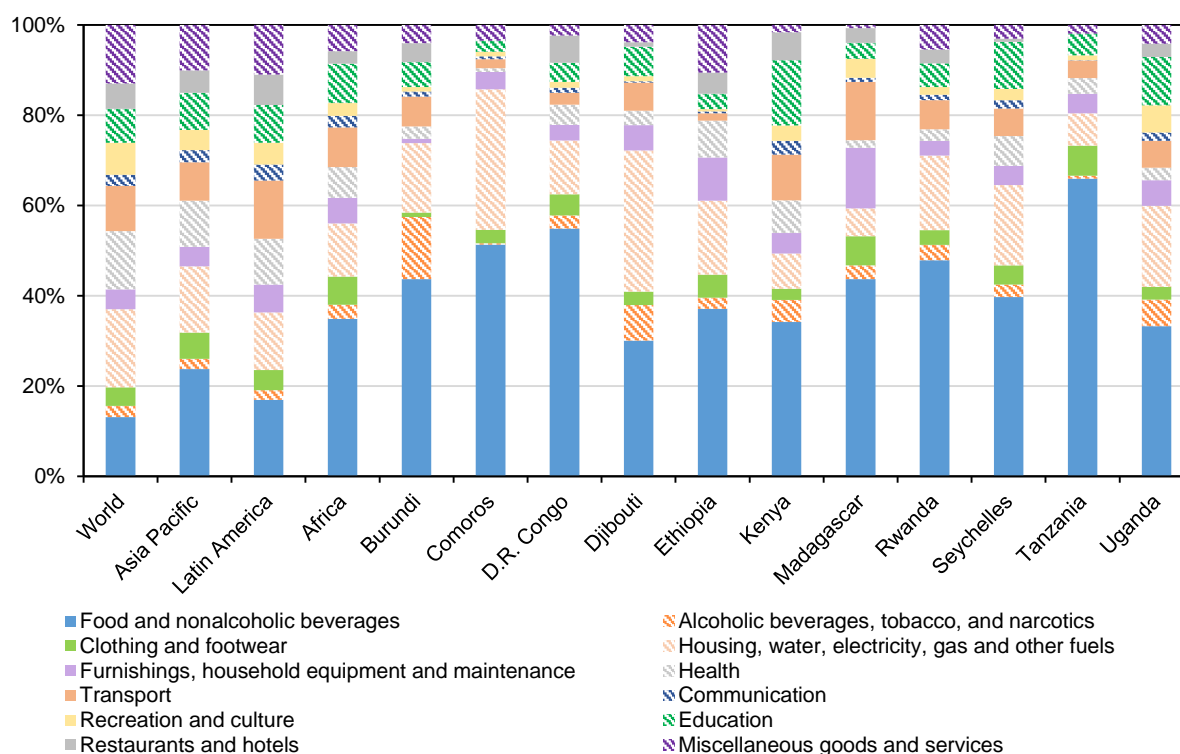
<sup>59</sup> It covers the expenditures of households, non-profit institutions serving households and general government at purchasers' prices.



**Table 9: Expenditure shares (GDP = 100), 2011**

Economy	Actual individual consumption	Collective consumption by government	Gross fixed capital formation	Changes in inventories and valuables	Balance of exports and imports
<i>World</i>	66.5	8.5	23.0	1.2	0.8
<i>Asia Pacific</i>	50.6	6.6	37.8	3.0	1.9
<i>Latin America</i>	68.6	10.7	20.0	1.0	-0.2
<i>Africa</i>	66.9	10.7	20.9	1.1	0.5
Burundi	93.2	12.8	18.9	0.7	-25.7
Comoros	98.7	23.0	13.4	3.8	-38.9
D.R. Congo	64.4	11.6	23.6	0.1	0.4
Djibouti	71.5	19.8	26.4	4.4	-22.0
Ethiopia	80.9	6.3	25.9	2.1	-15.1
Kenya	87.6	8.4	20.0	0.5	-16.5
Madagascar	90.8	7.2	17.4	0.0	-15.4
Rwanda	86.9	9.1	21.4	0.0	-17.4
Seychelles	60.7	20.3	33.9	5.8	-20.8
Tanzania	68.3	14.2	36.1	0.6	-19.2
Uganda	90.7	1.6	24.7	0.3	-17.3

Source: World Bank (2014).

**Figure 27: Composition of actual individual consumption, 2011**


Source: World Bank (2014).

Beyond the expenditure data, information on price level supplements the analysis on the demand of goods and services. Figure 28 presents the price level indexes of the different categories under actual individual consumption. Relative to the world average, Africa had a lower price level in all the categories, especially for the service sectors, such as health and education. More revealing is the variation of price level across the Eastern African countries. While it is expected that the non-tradable services sector would have the largest price variation, some tradable goods (e.g. alcoholic beverages, tobacco and narcotics, and clothing and footwear) also exhibited a high price variation. In addition, the

*The large price variation across Eastern African countries signifies potential gains from regional trade.*

price levels of some tradable goods were even higher than the world average, reflecting the large effective demand. The large price variation signifies potential gains from regional trade, particularly for food and nonalcoholic beverages, alcoholic beverages, tobacco and narcotics as well as household equipment.

**Figure 28: Price level index (World = 100), 2011**

Economy	Actual individual consumption	Food and nonalcoholic beverages	Alcoholic beverages, tobacco, and narcotics	Clothing and footwear	Housing, water, electricity, gas and other fuels	Furnishings, household equipment and maintenance	Health	Transport	Communication	Recreation and culture	Education	Restaurants and hotels	Miscellaneous goods and services
Africa	55	87	72	56	39	65	38	61	68	56	42	61	47
Burundi	43	72	73	40	27	56	21	73	88	54	20	52	35
Comoros	71	112	112	76	58	111	46	77	137	87	42	79	67
D.R. Congo	67	121	84	67	41	69	41	76	99	62	33	93	58
Djibouti	66	96	72	69	58	71	57	72	67	78	53	84	59
Ethiopia	36	59	46	42	37	46	22	43	43	33	16	30	25
Kenya	46	72	64	41	34	51	30	66	41	50	47	51	33
Madagascar	40	64	48	32	41	43	22	58	77	36	23	28	28
Rwanda	48	73	67	58	36	45	31	74	64	56	50	54	40
Seychelles	70	108	163	84	49	87	39	90	82	70	46	181	63
Tanzania	43	67	61	38	46	47	20	48	46	45	35	43	30
Uganda	43	63	58	46	43	51	28	59	55	45	27	47	32

Note: The heat map shows the price variation relative to the price level of Africa's actual individual consumption, with dark blue and dark red representing lower and higher price level respectively.

Source: World Bank (2014).

The Global Consumption Database provides another important perspective on household consumption. Analysis on consumption behaviors and purchasing power by segment<sup>60</sup> reveals opportunities for market-based approaches to better meet their needs, especially for the poor households in the region, thereby bringing them into the formal economy and improving the delivery of essential services to this large share of the population. Compared to the wealthier mid-market population segment, the base of the economic pyramid (BOP) markets<sup>61</sup> are often very poorly served, dominated by the informal economy, and relatively inefficient and uncompetitive (WRI and IFC, 2007). Yet the BOP markets represent a significant share of the world's population and have substantial purchasing power which should not be overlooked.

In fact, the BOP market is the dominant consumer market in Africa. The market size was about US\$ 120 billion as of 2010 and included 486 million people in the 22 surveyed countries, representing more than 70 per cent of aggregate purchasing power and around 95 per cent of the population (World Bank, 2012). For the nine surveyed countries in Eastern Africa, the lowest consumption segment constituted a market of US\$ 65 billion and 265 million people, accounting for around 63 per cent of aggregate purchasing power and 86 per cent of the population. Specifically, D.R Congo and Ethiopia represented around half of the lowest consumption market. Meanwhile, the middle and higher consumption

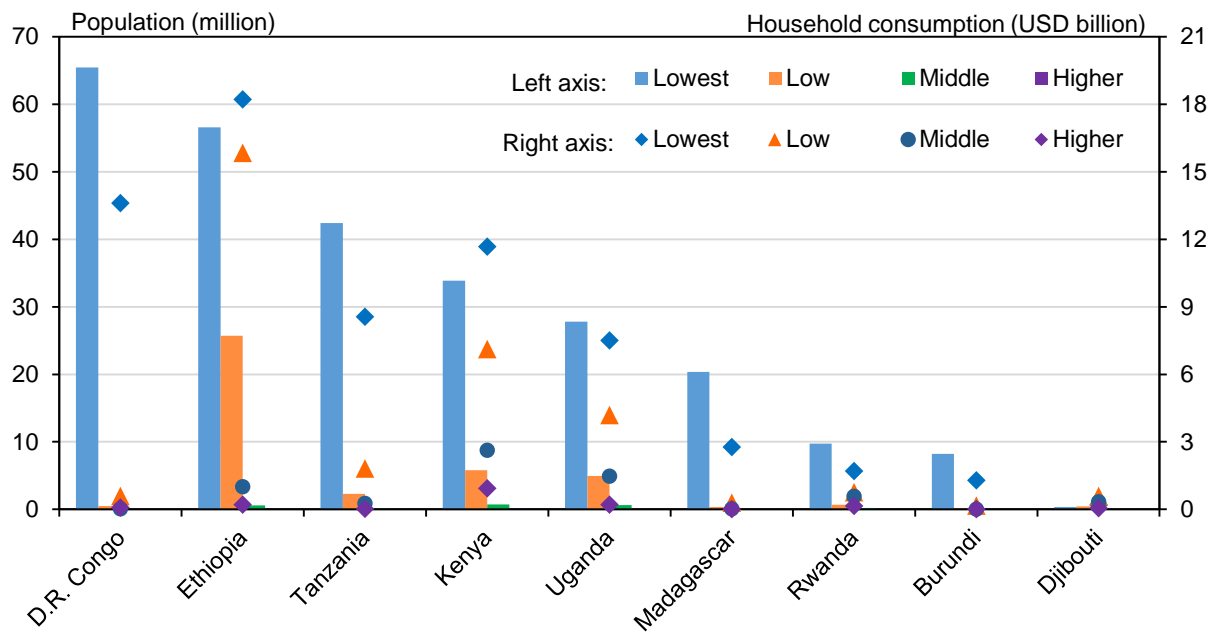
*The base of the economic pyramid market is the dominant consumer market in Africa, representing more than 70 per cent of aggregate purchasing power and around 95 per cent of the population.*

<sup>60</sup> Households are categorized in four consumption segments: lowest, low, middle and higher. They are based on global income distribution data, which rank the global population by income per capita. The lowest consumption segment corresponds to the bottom half of the global distribution, or the 50<sup>th</sup> percentile and below (below PPP\$2.97 per capita a day); the low consumption segment to the 51<sup>th</sup>-75<sup>th</sup> percentiles (between \$2.97 and \$8.44); the middle consumption segment to the 76<sup>th</sup>-90<sup>th</sup> percentiles (between \$8.44 and \$23.03); and the higher consumption segment to the 91<sup>st</sup> percentile and above (above \$23.03) (WRI and IFC, 2007).

<sup>61</sup> The base of the economic pyramid refers to the 4 billion people with incomes below \$3,000 in local purchasing power, constituting a US\$ 1.3 trillion global consumer market (WRI and IFC, 2007).

segments were remarkably small, and the low consumption segment was not notable except Ethiopia, Kenya, Uganda and Djibouti (Figure 29).

**Figure 29: Consumption market by segment, 2010**



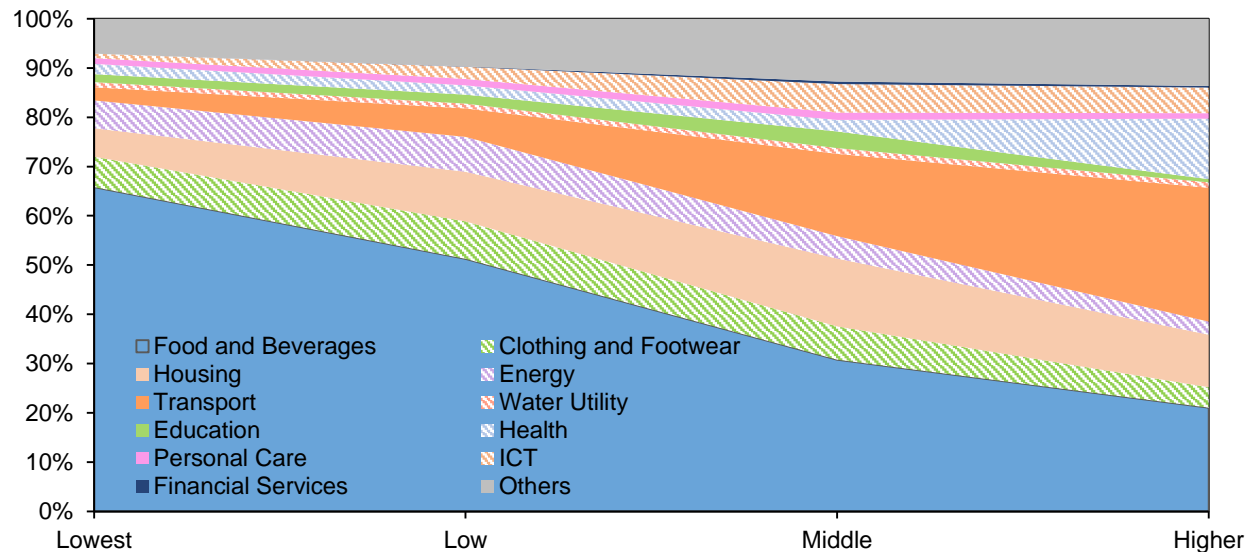
Source: World Bank (2012).

For the different segments, distinct spending patterns are observed. In general, food dominates the budget in the poor household, while the share spent on food declines and the shares for transportation and telecommunications increase significantly as incomes rise. Figure 30 presents the household consumption patterns by segment in the region. More notable changes

*Food dominates the budget in the poor household.*

are the shares for food and beverages, transportation, health and telecommunications, with the former one decreasing sharply from around 66 per cent to 21 per cent as income increases, and the latter rising from 3 per cent to 27 per cent, from 2 per cent to 12 per cent and from 1 per cent to 5 per cent respectively.

**Figure 30: Household consumption patterns by segment in Eastern Africa, 2010**



Source: World Bank (2012).

In order to address the needs of different household, it is important to characterize the market in details. Table 10 shows the top 10 type of household consumption by segment in the region. Out of the 106 types of product/service documented in the Global Consumption Database, the list is selected according to the share of consumption represented by a particular segment. For instance, the lowest segment accounted for around 91 per cent of the household consumption on preserved or processed fish and seafood in 2010. The total value of the top 10 product/service in the lowest segment was around US\$ 31.2 billion, representing around half of the total consumption of the lowest segment and with most of them being food and beverages. As income rises, the top 10 type of product/service shift away from food and beverages to transportation and health, e.g. motor cars and medical services, where the middle and higher segments are the major sources of demand. For example, they accounted for around 25 per cent and 32 per cent of the total spending on motor cars in the region respectively, in stark contrast to the 6 per cent and 2 per cent of the purchasing power they represented in 2010.

**Table 10: Top 10 type of household consumption by segment in Eastern Africa, 2010**

Lowest	Low	Middle	Higher
Preserved or Processed Fish and Seafood	Telephone and Telefax Services	Passenger Transport by Air	Motor Cars
Fresh or Chilled Potatoes	Coffee, Tea and Cocoa	Fuels and Lubricants for Personal Transport Equipment	Medical Services
Gas	Furniture and Furnishings	Motor Cars	Hospital Services
Rice	Passenger Transport by Road	Electricity	Fuels and Lubricants for Personal Transport Equipment
Fresh, Chilled or Frozen Fish and Seafood	Catering Service	Telephone and Telefax Services	Passenger Transport by Air
Other Edible Oil and Fats	Maintenance and Repair of the Dwelling	Audio-Visual, Photographic and Information Processing Equipment	Maintenance and Repair of Personal Transport Equipment
Frozen, Preserved or Processed Vegetables and Vegetable-based Product	Bread	Domestic Services	Domestic Services
Sugar	Actual and Imputed Rentals for Housing	Furniture and Furnishings	Audio-Visual, Photographic and Information Processing Equipment
Other Cereals, Flour and Other Products	Other Fuels	Maintenance and Repair of the Dwelling	Furniture and Furnishings
Fresh or Chilled Vegetables Other than Potatoes	Shoes and Other Footwear	Newspapers, Books and Stationery	Electricity
<u>Total value:</u> US\$ 31.2 billion	<u>Total value:</u> US\$ 10.2 billion	<u>Total value:</u> US\$ 1.6 billion	<u>Total value:</u> US\$ 0.8 billion
<u>Share of total consumption:</u> 48%	<u>Share of total consumption:</u> 32%	<u>Share of total consumption:</u> 26%	<u>Share of total consumption:</u> 46%

Note: The product/service is selected according to the share of consumption by a particular segment. To avoid distortion by small sample, product/service values below 1 per cent of the total consumption of the segment is not included.

Source: World Bank (2012).

### I.3. To What Extent is Domestic Demand Met by Local Production?

With the well identified domestic demand, the next question is whether they are met by local production or rather by imports. A simple assessment can be done by reviewing the trade balance of different products by country (Figure 31). Except D.R. Congo, all countries in the region experienced trade deficit in 2017, ranging from -5 per cent to -38 per cent of GDP. Despite the positive contribution from net exports of ores, metals, precious stones and non-monetary gold, it was not enough to counterbalance the enormous net imports of manufactured goods. Regarding food items, the major consumption of poor households, the region enjoyed a small surplus of US\$ 375 million in 2017 (or 0.1 per cent of the regional GDP), yet the situation was worrying in some countries (e.g. Comoros, Somalia, Djibouti and Eritrea).

**Figure 31: Trade balance as a share of GDP by product groups, 2017**

Country	Food items	Agricultural raw materials	Fuels	Manufactured goods	Ores, metals, precious stones and non-monetary gold	Others
Burundi	-2%	0%	-3%	-13%	2%	0%
Comoros	-9%	-1%	-1%	-21%	0%	0%
D.R. Congo	-2%	0%	2%	-8%	14%	1%
Djibouti	-7%	0%	-1%	-32%	0%	1%
Eritrea	-5%	1%	-1%	-11%	3%	0%
Ethiopia	1%	0%	-2%	-15%	0%	0%
Kenya	0%	1%	-3%	-12%	0%	0%
Madagascar	0%	0%	-4%	-17%	6%	0%
Rwanda	0%	0%	0%	-14%	7%	-1%
Seychelles	15%	-1%	-4%	-42%	0%	0%
Somalia	-8%	2%	0%	-2%	0%	0%
Tanzania	2%	0%	-8%	-22%	6%	0%
Uganda	2%	0%	-2%	-6%	1%	0%

Source: UNCTADStat (2018).

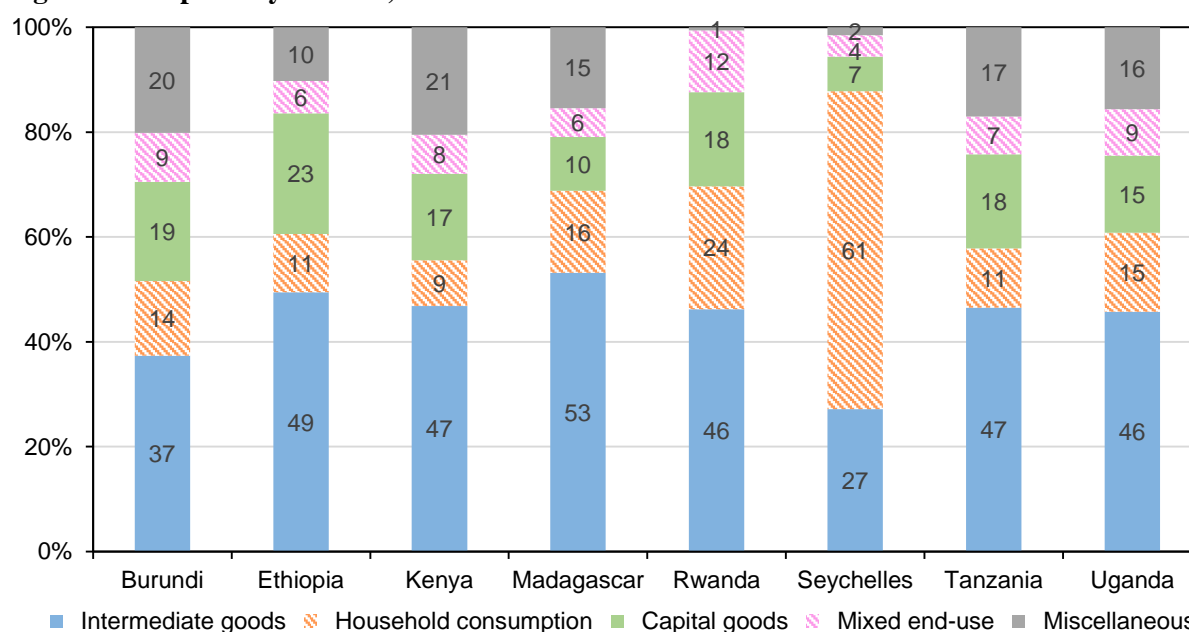
A continent with an enormous potential for increased food production, food self-sufficiency is an important issue for Africa. The President of the African Development Bank has indicated that Africa's annual food import bill is estimated to rise to US\$ 110 billion by 2025, thereby weakening African economies, and decimating its agriculture and exports jobs from the continent (AfDB, 2017). By 2017, that deficit already stood at US\$ 79 billion. In Eastern Africa, despite having a small surplus on food items, agricultural performance is highly vulnerable to weather-related shocks, as subsistence and cash crop farming coupled with rearing of animals characterizes most rural agricultural activities. In fact, the region has been experiencing serious food insecurity challenges in recent years, exacerbated by the successive episodes of drought in 2016 and 2017 resulting in extensive growing season failures and livestock deaths.

*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.*

Another important dimension of the trade analysis is the breakdown by end-use categories and industrial activities. On average, intermediate products (i.e. non-finished goods to be further processed before final use) accounted for about half of the merchandise imports in the region, whereas capital goods and consumption goods represented around one-seventh each, not including Seychelles which had a significant share of consumption goods (Figure 32). In terms of economic sectors, most imports were related to manufacturing (principally, food, beverages and tobacco, textiles, leather and footwear (mainly used as household consumption), as well as machinery and equipment, and transport equipment

(largely used as capital goods). Instead of adding value to the imports, many products were actually used as consumption and capital goods. More importantly, Africa continues to import most of its intermediates from the rest of the world, owing to a lack of competitiveness in its manufacturing sector and a lack of linkages to the domestic and regional economy. This points to a missed opportunity for the continent with shallow RVCs (UNECA, 2015).

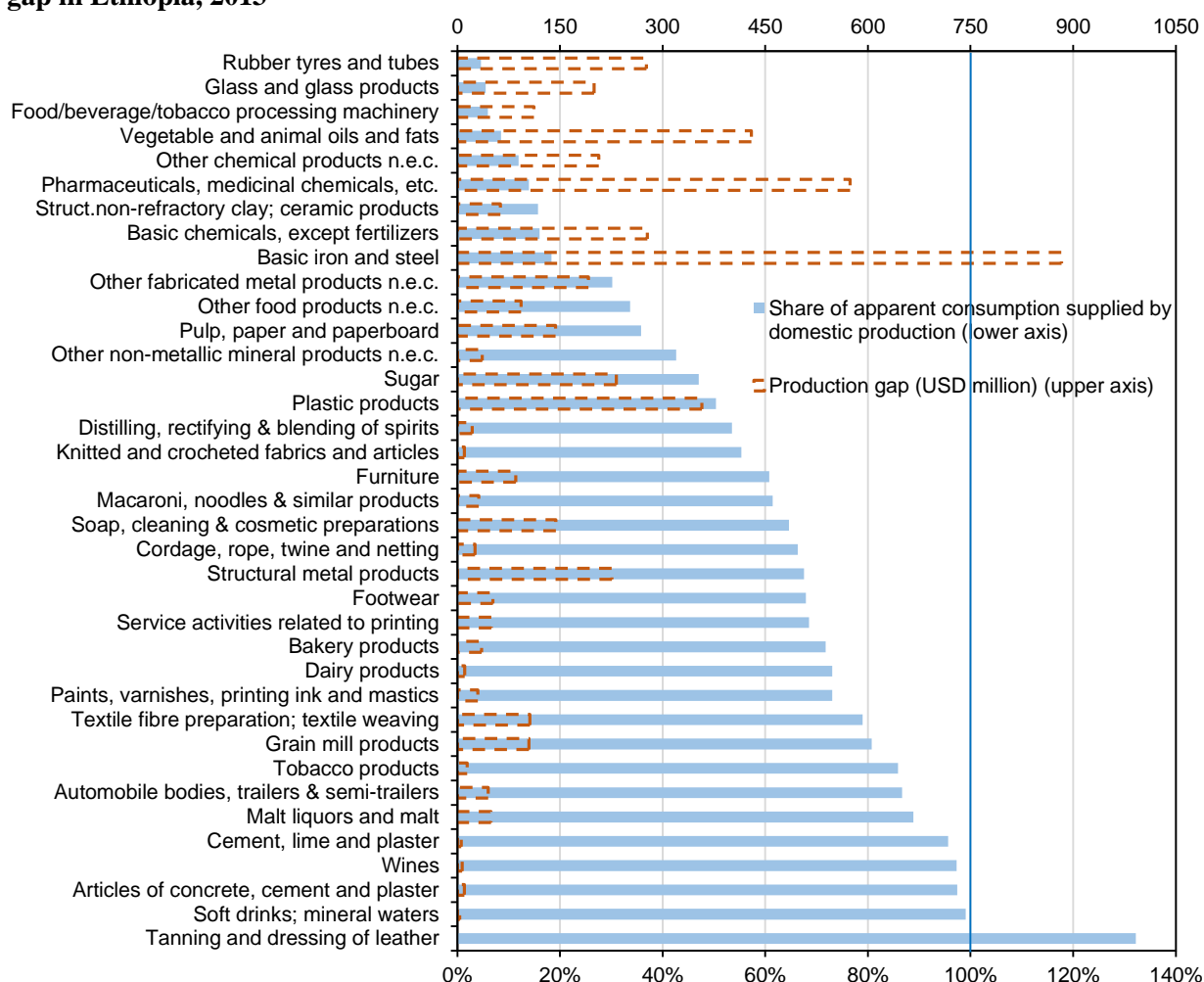
**Figure 32: Imports by end-use, 2016**



Note: Figures for Burundi and Kenya are as of 2015 and 2013 respectively.  
Source: OECD (2018d).

*Local firms may not be ready to produce what customers need and domestic demand has been met by imports from the rest of the world.*

The above findings suggest that local firms may not be ready to produce what customers need and domestic demand has been met by imports from the rest of the world. The situation is particularly revealing under a demand-supply balance. Take Ethiopia as an example, Figure 33 presents the share of consumption supplied by domestic production and the corresponding production gap based on the Industrial Demand-Supply Balance Database (UNIDO, 2018c). The disaggregated data on the manufacturing sector shows that domestic production was below consumption for most products, in particular rubber tyres and tubes, and glass and glass products, and to a lower extent for other food and beverages products. The detailed breakdown also indicates the production gap by products, highlighting the market opportunities which are not being met by local production, especially for basic iron and steel, pharmaceuticals and medical chemicals, and vegetable and animals oil and fat. In addition, supplemented by statistics on value added and number of employee from the Industrial Statistics Database (UNIDO, 2018d), it is found that the share of consumption supplied by domestic production is positively correlated with labour productivity (i.e. value added per employee), suggesting the importance of firm competitiveness.

**Figure 33: Share of apparent consumption supplied by domestic production and the production gap in Ethiopia, 2013**


Note: Apparent consumption equals to the sum of domestic production and net import. The data are arranged at the 4-digit level of the International Standard Industrial Classification of All Economic Activities (ISIC) Revision 3 pertaining to the manufacturing sector. Due to limited data on domestic production, not all products are covered here.

Source: UNIDO (2018c).

Apart from the challenges of food security and trade deficit, reliance on import has significant implications on economic development. One of the impacts related to domestic production is that import bottlenecks could hamper the full utilization of productive capacities.

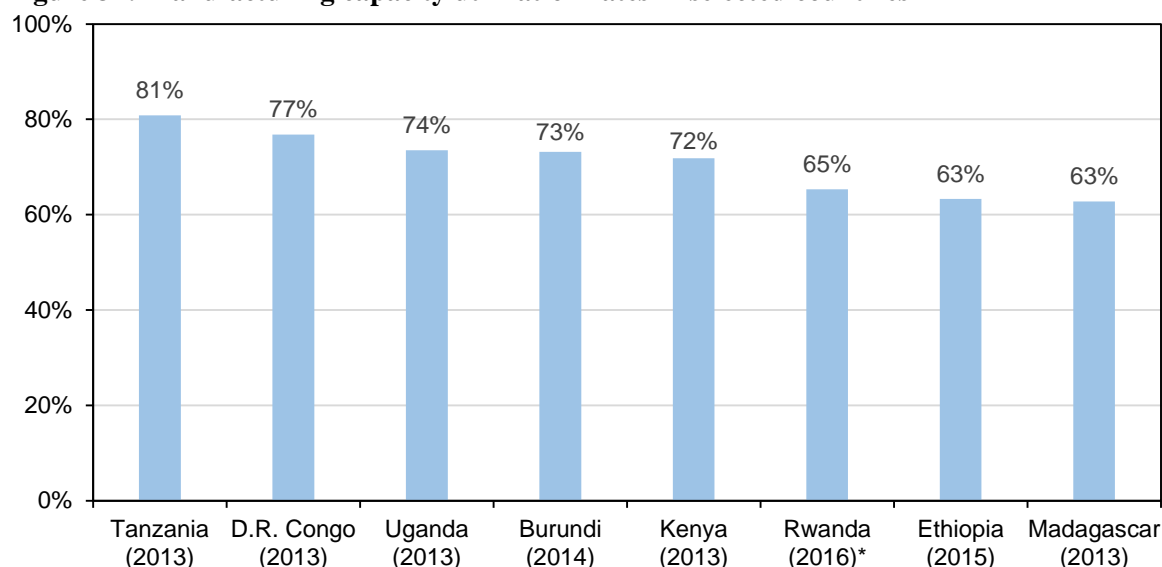
Specifically, there would be underemployment of labour, capital and resources in the import-dependent sectors if the imports could not be financed at levels necessary for full utilization of capacity. In fact, most LDCs are import-sensitive not simply because of the importance of imports for capacity utilization but also because of the high import content of investment processes, reflecting the absence of a domestic capital goods industry (UNCTAD, 2004).

*Import bottlenecks could hamper the full utilization of productive capacities.*

Enterprise surveys provide information on the capacity utilization rate. In the manufacturing sector, capacity utilization rates ranged from 63 per cent to 81 per cent in the region (Figure 34). For the case of Rwanda, more detailed data could be found in the Integrated Business Enterprise Survey (NISR, 2018). It shows that the manufacturing sector had one of the lowest rates of capacity utilization, with around three quarters of the enterprises declaring underutilization. Meanwhile, around 80 per cent of the manufacturing enterprises did not export any of their products abroad in 2016, as they alleged they could not find clients and financing to export. The contribution of manufacturing products to exports

was small and the manufacturing exports that did exist were principally destined to neighboring countries, suggesting the importance of regional markets for the future growth of manufacturing.

**Figure 34: Manufacturing capacity utilization rates in selected countries**



Note: (\*) Data is based on the Integrated Business Enterprise Survey by the National Institute of Statistics Rwanda as it is not available from the World Bank's Enterprise Surveys.

Sources: World Bank (2018a) and NISR (2018).

*Low domestic demand and different access and high cost of inputs, particularly for raw materials and credit, are the major reasons of capacity underutilization.*

Further analysis on the national enterprise surveys indicates that low domestic demand and different access and high cost of inputs, particularly for raw materials and credit, are the major reasons of capacity underutilization (Table 11). In terms of industrial groups, around half of the surveyed manufacturers of food products and beverages as well as footwear in Ethiopia reported shortage of supply of raw

materials as the first major problem, whereas about one-fourth of the manufacturer of furniture, fabricated metal products and wearing apparel stated the absence of market demand as the first major problem (CSA, 2012).

**Table 11: Top five reasons of capacity underutilization in selected countries**

Ethiopia	Kenya	Rwanda
Shortage of raw materials	High cost of electricity	Low demand
Absence of demand for products	High cost of materials	Unreliable supply of inputs
Absence of credit facilities	High cost and/or shortage of credit	Lack of working capital
Shortage of foreign exchange	Shortage of domestic inputs	Lack of technology and machinery
Shortage of spare parts	Poor transport facilities and/or high transport cost	Lack of skilled workers

Sources: CSA (2012), KNBS (2014) and NISR (2018).



## I.4. Recapturing Domestic Markets

Domestic demand has been the key impetus for economic growth in the region over the past decade or so. Yet the expansion of local productive capacities<sup>62</sup> has not been fast enough to capture the enormous opportunities and countries have been generally relying on imports, resulting in structural trade deficits. In fact, with the right set of conditions, domestic demand can set in motion a virtuous circle of industrial development comprising income creation, demand diversification and massification of consumption. The virtuous circle starts to work with a critical mass of income, which generates demand from necessities to more sophisticated goods. With industrial capacities in place, the diversified demand drives industrial development, which in turn leads to higher production efficiency and lower prices, enabling a broad-based diffusion of manufactures through mass markets. As a result, it improves the purchasing power of consumers which creates new disposable incomes, thereby keeping the circle turning (UNIDO, 2018a). To keep the virtuous circle spinning, the development of productive capacities and the growth of demand have to be mutually reinforcing each other (Knox et al., 2014 and Todaro and Smith, 2014).

*The expansion of local productive capacities has not been fast enough to capture the enormous opportunity in domestic markets.*

In Africa, starting and sustaining the interaction between growing demand and the development of productive capacities may not be easy within national markets, especially for small countries, generally offer limited opportunities for efficient mass production given the relatively low-income levels. Also, local firms do not usually have the necessary capabilities and the infrastructure, business environment and institutions may not be favourable, not to mention the fierce competition from the rest of the world (UNCTAD, 2006b).

In general, manufacturing firms in Africa perform significantly worse than firms in other regions as reflected by the lower productivity levels and growth rates. Yet research by Harrison et. al. (2014) suggests that once the factors of geography, infrastructure, political competition and the business environment are controlled for, African manufacturing firms actually exhibit a conditional advantage in productivity levels and growth compared with non-African firms, especially in low-tech manufacturing. This indicates that there is no inherent ‘curse’ that hinders the development of African manufacturing, but only a need for action to address the general business environment in order to move towards a positive reinforcing cycle towards higher unconditional productivity.

Supply-side constraints only represent part of the challenges. Industrial development will still be constrained if there is no demand stimulus which provides an inducement to capital accumulation and technological progress. This brings us back to the importance of a regional market in Africa and the recommendation of recapturing domestic markets.

The strategy of recapturing domestic markets<sup>63</sup>, which advocates domestic production for local consumption while promoting structural transformation in the productive sectors, has several advantages. Firstly, given high levels of market demand, as evidenced by the scale of imports, the risks of setting up industries oriented to meet that demand are lower compared to export promotion. Secondly, while much caution is needed because it can damage both consumer welfare and productivity, it is easier

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<sup>62</sup> There is no generally-accepted definition. UNIDIO defines it as ‘the ability to produce goods that meet the quality requirements of present markets and to upgrade in order to tap future markets’, while UNCTAD defines it as ‘the productive resources, entrepreneurial capabilities and production linkages which together determine the capacity of a country to produce goods and services and enable it to grow and develop’.

<sup>63</sup> It can be viewed as a strategy to enable local producers to compete with imports in the short term, and make them export-ready in the medium term.

in principle to protect the domestic market than to compete with foreign firms for exports.<sup>64</sup> Thirdly, while premature exposure of infant industries to global competition leaves no opportunities for industrial restructuring and economic diversification (Mkandawire and Soludo, 1998), it is easier for countries to become globally competitive in new industries after gaining competitiveness domestically and among neighboring countries in an incubation period of diversification in production (Bahar et al., 2014).

In fact, countries in the region have been focusing on domestic markets in recent years. For instance, Buy Uganda Build Uganda Policy (MTIC, 2014) and Domestic Market Recapturing Strategy in Rwanda (MINICOM, 2015a). While the full effects of the policy are to be monitored, the cement industry in Rwanda has made some notable progress. With a significant increase in domestic production, the reliance on cement imports dropped from around 82 per cent in 2014 to around 47 per cent in 2017 (BNR, 2018), thereby providing a more stable supply and cutting the expensive import bill. One recent concrete example of tariff-hoping FDI to take advantage of the domestic regional market is the investment by a Chinese firm in the Eastern African largest organic fertilizer factory in Uganda, which will produce about 300,000 tonnes of organic fertilizers annually.

Having said that, there are concerns on the strategy of recapturing domestic markets, such as corruption and inefficient industries accustomed to protection. The policy measures should thus be complemented with a comprehensive industrial policy and right institutional arrangements. Also, policy should be formulated with the consideration of the regional context to ensure deeper economic and social integration. Unlike the traditional industrial policy, i.e. the so-called ‘picking winners’ strategy that aims at shifting the structure of production towards promising sectors via subsidies and tariff and non-tariff barriers in the 1950s, which gave rise to rent-seeking issues and unproductive entrepreneurship, as well as the disappointing results of the structural adjustment programmes in the 1980s (Lall, 1995), the right model for industrial policy is based on a mixed, market-based model with government and private entrepreneurship working together to create strategic complementarities between public and private sector investment as a discovery process (Rodrik, 2004). Government essentially acts as a facilitator of learning and a provider of a regulatory framework that ensures private intellectual property rights, attracts FDI through fiscal incentives and indirect subsidies, and improves market governance by removing bottlenecks and correcting market failures (UNCTAD, 2006b).

*Industrial policy should be based on a mixed, market-based model with government and private entrepreneurship working together to create strategic complementarities.*

Apart from the macroeconomic policies oriented to promoting growth, investment and employment, meso-policies based on the dynamics of production structures are required to build enterprise capabilities as well as promote structural change and intersectoral linkages.<sup>65</sup> Despite the emphasis on recapturing domestic markets, governments should not to lock themselves permanently into local demand, and are advised to actively seek out new areas of comparative advantage instead of sticking to the static comparative advantage of export specialization of raw and unprocessed commodities which led to enclave economies and poor poverty reduction records. The most effective approach would be

<sup>64</sup> It is important to recognise that regional markets are actually already quite highly protected, with Most-Favour-Nation tariffs being significantly higher than global averages. For the EAC, for instance, the Common External Tariff stands at 25 per cent for consumer goods. Although Ethiopian trade policy is currently being reviewed, average MFN tariffs for Ethiopia stand at 17.4 per cent (WTO, ITC and UNCTAD, 2017).

<sup>65</sup> While the patterns of development vary by country, industries within manufacturing can be broadly classified as ‘early’, ‘middle’ and ‘late’. Early industries are mostly those that are relatively labour-intensive and/or domestic-oriented (typically food and beverages, tobacco, textiles, wearing apparel, wood products, furniture, and non-metallic minerals). Middle industries include those that process natural resources (typically coke and refined petroleum, paper, basic metals and fabricated metals). Late industries tend to be more knowledge- and capital-intensive (typically rubber and plastics, motor vehicles, chemicals, and machinery and equipment) (UNIDO, 2018b).

on one hand strengthening existing capacities, especially in sectors with high employment share, and on the other hand building new capacities in fast-growing and higher value-added sectors, while deepening the linkages among sectors to set off a dynamic growth process. Specifically, given the significant share of agriculture in GDP and employment in the region, it is essential to strengthen the linkages between agriculture and

the rest of the economy in order to sustain economic growth, and more importantly create an inclusive process of development which supports poverty reduction (Anriquez and Stamoulis, 2007). Box 10 discusses how the new line of research ‘Product Space’ helps analyze the productive capabilities of a country and advise the development of strategic sectors.

*The most effective approach would be on one hand strengthening existing capacities, and on the other hand building new capacities in fast-growing and higher value-added sectors, while deepening the linkages among sectors to set off a dynamic growth process.*

To summarise, the demand side analysis provides an important perspective on economic development. As the virtuous circle of the development of productive capacities and the growth of demand involves a recursive process, governments should continuously evaluate the progress against targets and the effectiveness of different policy tools to better codify their experiences. Apart from the traditional role of a regulator, governments can steer demand towards inclusive and sustainable industrialization as a facilitator of information exchange and removal of market failures, a consumer that stimulates demand through public procurement, as well as a technological capability-building partner with active promotion of innovation.

### Box 10: Identifying Strategic Sectors via Product Space

Traditional theory suggests that economic development and the ability to produce different products of a country are determined by the endowments of a number of factors such as land, labour and capital (Ohlin, 1933). The factor-based growth models assume that the existing product mix of a country has little or no effect on its economic prospect, and production can be easily adjusted to reflect changes in the relative price of factors.

Recent research, however, argues that the productive structure of a country is constrained by specific capabilities that serve as inputs for other industries and are unlikely to be accumulated in the absence of the products that demand them. That is to say, the ability to produce certain goods or services depends on the capabilities embedded in the mix of products that is currently making. More importantly, research shows that existing production does not only reflect the capabilities that a country has, but can also be used to predict its ability to produce as well as its economic development in the future (Hausmann and Rodrik, 2003, Hausmann and Klinger, 2006 and 2007, and Hausmann et al., 2007).

The new line of research provides an instrument called ‘Product Space’ to analyze the productive capabilities embedded in the mix of products. The product space of an economy can be understood as a network representation of all exported products. The linkages between different products are mapped by identifying the similarities of know-how required to produce them. For example, cheese and curd are closely linked to milk, cream and butter, rather than aircraft parts, and construction materials are related to the processing of minerals more than with textiles.

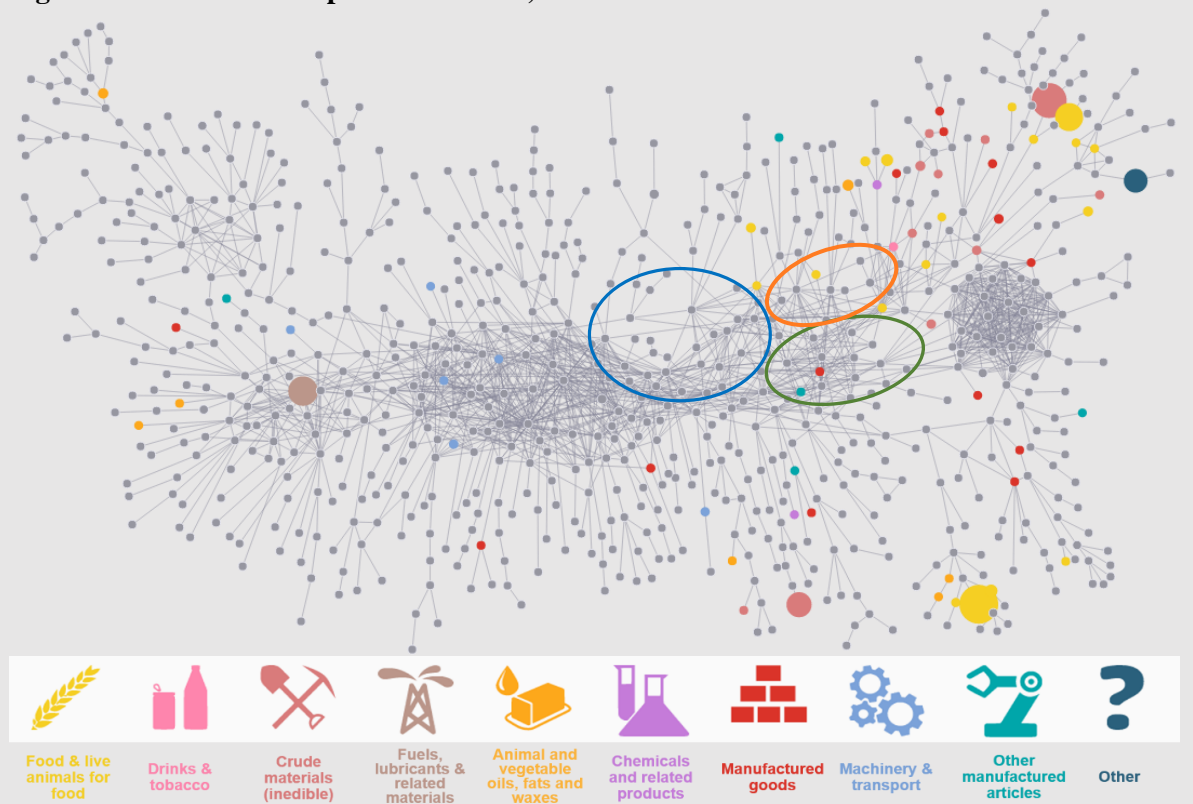
The structure and dynamic of the product space demonstrate that countries are more likely to develop and export a product that is close by the products that it already exports, which can be measured by the ‘distance’ between products (from similar to completely different capabilities, ranging from 0 to 1), suggesting path dependency of economic diversification (Hidalgo et al., 2007, and Hausmann and Hidalgo, 2011). To achieve higher levels of income, it is well established that countries must develop products that are more sophisticated (Imbs and Wacziarg, 2003). Identifying the strength of linkages between products helps both policymakers and the private sector to recognize where there may be opportunities to move into new products and/or sectors with a reasonable prospect of success.

As an example, the mapping for Rwanda is shown below, with highlighted nodes indicating exports with revealed comparative advantage and the size of nodes being proportional to total exports. Similar to neighboring countries, the major exports of Rwanda were food and animal products for food (coloured in yellow, e.g. coffee, tea, fruits and vegetables) as well as gold and ores exports (coloured in dark blue and rose), located in the top and bottom right corners of the product space. There were several manufactured exports (coloured in red, e.g. cement, leather and fabrics), yet they were scattered and located on the outer edges of the product space. The weakly connected peripheral products suggest a challenging situation for Rwanda to expand its exports to more complex and closely connected products in the core.

The key insight of the product space is that countries diversify by leveraging the existing productive capabilities to develop related products, in particular clusters of related products rather than scattered goods. Based on the current product landscape in Rwanda, it is advisable to transform local agricultural outputs into related products of higher complexity. The first major group is processed agricultural products, such as cheese, preserved meats, jams and cereal grains, highlighted in the orange circle. Secondly, it is recommended to consolidate the emerging industry of metal and wood articles, including packing containers, cask and drums, as well as construction materials like iron bars, builders' carpentry and electric wire, highlighted in the green circle. To further push the productive boundary to more complex clusters, chemical products, such as medicaments, certain polymers and agrochemicals, highlighted in the blue circle, represent an enormous opportunity, especially in the regional market (Hausmann and Chauvin, 2015). Despite different criteria and

methodologies, the products largely match those identified in Rwanda’s National Export Strategy and Domestic Market Recapturing Strategy (MINICOM, 2015a and 2015b).

**Figure 35: The Product Space of Rwanda, 2016**



Source: CID, 2018.

To formulate a comprehensive export strategy, however, it is crucial to take into account the regional context. Within the EAC, our study finds a notable degree of complementarity in the exports of Partner States, indicating that countries could benefit from production operating at a regional level with better regional value chains. As part of a larger economic bloc, new product development is much more feasible. In fact, deeper regional integration has the potential not only to create opportunities for new product development, but can also enhance the competitiveness of existing industries. Specifically, our analysis highlights the potential of agro-processing products, textiles and chemical products, which are generally in line with the strategic regional industries discussed in the EAC Industrialization Strategy 2012-2032 (EAC, 2012).<sup>66</sup> While there are various ways to select the strategic industries that meet the developmental objectives, it is clear that the enhancement of productive capabilities and the larger market of the EAC have compelling implications for regional integration and its benefits.

Source: Si Tou, 2018.

<sup>66</sup> Iron-ore and other mineral processing, fertilisers and agrochemicals, pharmaceuticals, petro-chemicals and gas processing, agro-processing, and energy and bio-fuels were identified as the six strategic regional industries.

## Part II: Creating a Continental Market

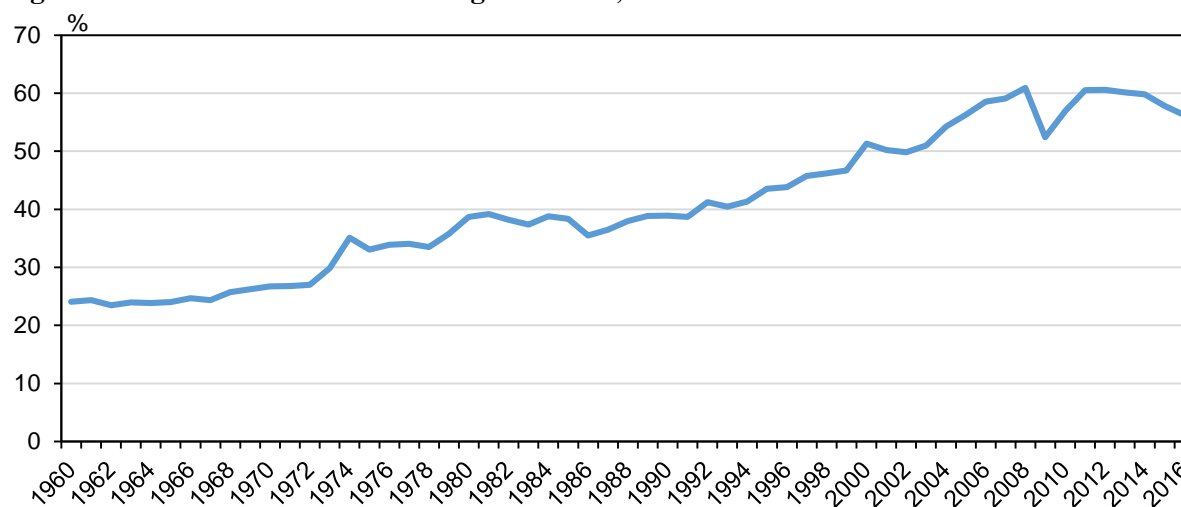
The first part of the thematic study highlights the importance and opportunity of domestic markets in the region. To harness the opportunity of domestic markets and build a stronger Africa, the implementation of the AfCFTA, which creates an integrated market for goods and services, as well as a customs union that enables free movement of people and capital, is an essential step. The creation of a continental market could facilitate economic and social integration among African countries. This is particularly important as regional ties would be more resilient if the trade protectionism and de-globalization process materialized (Arestis et al., 2011).

### II.1. Empirical Studies of the Impact of Trade Liberalisation

#### II.1.1. How Does Trade Grow? Multilateral vs. Regional Processes

Stylized fact is that trade growth globally was far in excess of GDP growth up until 2008. World trade as a share of GDP increased by a factor of three from 1960 to 2008 (Figure 36). However, trade growth declined significantly subsequent to the global financial crisis, and in the seven years following the financial crisis did not manage to keep pace with even the slow rate of economic growth in the recovery period (2010-2016).<sup>67</sup> At a time when the global trade regime is increasingly being challenged, and Africa is proposing to move forward with its own process of regional trade liberalisation under the umbrella of the AfCFTA, it is important to be cogent about what the literature tells us about the likely consequences.

**Figure 36: Global trade as a share of global GDP, 1960-2016**



Source: WDI (2018).

Although the extent to which this holds true for African economies has been challenged (Fosu and Mold, 2008), economists generally agree that tariffs and import quotas reduce economic welfare and that trade liberalisation is generally welfare improving. However, there has been much discussion in the literature about how trade liberalisation leads to faster growth of trade. A study by Rose (2004) estimated the effect on international trade of multilateral trade agreements: the World Trade Organization (WTO), its predecessor the Generalized Agreement on Tariffs and Trade (GATT), and

<sup>67</sup> In 2017, in a sign that global trade growth may be returning to the historical norm, global trade recorded its highest growth rate in six years, both in volume and value terms. Trade volume, driven primarily by cyclical factors, grew by 4.7 per cent, which was greater than the 3.0 per cent growth in global GDP (WTO, 2018).

the Generalized System of Preferences (GSP) extended from rich countries developing countries<sup>68</sup>. Contrary to orthodox opinion, the study found that multilateral liberalisation under the GATT/WTO had not had a significant impact on trade patterns.<sup>69</sup> Subsequent studies have challenged Rose's results and found positive effects of the WTO. For example, Subramanian and Wei (2005) found that membership of the WTO increased world trade by as much as 120 per cent of additional world trade. They did however concede that the impact was uneven, with industrial countries benefiting more than the developing countries. Additionally, sectors that did not liberalise did not see an increase in trade. Kim (2010) analysed the effects of the WTO on only the sectors that were covered by the agreement. The study find that the GATT/WTO's increased trade by approximately 30 per cent for member countries.

Other authors have challenged the idea that the increase in trade flows has been driven predominantly by multilateral liberalisation. Chortareas and Pelagidis (2004) examined the evidence of the extent of globalisation by focusing trade flows. Using both descriptive indicators and formal analysis of convergence, they found that the degree of openness converges faster across the countries of a given region rather than at the global level. They concluded that trade integration was more of a 'regional' phenomenon than a 'global' one. Arestis et al. (2011) also analysed the relative effects of globalisation and regionalism. They found that in the 1990s and the 2000s globalisation outpaced regionalism. However, the effects of regionalism remained resilient. The findings from these studies suggest that trade is achieved essentially through regional process like the AfCFTA, and not through multilateral or unilateral processes.

### **II.1.2. Competing Methodologies: Econometric vs. Computable General Equilibrium Simulations**

There are a variety of tools used by economists to measure the effect of trade policy and these include ex-ante simulation models (either partial or general equilibrium approaches) and ex-post econometric estimation models. Ex-ante simulation involves simulating the effects of a trade policy change onto a set of economic variables of interest, while ex-post approaches use econometrics and historical data to conduct an analysis of the effects of past trade policy.

Computable general equilibrium (CGE) are among the most widely used methodology for an ex-ante assessment of the future effect of trade policies (usually used during multilateral or regional market access negotiations). CGE models are computer-based simulations, like experiments. They compute how today's economy will look in the future as a consequence of a specified set of policy changes. Gravity econometric estimation models are widely used for ex-post assessment of trade policy, they are useful for understanding the drivers of trade and for assessing the trade effects of certain trade policies, such as the effect of the signing of preferential trade agreements.

The results of trade policy analysis can, therefore, vary depending on the choice of model, the structure of the model and data. The empirical literature has shown that CGE simulation models tend to show relatively small effects of trade policy. This was something observed by Fosu and Mold (2008), who noted a gradual secular decline in the magnitudes of welfare estimates produced by CGE models from trade liberalisation. This was partly due to i) more comprehensive models and databases, ii) the inclusion of existing preferential market access schemes within the modelling framework, and iii) preference erosion. For Africa, in particular, Fosu and Mold (2008) argued that the tangible benefits from further multilateral liberalisation were likely to be quite meagre. Therefore, the main advantage of CGE models is that they offer a rigorous and theoretically consistent framework for analysing trade

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<sup>68</sup> Rose's study used a standard gravity model of bilateral merchandise trade and a large panel data set covering over fifty years and 175 countries.

<sup>69</sup> Rose's results did however suggest that the GSP had a strong significant positive effect on trade, leading to an approximate doubling of trade.

policy questions. But it is also argued that the numbers that come out of the simulations should only be used to give a sense of the order of magnitude that a change in policy can mean for economic welfare or trade (Piermartini and Teh, 2005).

Gravity models, by contrast, explain and measure the effect on trade flows of a policy that has already been implemented. Unlike CGE models, they are not used to predict the impact of introducing a new policy. Head and Mayer (2014) carry out a meta-analysis of papers (159 papers) and provide estimates for the most frequently used variables in gravity equations, including policy-relevant ones (Table 12).

**Table 12: Estimates of typical gravity variables**

	All Gravity				Structural Gravity			
	Median	Mean	s.d.	#	Median	Mean	s.d.	#
Origin GDP	0.97	0.98	0.42	700	0.86	0.74	0.45	31
Destination GDP	0.85	0.84	0.28	671	0.67	0.58	0.41	29
Distance	-0.89	-0.93	0.4	1,835	-1.14	-1.1	0.41	328
Contiguity	0.49	0.53	0.57	1,066	0.52	0.66	0.65	266
Common language	0.49	0.54	0.44	680	0.33	0.39	0.29	205
Colonial link	0.91	0.92	0.61	147	0.84	0.75	0.49	60
RTA/FTA	0.47	0.59	0.5	257	0.28	0.36	0.42	108
EU	0.23	0.14	0.56	329	0.19	0.16	0.5	26
CUSA/NAFTA	0.39	0.43	0.67	94	0.53	0.76	0.64	17
Common currency	0.87	0.79	0.48	104	0.98	0.86	0.39	37
Home	1.93	1.96	1.28	279	1.55	1.9	1.68	71

Source: Head and Mayer (2014).

Note: The number of estimates is 2,508, obtained from 159 papers. Structural gravity refers here to some use of country fixed effects or ratio-type method.

Gravity models on Africa tend to give larger effects of regional trade agreements. As a region whose external trade is still dominated commodity exports, Africa is chronically under-trading with itself. A meta-analysis by Afesorgbor (2013) conducted on 159 previous empirical studies of African countries using the gravity model found an even stronger positive effect on intra-regional trade (with a mean elasticity of 0.8 compared with 0.59 in the results in the previously cited paper by Head and Mayer). Add on the lack of infrastructure, the non-tariff barriers and the like, and it is thus not surprising that the results of these studies are so large in magnitude compared to other methodologies.

Should such large discrepancies from different modelling methodologies worry us? No, they are to be expected in such exercises. For instance, CGE studies on the effect of the European single market and the North American free trade treaty (NAFTA) show variations in the estimated impact of regional integration. The Cecchini Report (1988) estimated total benefits of the European single market from removing barriers to trade, technical barriers, economies of scale and competition to range from 5.8 to 6.4 per cent of GDP. Gasiorek et al. (1992), Haaland and Norman (1992) and Baldwin (1992) estimated that the European Single Market Programme would improve welfare by 1.2 per cent, 0.5 per cent, and 0.3 per cent respectively.

Studies on NAFTA by Brown (1992) estimated welfare effects that varied from 1.6 per cent, 0.1 per cent and 0.7 per cent for Mexico the USA and Canada. Bachrach and Mizrahi (1992) estimated welfare effects of 0.32 per cent and 0.02 per cent for Mexico and the USA. The anticipated welfare gains from these studies were clearly small.<sup>70</sup> As Krugman (1993) made the point at the time, any benefits from

<sup>70</sup> These CGE studies were extensively cited in the early 1990s to support the case for NAFTA. But the results were very wide of the mark in terms of underestimating the rate of export growth between Mexico and the United States (Kehoe, 2003).



NAFTA were likely to be marginal, particularly in terms of job creation. Few studies indicate that NAFTA could add much more than 0.1 per cent to U.S. real income.<sup>71</sup> Some authors (e.g. Schiff and Winters, 2003) have even insisted that ‘North-South’ agreements like NAFTA are fundamentally better than ‘South-South’ agreements, essentially because a North-South Agreement allows the low income economy to specialise more in sectors where it has a comparative advantage, along Heckschler-Ohlin lines, in primary commodities, agriculture and low-tech manufacturing, allowing the higher-income partner to specialise more on technologically more advanced sectors in manufacturing and services. Schiff and Winters (2003: 70) actually claim that “*the same basic forces therefore mean that regional integration between rich countries causes their incomes to converge, whereas integration between poor ones causes divergence.*”

Such arguments, product of a static rather than a dynamic approach to comparative advantage (Lin and Chang, 2009), are not born out empirically. Thus, for instance, returning to the case of NAFTA, the end results for Mexico were deeply disappointing – although the export structure of Mexico diversified very significantly under NAFTA, the aggregate impact on welfare and employment were deeply disappointingly, with almost stagnant per capita income growth in the decade following the signing of NAFTA. Contrary to the arguments of Schiff and Winters, NAFTA actually ended up undermining Mexican industry, because it locked the country into buying high cost intermediate products from the United States, rather than purchasing those products from lower cost suppliers in Asia and elsewhere (Mold and Rozo, 2005).

It is also worth stressing the discrepancies between the *ex-ante* and *post-hoc* studies. Landau (1995) examined the impact of the European Common Market on the growth of its member countries, using econometric regression models. The study found that there had not been a statistically significant difference between the growth of European Common Market countries and the non-member developed market economies. By contrast using a gravity model, Mayer et al. (2018) studied the effects of the European single market over the period from 1950 and 2012, and showed the single market increased trade between EU members by 109% on average for goods and 58% for tradable services.

To sum up, the results of trade policy analysis will crucially depend on the choice of model, the assumptions the model and data. It is nevertheless important that such exercises are undertaken to have a better understanding of the potential implications. So far, however, the AfCFTA is under-researched in terms of impact evaluation. Mevel and Karingi (2012) explore the effects of the African continental free trade area using the dynamic MIRAGE CGE model to study the potential effects of the AfCFTA. They found that the AfCFTA would increase intra-African trade, by 52.3 per cent (or \$34.6 billion). A study by UNCTAD (2017a) estimates the costs and benefits of tariff reduction under the AfCFTA under a scenario that assumes that all tariffs will be fully eliminated in the AfCFTA. The study finds substantial welfare gains of about US\$ 16.1 billion, even after deducting US\$ 4.1 billion of tariff revenue losses for all African countries.

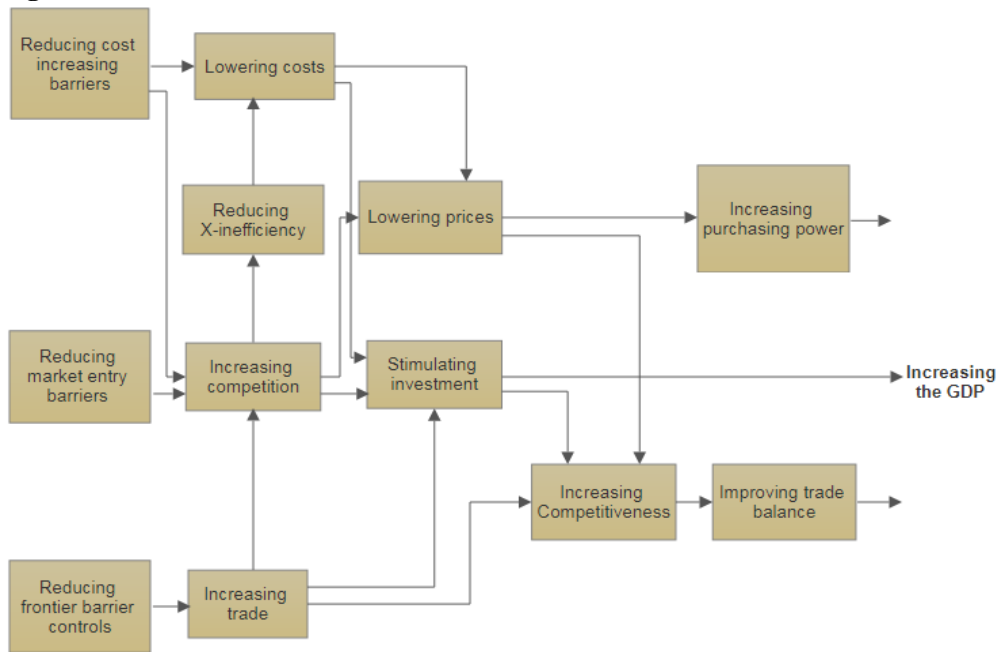
A stylized way of portraying these benefits from the implementation of the AfCFTA is shown in Figure 37. These benefits are expected to stem principally from the removal of tariff and nontariff barriers to both goods and services produced in Africa. However, it would be wrong to neglect the ‘phase 2’ effects – the reduction or elimination of obstacles to the free movement of labour and capital will reduce market entry barriers, leading to an increase in competition and firm efficiency. The associated harmonisation of regulations and technical standards would reduce the price of goods manufactured in Africa. Finally, the overall reduction in supply-side costs would lead to a boost in aggregate demand by increasing

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<sup>71</sup> Why were the estimated gains so small? First, the United States and Mexico had already moved a considerable way to free trade in advance of NAFTA, so the improvement brought about by the agreement was incremental. Secondly, Mexico’s economy was less than 4 per cent the size of the US GDP, so it was evident that such an agreement would have a limited impact on the US economy (Krugman, 1993).

purchasing power, investment and improving the competitiveness of the African firms relative to the rest of the world.

**Figure 37: Effects of the AfCFTA on GDP**



Source: UNECA (2018e).

### II.1.3. How Much is the East African Community Currently Under-trading?

Based on a gravity model using a stochastic frontier approach, EAC members bilateral export flows performances were examined for this report. The gravity framework is given as:

$$\ln Y_{ijt} = \ln f(X_{jt}, \beta) \cdot \exp^{(V_{it} - U_{it})}$$

where  $i$  denotes the EAC member (exporter),  $j$  denotes the partner country (importer) in year  $t$ . The gravity stochastic frontier model is composed of a deterministic component  $f(X_{jt}, \beta)$  common to all exporters and a random component  $(V_{it} - U_{it})$  specific to exporters. In the deterministic part, the term  $Y_{ijt}$  represents the observed bilateral export from an EAC member  $i$  to a partner country  $j$  in year  $t$ . The potential bilateral exports are a function of a vector of variables  $X_{jt}$  (e.g. distance and GDP);  $\beta$  is a vector of unknown parameters to be estimated.  $V_{it}$  is a double-sided statistical error term to account for error measurement, omitted relevant variables in the regression and errors from the choice of the functional form.  $U_{it}$  is associated with trade inefficiency and is assumed to be one-sided, non-negative and truncated at zero.

The stochastic frontier analysis framework has the advantage of measuring the corresponding trade inefficiency across EAC members with their partners over time. Trade efficiency is calculated by taking the ratio of observed exports to the corresponding efficient (maximum achievable) exports on the frontier function:

$$\text{TradeEfficiency}_{ijt} = \frac{Y_{ijt}}{Y_{ijt}^*}$$

where  $Y_{ijt}$  and  $Y_{ijt}^*$  are respectively the actual (observed) and potential (maximum or efficient) export amounts.

The results, in the tables below, show that for all EAC countries actual intra-EAC and intra-African trade flows were significantly below the potential trade estimated by the gravity model. Intra-EAC trade could increase by 95 per cent if it were to reach its maximum potential, while intra-African trade could increase by 79 per cent. Thus the two agendas are mutually reinforcing – potential intra-EAC trade

could be enhanced by deepening of regional integration within the EAC, while the potential intra-African trade can be boosted by the formation of the AfCFTA.

**Table 13: Gravity model regression results**

	Burundi	Kenya	Rwanda	Tanzania	Uganda
Ln (Distance)	-1.11***	-2.23***	-1.12***	-2.08***	-1.46***
Ln (GDP_Exporter)	1.17***	-0.22	1.26***	-0.03	0.74***
Ln (GDP_Importer)	0.54***	0.69***	0.69***	0.73***	0.64***
Ln (Population_Exporter)	-4.08***	1.87***	-2.51***	1.17	-1.37***
Ln (Population_Importer)	0.19*	0.05	0.13	0.15*	0.13
Constant	45.13***	-10.27	15.14*	-7.48	15.25***
Sigma_U	2.52***	1.86***	2.29***	2.03***	2.31***
Sigma_V	0.98***	0.67***	1.34***	0.83***	0.84***
Lambda	2.56***	2.76***	1.71***	2.45***	2.75***
Theta	1.74***	1.61***	1.81***	1.52***	1.66***

Note: Sigma\_V is the variance due to random effects, Sigma\_U is the variance due to exporter specific variability, Lambda is the ratio between Sigma\_U and Sigma\_V. Lambda tests whether exporter specific inefficiencies play an important role in achieving the maximum on the frontier model. Theta tests whether the efficiency is improving over time.

**Table 14: Exports potential of EAC members in 2016**

	To the EAC			To Africa		
	Actual exports (A)	Potential exports(B)	Ratio % (C)	Actual exports (A)	Potential exports(B)	Ratio % (C)
Burundi	10	16	71	21	34	66
Kenya	1,260	2,430	93	2,860	5,270	84
Rwanda	108	171	58	219	345	58
Tanzania	626	1,640	162	1,588	3,330	110
Uganda	666	947	42	1,441	2,007	39
<i>Total</i>	<i>2,670</i>	<i>5,204</i>	<i>95</i>	<i>6,129</i>	<i>10,986</i>	<i>79</i>

Note: A is actual (observed) exports (in millions USD); B is potential (maximum) exports (in millions USD), and C is the ratio between B and A (i.e.  $((B/A)-1)*100$ ).

## II.2. Unleashing the Full Potential of Regional Trade and Industrialization

*The AfCFTA could provide a significant boost to the industrialization and diversification of African economies.*

An alternative methodology, as discussed in previous section, is to use a CGE approach. Based on UNECA's recent empirical assessment of the AfCFTA using the MIRAGE model<sup>72</sup>, the value of intra-African trade is estimated to increase by a range of 15 per cent and 25 per cent, depending on the ambition of the liberalization.

Specifically, for the intra-African trade in industrial products, the increase would range between 25 per cent and 30 per cent, with textile, apparel, leather, wood and paper, vehicle and transport equipment, electronics and metals benefiting the most from the AfCFTA. This is especially important because manufactured goods account for around half of intra-African exports, in stark contrast to exports of mainly unprocessed primary commodities to the rest of the world. Greater intra-regional trade in intermediate manufactured goods offers scope for the development of RVCs. Meanwhile, countries with more advanced manufacturing sectors are expected to benefit significantly from the resultant trade. In this regard, the AfCFTA could provide a significant boost to the industrialization and diversification of African economies. It also allows consumers to access a greater variety of product at lower prices and firms to access a large continent market and gain from economies of scale.

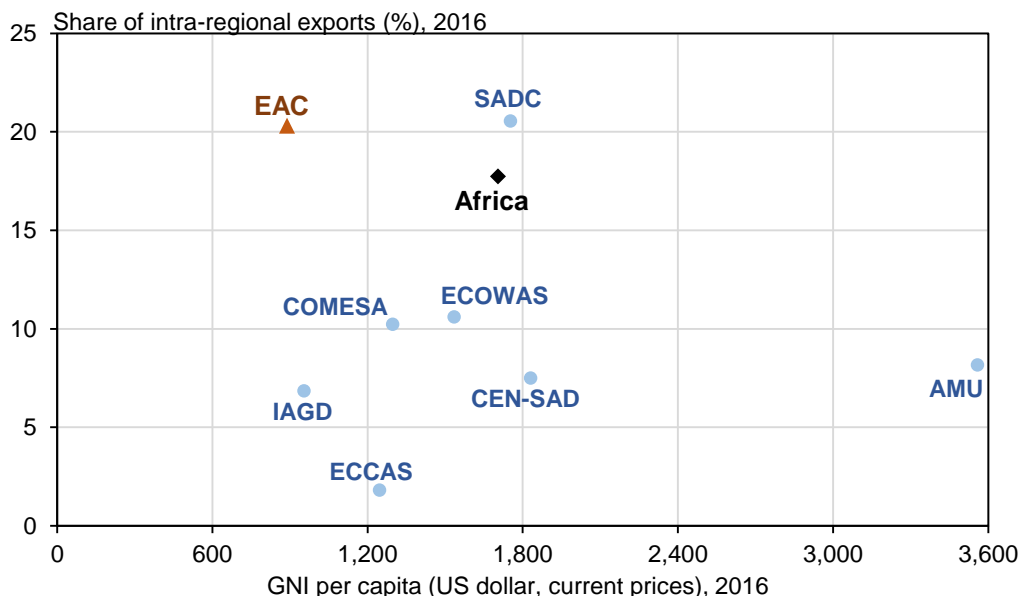
Regarding the intra-regional trade, the EAC has one of the highest shares among the major Regional Economic Communities (RECs) in Africa, despite its much smaller economic size (Figure 38). Moreover, according to the composite indicator of progress towards regional integration in Africa, the EAC is the top performing REC, with a distinctively high score in trade integration (ARII, 2018). Thus, it is not surprising that EAC Partner States have closer trading relations with African countries partly due to the integrated intra-EAC trade (Figure 39). Specifically, Uganda and Kenya stand out in terms of the share of exports to Africa, largely driven by the significant exports to other EAC Partner States. Uganda, in particular, has increased its share of exports to Africa, from around 30 per cent in early 2000s to more than 50 per cent between 2015 to 2017. Having said that, the share of imports from Africa has been declining over the past decade, especially for Uganda and Tanzania which dropped from around 40 per cent and 22 per cent in early 2000s to less than 20 per cent and 10 per cent between 2015 and 2017 respectively, partly due to a sharp rise in imports from the developing countries in Asia.

*EAC Partner States have closer trading relations with African countries partly due to the integrated intra-EAC trade.*

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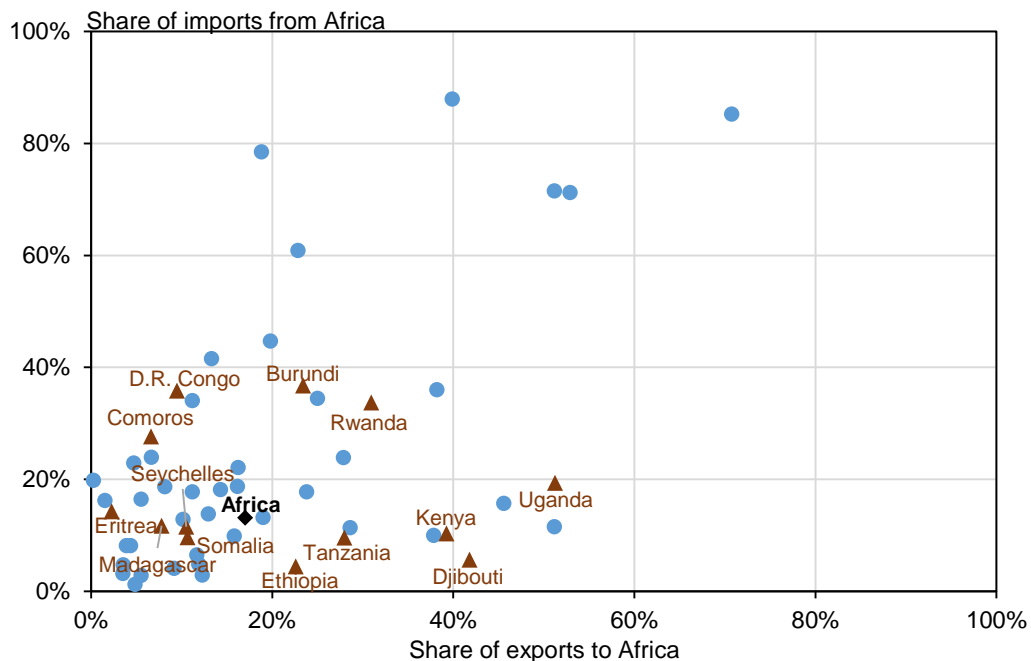
<sup>72</sup> Based on the dynamic multi-country multi-sector MIRAGE CGE model, relying mainly on the global trade analysis project (GTAP) version 9.2 database and the Market Access Map database with tariff information at the harmonized system 6-digit level of products (MAcMap-HS6).

**Figure 38: Share of intra-regional exports vs GNI per capita, 2016**



Source: UNCTADStat (2018).

**Figure 39: Share of trade flows with Africa, 2015-2017 average**



Note: Countries in the region are marked in triangle and other African countries are represented by circle.  
Source: UNCTADStat (2018).

*The continental market is complimentary to regional integration efforts.*

In fact, the continental market is complimentary to regional integration efforts. The EAC faces much higher tariffs on exports to other parts of Africa compared to exports outside the continent (Table 15). While the average applied tariff rates of EAC exports to the rest of Africa was 6.0 per cent in 2014, it was much higher in some cases. For example, the average applied tariff on EAC exports to Ethiopia reached an average of 16.5 per cent, revealing significant room for further trade liberalization within Eastern Africa. Regarding the distribution of tariffs by product, processed foods and light manufactured goods had the highest trade tariffs (Table 15). The sectoral distribution of tariffs is of great concern to African manufacturing prospects as it has significant negative implications on the development of the sector given the relatively high shares of

processed foods in manufacturing for most African countries and the important backward linkages of the processed food sector to the agricultural sector.

**Table 15: Applied tariffs on EAC exports of goods, 2014**

(%)	EAC	The rest of Africa	Ethiopia	Asia	EU	North America
Processed food	0	15.1	26.9	8.3	0	1.9
Light manufacturing	0	8.6	23.2	1.8	0	0.6
Meat and livestock	0	6.2	13.6	0.6	0	0.2
Textiles and apparel	0	4.9	23.4	4.2	0	0.5
Heavy manufacturing	0	4.2	13.8	1.0	0	0.1
Grains and crops	0	1.8	7.0	7.6	0	0.1
Extraction	0	1.1	7.6	0.2	0	0.0
<i>Average</i>	<i>0</i>	<i>6.0</i>	<i>16.5</i>	<i>3.4</i>	<i>0</i>	<i>0.5</i>

Source: Author calculations based on GTAP 10.0 database.

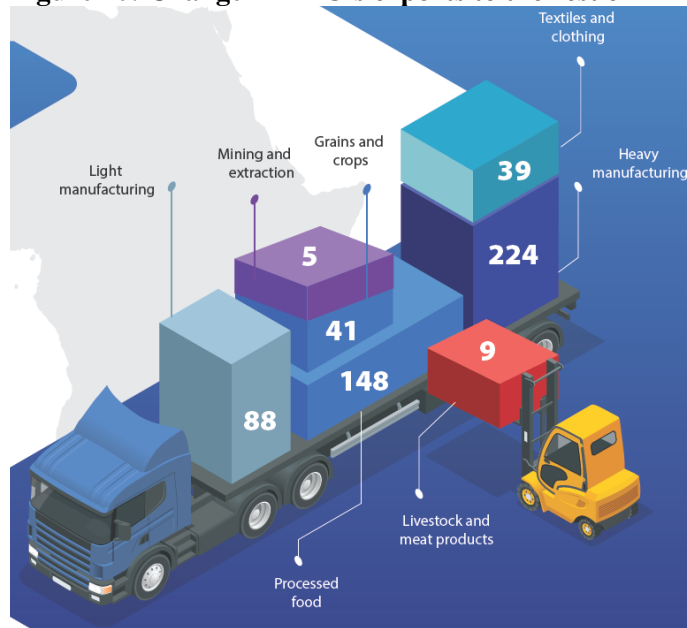
How would the implementation of the AfCFTA help this situation? Based on a computable general equilibrium model (GTAP), and simulating the removal of the existing tariffs on all intra-African trade, our office's preliminary simulation work<sup>73</sup> suggests that the AfCFTA could boost the integration of the EAC economy into the wider African economy, with an increase of EAC exports to the rest of Africa by 33 per cent. The beneficiary sectors would principally be the employment-intensive manufacturing sectors such as manufacturing, processed food and textiles (Figure 40). As for the effect of the full removal of intra-African tariffs on individual country, Uganda and Tanzania would have larger boost in exports to the rest of Africa, especially for processed food and manufacturing products.

Similarly, for Eastern Africa<sup>74</sup> as a whole, the AfCFTA would boost its exports to the rest of Africa by around 31 per cent, with the processed food and heavy manufacturing being the main beneficiary sectors. While the AfCFTA will boost intra-regional trade, it will not necessarily have a significant effect on the overall trade balance of the Africa region (increased intra-regional exports will imply of course increased intra-regional imports). Nonetheless, the AfCFTA will boost competition and firm efficiency in Africa. Through increased regional trade, the region will thus build stronger firms and industries, which will be able to better compete in global markets. We should also note that, unlike Mevel and Karingi (2012), our simulations do not include any allowance for accompanying measures to remove non-tariff barriers – in their study, Mevel and Karingi find that the impact of the AfCFTA on intra-African exports is doubled if measures are implemented to reduce non-tariff barriers.

<sup>73</sup> For our simulations, the GTAP 10.0 database is used, which describes global bilateral trade patterns, production, consumption and intermediate use of commodities and services. The underlying data in the GTAP 10.0 database refers to a 2014 baseline. The model closure determines which variables are exogenous and which are endogenous. Endogenous variables have values that are determined within the model. The exogenous variables have values that are fixed at their initial levels and do not change when the model is solved. Because there is no theoretical framework for choosing between different closures, the choice of closure needs to be guided by the structure of the economy under investigation. In this study, the standard GTAP closure with the exception of allowing for capital mobility and fixing wages of unskilled labour in Africa (i.e. to reflect the high levels of un- and under-employment that characterise African labour markets) is employed. The model is run using a regional aggregation which includes the standard regions within the GTAP model, plus the EAC region which comprises of Kenya, Rwanda, Tanzania and Uganda (Burundi could not be included as there is no underlying data in the GTAP database. While Burundi only represents around 2 per cent of the regional economy, it is unlikely that its exclusion would impact significantly on the results. South Sudan was not considered in the analysis) and a 'Rest of Africa Region' which includes all the non-EAC African countries. The figures cited in the simulation are not directly comparable to the CGE studies discussed in the previous section due to the use of different CGE models, closures and scenarios adopted.

<sup>74</sup> Eastern Africa refers to Burundi, Comoros, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Mayotte, Rwanda, Seychelles, Tanzania, Uganda, Somalia and Sudan based on the 2014 dataset in GTAP.

**Figure 40: Change in EAC’s exports to the rest of Africa by sector (USD million)**



Source: Author calculations based on GTAP.

Regarding the concerns about tariff revenue losses due to the AfCFTA, our preliminary estimates suggest that the tariff losses would be modest (Table 16). Average revenue losses are less than 1 per cent of total government revenues. Moreover, the tariff revenue losses in the short-run should not be understood as absolute losses but as redistribution of income from governments to consumers and producers (i.e. lower taxes paid by domestic consumers and exporters). The loss of revenues may be construed as a small price to pay for the wider economic benefits accruing from the implementation of the AfCFTA.

**Table 16: Summary results of tariff revenue losses**

	Tariff revenue loss (USD million)	As a share of total tariff revenue	As a share of total government revenue	As a share of GDP
Ethiopia	61	6.1%	0.7%	0.1%
Kenya	67	3.2%	0.6%	0.1%
Madagascar	2	0.7%	0.1%	0.02%
Rwanda	6	4.0%	0.3%	0.1%
Tanzania	91	6.2%	1.3%	0.2%
Uganda	23	8.4%	0.6%	0.1%

Source: Author calculations based on GTAP 10.0 database.

*The development of regional markets and RVCs provide significant opportunities for growth as consumer markets across Africa develop rapidly.*

The development of regional markets and RVCs provide significant opportunities for growth as consumer markets across Africa develop rapidly. It also gives domestic firms the opportunity to learn, meet the products standard, upgrade and achieve international competitiveness, thus facilitating the entry into global networks (Slany, 2017). This again reinforces the importance of implementing the AfCFTA and removing

both tariffs and non-tariff barriers.

In short, the AfCFTA could open the way to Africa's economic transformation to dynamically-diversified economies via unlocking the opportunities for intra-African trade and the potential of industrialization. Given that intra-African trade accounts for a much larger share of growth in Africa's valued-added and industrialized exports than other market, the AfCFTA could help pivot Africa's trade away from extractive

exports towards more sustainable and inclusive trade that is less dependent on the fluctuations of commodity prices and has a stronger impact on development than other types of trade (UNECA, 2018c). While trade as a means of development is also viewed as an important pathway out of poverty, the gender dimension of trade liberalization should not be neglected (Box 11). Looking forward, further to the signing and ratification of the AfCFTA, a crucial next step for country is to develop an AfCFTA 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.

*The AfCFTA could open the way to Africa's economic transformation to dynamically-diversified economies via unlocking the opportunities for intra-African trade and the potential of industrialization.*

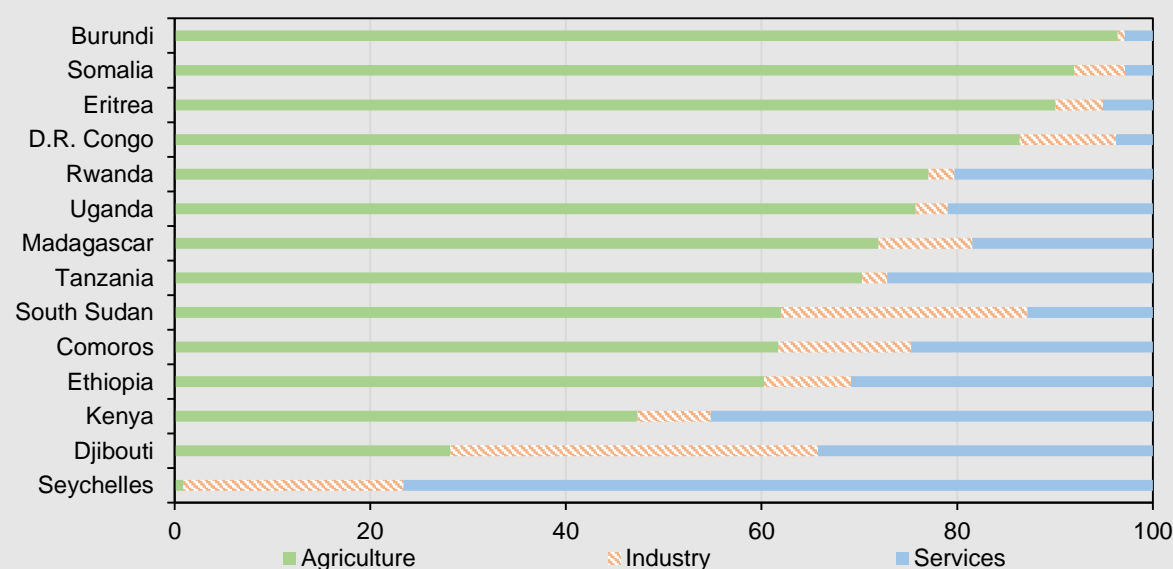


### Box 11: How East Africa Could Use the AfCFTA to Tackle Gender Inequality

Economies with better opportunities for women are more competitive and will benefit more from openness than economies that are less ‘friendly’ to female involvement in the economy (ITC, 2015). Increased female income is likely to be disproportionately spent on the well-being and education of children. As a result, women’s income has a direct impact on reducing income inequality and on future growth through its impact on education. On the road to attaining the SDGs and implementing the AfCFTA, African countries should work with the foresight and determination to guarantee an AfCFTA rid of discrimination against women.<sup>75</sup>

Benefits from trade liberalization are usually characterised as inclusive, without sufficient consideration of gender dimensions. An assumption that benefits accrue to both women and men can no longer hold, especially as Africa strives towards Agenda 2063 and other development aspirations. It is thus important at every step of implementing the national and continental visions to ensure that all citizens benefit.<sup>76</sup> African women are more economically active as farmers and grow most of Africa’s food (AfDB, 2015). As Eastern Africa’s economic growth is driven largely by agriculture and services (UNECA, 2018), it is especially important to deepen analysis and explore the gender dimensions in these two sectors. In 2012, a UN Task Force found that yields on women’s farms in developing countries would grow by 20 to 30 per cent, total agricultural output would increase by 2.5 to 4 per cent and the number of people suffering from hunger would decrease by 12 to 17 per cent if female farmers had the same access to productive resources as men. Similarly, FAO (2011) argues that if women were given same resources as men, they could increase yields by 20 to 30 per cent on their farms. This could also result in increased trade volumes. While structural transformation of the economies may be taking place, women’s occupations in East Africa are still predominantly concentrated in the agriculture sector. Djibouti and Seychelles are the only countries employing more women in industry and services.

**Figure 41: Share of female employment in agriculture and services, 2016**



Sources: ILOStat database and National Bureau of Statistics of Seychelles.

<sup>75</sup> Higher wages for women are known to have spill over effects on the well-being of their family, including girl-children.

<sup>76</sup> Failure to adopt this inclusive approach threatens going against the SDG motto of leaving no one behind.

UNCTAD (2018a) recognises that agriculture remains the dominant sector of employment in the EAC for women, and that EAC integration and trade liberalization have shifted over time from agriculture to services in sectoral composition of female employment. Special focus on the gender-trade dynamics is particularly important now when the Continent awaits ratification of the AfCFTA. It becomes increasingly important for the AfCFTA to ensure linkages in the agricultural value chain. According to UNCTAD (2014), for example, in Rwanda it was found that women and men are not benefitting equally from trade gains, due to “a growing polarization in terms of employment whereby women are increasingly segregated in the less-dynamic, contracting sectors (by and large, informal and non-tradable), while men engage in the expanding sectors.”

Making a case for gender parity, McKinsey (2015) exploring a scenario in which women fully participate in the economy in the same manner as their male counterparts, found out that this change could result in a US\$ 28 trillion or 26 per cent annual global GDP growth by 2025. This is achievable just by bridging the gender gaps, allowing women to play an identical role as men in the labour markets. It further notes that increasing women’s labour force participation would account for 54 per cent of potential GDP increase.

UNCTAD (2018) has recently developed the *Trade and Gender Toolbox* to evaluate the impact of trade reforms on women to analyse the impact of the Economic Partnership Agreement on Kenyan women. Similar tools could be developed for the AfCFTA and ex-ante analyses carried out to ensure that AfCFTA is beneficial to women. There is also a need to support women traders through positive discrimination. One such example is the International Women’s Coffee Alliance (IWCA) which supports women in the coffee value chain – growers, exporters, roaster, buyers to achieve the best quality. The International Trade Centre (ITC) and other regional players have strengthened women entrepreneurship by improving women’s skills in ways that have boosted women’s confidence and allowed them to enter markets in their countries. The IWCA Uganda chapter for example, aims to “stimulate meaningful, sustainable and women-led economic growth in Uganda’s coffee sector as well as to unrestrict participation of women throughout the coffee value chain in Uganda and beyond.”

### II.3. Expanding Intra-African Agricultural Trade

Most African countries are experiencing rising food insecurity and undernourishment (FAO, 2018).<sup>77</sup> Some of the key factors explaining worsening food insecurity are attributed to climate variability resulting in lower rainfalls, droughts, floods and conflicts. Eastern Africa has not been spared. In 2017, Eastern Africa suffered a worrying level of undernourishment, with 31.4 per cent of the population or 132 million people experiencing food insecurity.<sup>78</sup>

Africa's status as a net food importer since the early 1980s is key to understanding food security in the region. In 2016, the continent imported US\$ 75 billion of food.<sup>79</sup> Even Eastern Africa, with large areas of arable land, has become food import dependent, with an average annual import growth of 11 per cent between 2005 and 2016 (compared to only 6 per cent between 1995 and 2004).

*Eastern Africa has become food import dependent with an average annual import growth of 11 per cent between 2005 and 2016.*

These trends reflect the fact that the level of food production per capita has not kept pace with population growth. And the trends do not seem to be getting any better. A 47 per cent decline in per capita cereal production in Eastern Africa has been projected between 2007 and 2030 (Funk and Brown, 2009). By shifting food supplies from food surplus regions to regions facing deficits, increased intra-African trade has emerged as a priority in enhancing African countries' food security.<sup>80</sup>

An important precondition for the structural transformation and diversification of African economies is attaining an agricultural transformation. This has been the historical experience of rapidly growing developing countries, such as China, Indonesia and Vietnam – an agricultural transformation preceded the take-off to rapid growth (Henley, 2012). The AfCFTA could facilitate this process by raising intra-African exports, increasing competitiveness and enhancing food security. Continental trade integration in agricultural commodities could have a growth-enhancing effect and improve the trade balance for countries that have an established competitive agricultural sector (De Schutter, 2009). This could lead to greater diversification in the agricultural sector.

*An important pillar in a strategy to promote structural diversification is to promote agro-processing through intra-regional trade under the AfCFTA.*

Agriculture products (mainly food items) currently account for a fifth of the total intra-African exports (Table 17). An important pillar in a strategy to promote structural diversification is to promote agro-processing through intra-regional trade under the AfCFTA. Africa exports have already shifted away from bulk crops to processed food products and horticultural products (IFPRI, 2018). The same arguments hold true here as they do for industrial goods, in so far as processed food is far more prevalent in intra-African trade than it is with commodities to the rest of the world (Figure 42).

<sup>77</sup> According to the latest FAO statistics, in 2017, Africa has the highest prevalence of undernourishment (20.4 per cent) in the world and almost 30 per cent of the world population exposed to severe food insecurity reside in Africa (FAO, 2018).

<sup>78</sup> FAO's report also finds that food security is worse in countries where agriculture is highly rainfall dependent and with high proportion of the population living of agriculture. This is the case in most of African countries where agriculture is a major economic activity, employing over half of the economically active population in 2014-17 (ILO, 2018) and providing livelihood to more than 60 per cent of the total population (Tomšik et al., 2015).

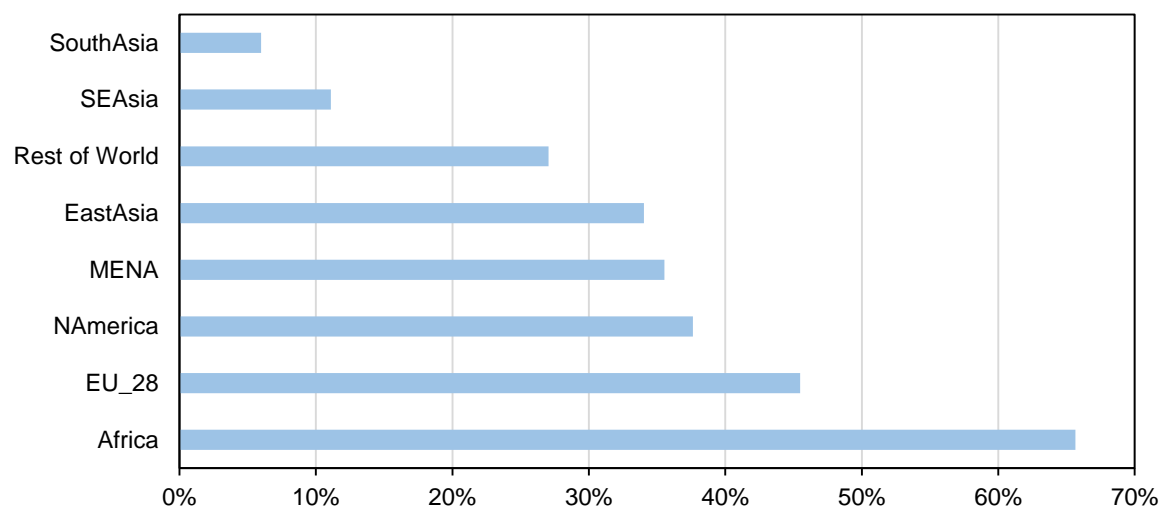
<sup>79</sup> Currently, the top food importers are Egypt, Algeria, Morocco, Nigeria and South Africa. Numerous of the products imported by these countries are also produced on the continent.

<sup>80</sup> This is true both at the sub-national level (e.g. Tigray from Oromo within Ethiopia) as well as at the regional (e.g. intra-EAC) and continental levels.

**Table 17: Intra-African exports**

	2000-02	2007-09	2014-16
All products (US\$ billion)	14.1	49.9	71.5
Share of intra-African exports in total exports	10%	11%	17%
All agricultural products (US\$ billion)	3.4	8.4	14.2
Share of agriculture exports in total intra-African exports	24%	17%	20%

Source: UNCTADStat (2018).

**Figure 42: Share of processed food in total African agricultural exports, by destination (2014)**


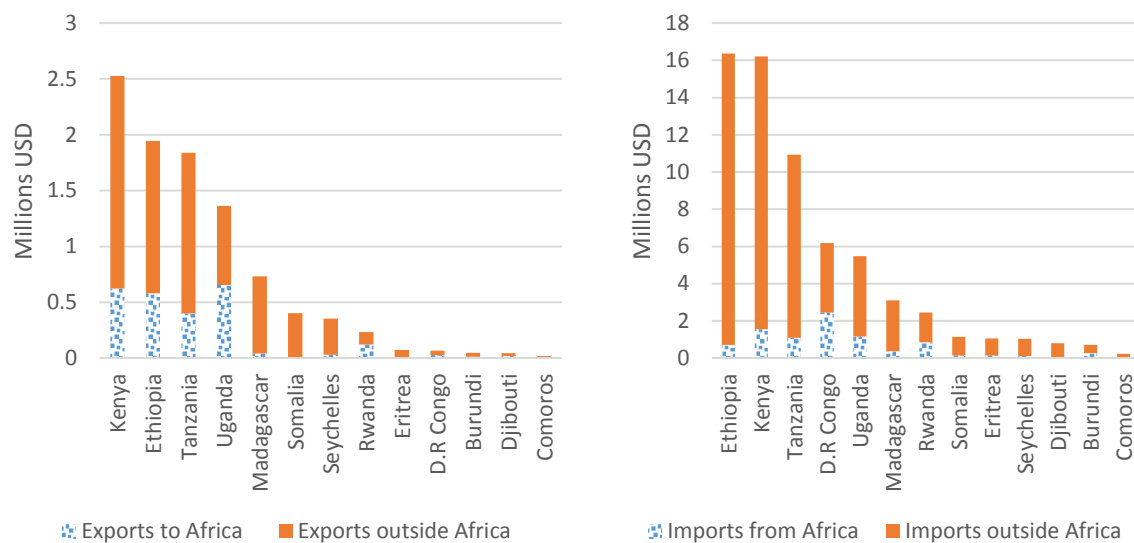
Source: Author calculations based on GTAP 10.0 database.

### II.3.1. The State of Agricultural Trade in Eastern Africa

The major intra-African agricultural exporters in Eastern Africa are currently Kenya, Ethiopia, Tanzania and Uganda. But smaller countries will also have a lot to gain. Figure 43 outlines some stylised facts about patterns of agricultural imports, with the largest importers being D.R. Congo, Uganda, Somalia, Eritrea and Burundi. Countries like Comoros, Djibouti, Burundi and Eritrea whose agricultural exports are less than US\$ 100 million (mostly destined to outside Africa) tend to import from African countries. Greater intra-African trade will bring greater benefits to the livelihoods of producers, consumers and traders in the region. In view of these imbalances and heterogeneities in trade patterns, it is evident that to further strengthen the intra-African trade, key challenges facing the exports of agricultural products should be addressed. These comprise the proliferation of import/export bans recently imposed by some countries or even the lack of policies in support to agriculture to facilitate trade and lowering trade costs.<sup>81</sup>

<sup>81</sup> For instance, Tanzania recently banned imports of poultry, which reportedly created shortages and raised retail prices from 2.8 USD to 4.5 USD per kg in Tanzania. Another example is that in 2017, maize production was excellent in Tanzania, but a ban was still maintained on maize grain exports. Maize prices were reported to be around 198 USD / ton in Tanzania while at the same period, a ton of maize cost over 400 USD in Kenya due to a shortage.

**Figure 43: Exports to and imports from Africa of food items, 2014-17 average**



Source: UNCTADStat (2018).

The region has a lot of potential to improve its intra-African trade. In Kenya, horticulture is the foremost food export of the country. Recent droughts in 2016/17 hindered agricultural productivity and the sector accounted for 15 per cent of the growth (AfDB, 2018). In Burundi, recent restrictions on coffee and tea exports have put downward pressure on the economy. These two crops account for almost 80 per cent of total exports. The major export crops of Rwanda are also tea and coffee, both of which benefited from higher international prices in 2016. In Comoros, vanilla employs about 45 per cent of the labor force and accounts for 80 per cent of exports (the second largest producer in the world). The recent rise in market prices of vanilla from US\$60 in 2014 to US\$400–\$500 in 2017 has given more trade opportunities to expand exports.

Eastern African countries exports of higher value agricultural products are growing. A focus on intra-African trade is vital for expanding overall exports and increasing the returns from agriculture. Agricultural products face about 60% higher tariff rates in Africa than in other parts of the world (Fukase and Martin, 2017). This clearly reduces agricultural trade among African countries. Reducing trade barriers facing Africa export and imports is critical to improve the productivity of the sector especially for higher value agriculture.

*Agricultural products face about 60% higher tariff rates in Africa than in other parts of the world. This clearly reduces agricultural trade among African countries.*

**Table 18: Categories of food items imported from and exported to Africa for selected Eastern African countries (2014-2016)**

USD million	Exports to Africa				Imports from Africa			
Countries	Food and live animals	Beverage and tobacco	Oil seed and oleaginous fruits	Animal and vegetable oils, fats and waxes	Food and live animals	Beverage and tobacco	Oil seed and oleaginous fruits	Animal and vegetable oils, fats and waxes
Burundi	8.3	4.9	0.0	0.0	34.5	7.4	0.2	13.1
Comoros	1.2	0.0	-	-	21.1	3.0	0.1	0.1
Djibouti	15.9	0.4	0.2	0.9	13.8	0.7	0.7	0.2
D.R Congo	8.9	6.6	0.3	12.0	373.4	91.8	4.3	64.9
Eritrea	3.2	0.5	1.2	-	56.9	5.6	1.5	7.1
Ethiopia	572.7	2.4	5.8	0.6	53.3	4.4	0.6	9.2
Kenya	414.0	130.5	6.4	71.9	383.8	97.7	18.4	10.0
Madagascar	40.9	0.2	0.5	0.0	77.3	2.4	0.3	8.8
Rwanda	105.1	2.5	0.5	13.6	159.6	22.7	10.2	86.0
Seychelles	30.0	0.5	-	0.1	22.8	4.3	0.0	5.5
Somalia	1.0	0.0	0.2	-	114.4	0.2	0.2	0.1
Tanzania	268.0	64.4	7.8	59.7	114.1	22.4	10.2	17.7
Uganda	472.2	93.2	10.4	77.8	152.9	46.1	1.6	8.2

Source: UNCTADStat (2018).

### II.3.2. The Scope for Expanding Agro-Industrial Trade Under the AfCFTA

Against the background of potential opportunities for African countries to promote intra-African trade and accelerate a continental market integration, reports on the economic impact of the AfCFTA have generally argued that one of the largest positive impacts will originate from the agricultural sector (UNECA, 2017 and UNCTAD, 2016b). Mevel and Karingi (2012)<sup>82</sup> find a potential increase of African exports to the world by 4.0 per cent (US\$ 25.3 billion), with the most substantial export improvement

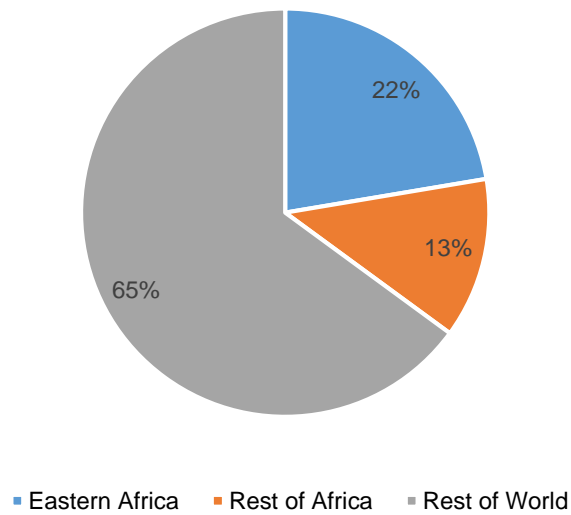
*There is enormous potential of intra-African trade growth by moving towards a more integrated continental market and a full implementation of the AfCFTA.*

being in the agricultural sector (+9.4% or US\$ 5.0 billion). The intra-African agricultural exports will also follow similar increase of +53.1% (US\$ 5.7 billion) by 2022. These findings are suggestive of enormous potential of intra-African trade growth by moving towards a more integrated continental market and a full implementation of the AfCFTA.

Building trade on more productive economic activities of value-addition within the continent is key for a successful transition to the AfCFTA. This means that to avoid trading imported goods from abroad within the continent, agro-processing and higher value addition to agricultural produces need to be privileged. There has been increased interest in promoting high value agricultural exports in the region. In Ethiopia, the government adopted an Agricultural Development-Led Industrialization program for export promotion (Gebreselassie, 2006). Another example is the Strategic Plan for the Transformation of Agriculture in Rwanda or the promotion of the horticultural sector in Kenya (Ansoms, 2009). These national policies favour the development of higher value added processed food in the region.

<sup>82</sup> Mevel and Karingi (2012) conducted an ex-ante impact evaluation of the potential wealth improvement with the formation of both regional and continental trade areas (RTA, CFTA). Their findings are compared to the baseline scenario in 2022 without and RTA or CFTA.

**Figure 44: Processed food export shares from Eastern Africa to other regions, 2014**



Source: Author calculations based on GTAP 10.0 database.

## II.4. The Blue Economy and the AfCFTA

The Blue Economy could play an instrumental role towards the achievement of the AfCFTA through enhanced use of resources it offers, in particular the increased use of inland waterways for transport of goods. The development of access to the two largest African lakes, namely Lake Victoria and Lake Tanganyika, forming part of the Northern and Central Corridors, is expected to contribute greatly to the improvement of intraregional trade in Eastern Africa.

*The development of access to the two largest African lakes, namely Lake Victoria and Lake Tanganyika, forming part of the Northern and Central Corridors, is expected to contribute greatly to the improvement of intraregional trade in Eastern Africa.*

The Blue Economy framework recognizes that islands, coastal countries, as well as land-locked States can benefit from the sustainable use of healthy freshwater and ocean ecosystems based on a multisectoral and integrated approach for sustainable development and growth. The Blue Economy aims to enhance linkages and synergies at all levels, between different socio-economic sectors such as maritime transport, shipbuilding, port infrastructure, etc. as well as between island, coastal and landlocked States. The AU has recognized the strategic importance of the Blue Economy for job creation, and socio-economic transformation by calling it a ‘new frontier for African Renaissance’ in its Agenda 2063, and its 2050 African’s Integrated Maritime Strategy.<sup>83</sup>

In its African Development Report 2010, focusing on *Ports, Logistics and Trade in Africa*, the African Development Bank had underlined that for landlocked countries, median transport costs are almost 50 per cent higher than the equivalent costs for coastal economies due to low port efficiency, dilapidated connected infrastructure networks and delays at borders.

Internationally funded projects and initiatives are underway to address some of the existing challenges through the rehabilitation of key ports on Lakes Victoria and Tanganyika, and the improvement of their navigability and safety. Nevertheless, additional efforts to ensure long-term socio-economic and environmental sustainability of planned interventions would be required against the backdrop of their scale and scope. The strengthening of the role of the Northern and Central Corridors in the harnessing of the untapped potential of inland waterways within the framework of their intermodal transport infrastructure would be one of the keys to the implementation of the AfCFTA.

### II.4.1. The Northern and Central Corridors: Backbones of Transport of Intraregional Trade

The Northern and Central Corridors are two distinct multimodal routes connecting the seaports of Mombasa in Kenya and Dar es Salaam in Tanzania respectively, by road, rail and inland waterways to the landlocked countries of the Great Lakes Region including Burundi, D.R. Congo, Rwanda, South Sudan and Uganda (Figure 45). Both corridors form the backbone of regional transport in Eastern Africa. They include Lakes Victoria and Tanganyika waterways as well as their major ports (Kisumu-Kenya, Mwanza-Tanzania, Port Bell-Uganda on Lake Victoria, Bujumbura-Burundi, Kalemie-D.R. Congo and Kigoma-Tanzania on Lake Tanganyika).

Table 19 highlights similar import and export shares of cargo handled by the ports of Mombasa and Dar es Salaam, with imports taking the major share in both cases. The total volume of goods processed at Dar es Salaam port has grown by 1 per cent from 2016 to 2017 compared to an increase of 11 per cent

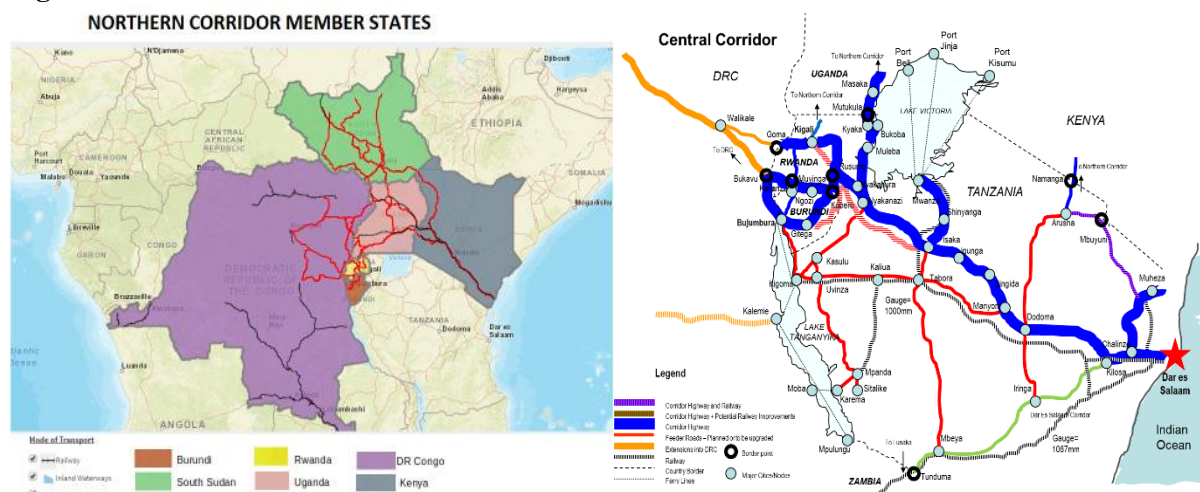
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<sup>83</sup> With a view to taking into account the interests of ‘land-connected’ or landlocked countries and inland water ecosystems, the AU and UNECA have adopted a wider definition of the word ‘blue’ to include lakes, rivers and underground water in addition to oceans, seas and coasts. River and lake basins often constitute essential lifelines for landlocked and coastal states interconnected through continental corridors.



of the total throughput of Mombasa port over the same period. Meanwhile, Mombasa port handled a total volume of 30 million metric tons in 2017, more than double the Dar es Salaam port.

**Figure 45: The Northern and Central Corridors**



Sources: Northern Corridor Transit and Transport Coordination Authority and Central Corridor-Transit Transport Facilitation Agency (2018).

**Table 19: Cargo imports, exports and total throughput (million metric tons)**

	Northern Corridor (Mombasa Port)			Central Corridor (Dar es Salaam Port)		
	2016	2017	Growth	2016	2017	Growth
Imports	23.1	25.6	11%	11.1	11.4	2%
Exports	3.7	3.8	4%	1.8	1.8	-4%
Total throughput (including transshipment)	27.4	30.3	11%	13.6	13.8	1%

Sources: Kenya Ports Authority, Tanzania Ports Authority, Northern Corridor Transport Observatory and Central Corridor Transport Observatory (2018)

Table 20 shows that the domestic market (Kenya) accounted for 69 per cent of the total throughput of Mombasa port, followed by Uganda market (26 per cent). Tanzania market represented 59 per cent of the total throughput of Dar es Salaam port, followed by other markets, then Rwanda and D.R. Congo

*There was an increase of 43 per cent in imports destined to Tanzania and channeled through the port of Mombasa from 2016 to 2017, perhaps due to congestion at the port of Dar es Salaam.*

markets. Meanwhile, there was an increase of 43 per cent in imports destined to Tanzania and channeled through the port of Mombasa from 2016 to 2017, perhaps due to congestion at the port of Dar es Salaam.<sup>84</sup> Table 20 also illustrates an ongoing shift in the volume of goods transported by member States (e.g. Burundi and Rwanda), from the Northern Corridor to the Central Corridor, essentially motivated by shorter distances, reduced freight charges and other fees<sup>85</sup>, improved road condition, lower number of transit nodes and lesser traffic congestion. Imports from Burundi

<sup>84</sup> In 2017, the Tanzania Ports Authority has signed a US\$ 154 million contract with China Harbour Engineering Company Limited for the expansion of the port of Dar es Salaam.

<sup>85</sup> According to transporters interviewed by the Northern Corridor Transport Observatory, the effect of devolution in Kenya has led counties to charge additional fees. Meanwhile, Cargo delivery related costs have become lower on the Central Corridor (US\$ 65 per ton) than on the Northern Corridor (US\$ 90 per ton) (The EastAfrican, 2018b).

through the Northern Corridor have declined by 40 per cent from 2016 to 2017 and increased by 34 per cent through the Central Corridor during the same period. Similarly, imports by Rwanda through the Northern Corridor have decreased by 7 per cent from 2016 to 2017 and increased by 24 per cent through the port of Dar es Salaam. In fact, the analysis of trade flows in both corridors reveal that they are of similar nature negatively impacting on competitiveness at country and sub-regional level.

**Table 20: Imports (in thousand metric tons) through the Northern and Central Corridors**

	Northern Corridor (Mombasa Port)			Central Corridor (Dar es Salaam Port)		
	2016	2017	Growth	2016	2017	Growth
Burundi	35.8	21.6	-40%	301.0	403.8	34%
D.R. Congo	341.8	317.1	-7%	789.0	785.3	0%
Kenya	15,899.0	17,701.0	11%	-	-	-
Rwanda	180.3	167.3	-7%	840.3	1,040.3	24%
South Sudan	552.2	545.3	-1%	-	-	-
Tanzania	171.2	244.2	43%	7,190.3	6,703.9	-7%
Uganda	5,922.2	6,590.1	11%	165.1	270.4	64%
Others	13.6	16.9	24%	1,807.9	2,154.6	19%
<i>Total</i>	<i>23,116.1</i>	<i>25,603.9</i>	<i>11%</i>	<i>11,093.7</i>	<i>11,358.3</i>	<i>2%</i>

Sources: Kenya Ports Authority, Tanzania Ports Authority, Northern Corridor Transport Observatory and Central Corridor Transport Observatory (2018)

The above tables illustrate the growing trade volumes and rapidly evolving dynamics between coastal and landlocked countries in Eastern Africa in line with infrastructure development trends over the past couple of years. Regarding the latest infrastructure development, one of the game-changing breakthrough is the Standard Gauge Railway (SGR) between Mombasa to Nairobi. According to the Northern Corridor Transport Observatory, the SGR is expected to be moving 22 million tons per year by 2019.<sup>86</sup> The SGR is set to mark a turning point in trade

*The SGR is set to mark a turning point in trade movements in the region and greatly contribute to the implementation of the AfCFTA.*

movements in the region and greatly contribute to the implementation of the AfCFTA. Another important development has been the launch of the construction of the Central Corridor Standard Gauge Railway of 2,561 km by Tanzania in 2017 which will eventually link the port of Dar es Salaam with Mwanza on Lake Victoria and Kigoma on Lake Tanganyika, as well as neighboring Rwanda and Burundi. Currently, rail operation along the Central Corridor is ongoing through the existing meter gauge with uncompetitive rates compared to road transport and an insufficient number of locomotives and wagons. However, the rehabilitation of the Central Railway line in Tanzania has started and ongoing, of which the railway line from Dar es Salaam to Mwanza through Isaka is operational. The Dar es Salaam- Kigoma railway line is also operational of which block trains carrying Burundi cargo (World Bank, 2017).

<sup>86</sup> Kenya has a rail network of 2,778 km of the meter gauge railway line and approximately 609 km track length of the SGR. Uganda, on the other hand, has a network of 1,226 km but an important portion of this line is not operational. In June 2018, Uganda announced that it will sign the financial agreement for the construction of the Kisumu-Malaba-Kampala part of the SGR. The existing branch line of the meter gauge railway extending to Kisumu is currently not operational.

## II.4.2. Lakes Victoria and Tanganyika: The Two Hidden Gems of the Northern and Central Corridors

Inland waterways have historically been an essential component of a multimodal transport networks.<sup>87</sup> Lake Victoria<sup>88</sup>, the largest lake in Africa as well as the largest inland fishery in the world, and Lake Tanganyika<sup>89</sup>, the second largest and the deepest lake in Africa, played a historical role in the development and shaping of

*Lake Victoria and Lake Tanganyika played a historical role in the development and shaping of intraregional trade in Eastern and Central Africa connecting coastal States to landlocked countries.*

intraregional trade in Eastern and Central Africa connecting coastal States to landlocked countries, and paved the way to the implementation of the AfCFTA. Lake Victoria was of particular importance, offering transportation services of passengers and cargo as part of the railroad system, linking up the rail to the lake ports of Kisumu (Kenya), Bell (Uganda), and Mwanza (Tanzania). In Kenya and Uganda, lake operations were concessioned together with the railroad system, whereas in Tanzania lake services were dissociated from the railroads. Key ports on Lake Tanganyika include Bujumbura (Burundi), Kalemie (D.R. Congo) and Kigoma (Tanzania). Both lakes share similar operational characteristics, which gave life to the Northern and Central Corridors.

Both lakes are navigable but the state of navigation aids has been nonfunctional for a long time leading to increased accidents<sup>90</sup>. Meanwhile, existing hydrographic survey maps are outdated, with most of them dating from the beginning of the past century. The construction of principal inland ports, namely Mwanza and Port Bell (on Lake Victoria), Kigoma, and Kalemie (on Lake Tanganyika) started at the beginning of the nineteenth century<sup>91</sup>. Their infrastructure and equipment conditions are quite obsolete, making these ports virtually inoperative. Kisumu (on Lake Victoria) was established as a shipbuilding and assembly place before the end of the First World War, with ferries and cargo ships travelling to Uganda. By the mid-past century, the East African Railways and Harbours Corporation (EARHC) operated regular transport from Kisumu to Port Bell and Mwanza, using rail ferries carrying rail wagons loaded and unloaded directly from/to rail tracks in all ports. However, the breakup of the EARHC in 1977 started the decline in transport services on the lake, leading to their gradual disintegration. The development of the road network around the lake further undermined their competitive position. High sedimentation levels in access areas and port basins of Lake Tanganyika constitutes a major threat for port practicability.

Lake Victoria ports are based on traditional general cargo traffic except for the ports of Bell, Kisumu and Mwanza which were initially developed for rail wagon RoRo<sup>92</sup> traffic and equipped with a linkspan. Contrary to Bujumbura, Kilemie and Kigoma ports on Lake Tanganyika, none of the Lake Victoria

<sup>87</sup> For instance, the prevalence of navigable waterways is often attributed by economic historians to the reasons for the British industrial revolution in the 18<sup>th</sup> and 19<sup>th</sup> centuries, for instance, because it was possible to transport coal from the mines to industrial centers at relatively low cost using rivers and canals.

<sup>88</sup> EAC has identified Lake Victoria basin as a critical economic growth zone. It is estimated an annual fish catch in excess of one million tonnes (FAO, 2018). The catchment area of the lake encompassing parts of Burundi, Kenya, Rwanda, Tanzania and Uganda supports a population of over 40 million inhabitants and has a GDP estimated at US\$ 30 billion.

<sup>89</sup> It interconnects Burundi, D.R. Congo, Tanzania and Zambia targeting a population of over 10 million people. It is estimated an annual fish catch fluctuating between 165,000 and 200,000 tons, but the lake productivity has been worryingly declining due to global warming (FAO, 2018).

<sup>90</sup> 227 people are thought to have lost their lives in the incident that occurred on 20 September 2018 while travelling between the island of Ukerewe and Ukara on the Lake Victoria.

<sup>91</sup> The port of Bujumbura was built in the 1950s.

<sup>92</sup> Roll-on and roll-off cargo driven on and off a vessel.

ports has container-handling equipment and most of them are in a poor state with difficult road and rail access (IMDC, 2016). Currently, inter-lake ports and lake-rail links are either inexistent or very weak within member States bordering both lakes. All lake ports have suffered lack of investments reflected into outdated infrastructure, unreliable or broken rail connections, erratic ferry operations across the lakes, reduced number of active rail ferries, inadequate maintenance and equipment, and unsatisfactory safety measures. Furthermore, the lack of shipbuilding capabilities has led to the importation of vessels that are then disassembled and transported to the lakes where they are reassembled, adding on new costs for handling activities.

This situation has led to a declining demand for lake transport, which has in turn been affecting the overall performance of intermodal freight in Eastern Africa. In Tanzania, Mwanza port handled around 210,000 tons<sup>93</sup> and Kigoma port 73,000 tons in 2011/12<sup>94</sup> showing a decrease in traffic of 16 per cent and 20 per cent respectively compared to 2010/2011 mainly due to poor performance of railways and inadequate availability of wagon ferries (Tanzania Ports Authority, 2012). In Uganda, the total amount of cargo (3,300 tons) ferried through Port Bell fell by 66 per cent in 2015 compared to 2014 (UBS, 2017), while volumes had peaked at over 500,000 tons during early 2000s (Central Corridor Transport Observatory, 2018)<sup>95</sup>. In July 2017, the two governments of Tanzania and Uganda signed a Memorandum of Understanding (MoU) on joint ministerial cooperation and improvement of ports, inland waterways and railway transport in order to increase transit trade and strengthen the critical Mwanza-Port Bell-Kampala link for the Central Corridor.

In Kenya, Kisumu port has handled 21,900 tons in 2014, which estimates that the total cargo demand at Kisumu port will increase to 290,000 tons by 2025 and 410,000 tons by 2035 as a result of infrastructure development<sup>96</sup> (Kenya Ports Authority, 2018). In Burundi, the port of Bujumbura of a capacity of 500,000 tons handled 180,400 tons in 2017, an increase of 65 per cent compared to 2016 (Bank of the Republic of Burundi, 2018). Between a quarter and a third of Burundi's trade is dependent on the lake. The cost of moving a container from Dar es Salaam to Bujumbura, using the rail-lake intermodal route, is estimated at approximately half the cost of road alone (World Bank, 2017), hence increasing the quantities traded by Burundi. In D.R. Congo, Kalemie port handled 10,000 tons in 2014, a decrease of 51 per cent from 2013's volume mainly due to economic and security crisis<sup>97</sup>.

*Between a quarter and a third of Burundi's trade is dependent on the lake.*

The Eastern Africa region is foreseen to become a major economic and political powerhouse, which will feedback into the building of the AfCFTA. The Northern and Central Corridors have demonstrated that regional transport infrastructure plays a strategic role towards strengthening regional integration

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<sup>93</sup> Between 200,000 and 300,000 tons seem to be ferried nowadays from Mwanza port to Port Bell port (AllAfrica, 2018).

<sup>94</sup> Cargo volumes seem to have been a little over 130,000 tons in 2016 compared to 2.5 million tons in 2003, a drop essentially due to insufficient investments infrastructure and increased competition from road transport (World Bank, 2017).

<sup>95</sup> In an effort to revive the Central Corridor trade and transport route, Uganda has invested about Ugandan shillings 1 billion to rehabilitate the line from Port Bell to Kampala that had not been used since 2007.

<sup>96</sup> China Roads and Bridges Company is expected to build a modern US\$ 14 billion port in Kisumu as part of phase two of the SGR (construction of the Naivasha-Kisumu line).

<sup>97</sup> Kalemie port handled about 220,000 tons in 1958. However, traffic seems to resume as a result of the rehabilitation of the Lubumbashi-Kamina-Kabalo-Kalemie railway line (1,210 km) and the acquisition of 18 locomotives and wagons under the World Bank-financed Multimodal Transport Project. The port of Kalemie was granted by the European Union with mobile handling equipment and generators (Central Corridor Transport Observatory, 2018).

and trade through an improved access to economic growth zones and their link up. Transport infrastructure is key in providing linkages between local, regional and global markets, sources of raw material, manufacturing centres through an optimal and functional intermodal system. It is also vital for social cohesion and integration of citizens. No effective trade between member States can occur without adequate transport infrastructure. However, inland waterways

*Inland waterways and lake ports, which have been neglected and underutilized for decades, have emerged as key missing links in the Eastern Africa infrastructure framework.*

and lake ports, which have been neglected and underutilized for decades, have emerged as key missing links in the Eastern Africa infrastructure framework. They need to be provided with support for them to fulfil their role in promoting intraregional trade as well as regional cooperation and integration. On a positive note, things seem to be moving in the right direction with increased awareness on the competitiveness and attractiveness of inland waterways as highlighted by recent developments.

In June 2018, after more than one decade, and as a result of its MoU between Tanzania and Uganda, a 900-tonne cargo ship from Mwanza docked at Port Bell on Lake Victoria and is expected to make 26 trips a month (The EastAfrican, 2018c). It was very recently reported that one company had saved a substantial amount (US\$ 240,000) in transport costs in just six-weeks use of the reopened route on Lake Victoria (Chimp Reports, 2018). This confirms the huge potential of Lakes Victoria and Tanganyika in terms of complementary and affordable transport options (in particular for landlocked countries) as an integrative part of an operational regional intermodal system. Inland waterways often offer either the most direct route or the only one to some local markets. Their rehabilitation will also have a boosting effect on the development of rail and road infrastructure.<sup>98</sup>

To move towards better integrating inland waterways and lake ports in regional intermodal transport in support to the AfCFTA, capacity development in bathymetric surveys<sup>99</sup> and other relevant science topics is required to address important existing knowledge gaps on Lakes Victoria and Tanganyika. The same applies to other component areas of the transport infrastructure supply chain, such as port and vessel related operations, maintenance management, etc. Knowledge building through in-depth baseline information studies is conditional to successful planning and activity implementation.

In addition, both Northern and Central Corridors share a ‘common destiny’ of regional integration and are expected to become main engines of the AfCFTA, through the revamping and development of regional transport infrastructure for the facilitation of intraregional trade. In light of increasing cargo volumes in Eastern Africa, in particular cross-border trade, corridors’ authorities have identified the opening of new trade routes and border stations as key prerequisites. A joint integrated action plan aimed to rehabilitate and develop regional infrastructure along both corridors for an improved connection of roads, railways and waterways could be further prepared by stakeholders involved. The plan would need to also address the growing containerization trends in the region and specific needs of landlocked countries, and explore related feasible interventions.<sup>100</sup>

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<sup>98</sup> The World Bank is supporting two transport programmes on Lakes Victoria and Tanganyika aimed to facilitate the sustainable movement of goods and people in the region, whilst strengthening the institutional framework for navigation and transport safety. Specific objectives include reduction of travel time and transport costs for users as well as better access for rural populations (World Bank, 2018d).

<sup>99</sup> Lakes Victoria and Tanganyika’s navigational charts are outdated and usually not publicly available making navigation risky.

<sup>100</sup> Both Corridors’ authorities will need to closely follow-up on the implementation of the World Bank funded projects in consultation with the EAC and mainstream related progress and achievements in their policy planning and development. The joint corridor plan could then focus on new and complementary activities to avoid duplication and dispersion of resources.

Moreover, the integration of neglected inland waterways and lake ports as part of the regional intermodal transport could be strengthened through updated cost benefit analysis of the different types of transport, their trade-offs, linkages and synergies as well as the assessment of mutual impacts of related investment projects<sup>101</sup>. It is currently quite difficult to gather up to date and consistent data and information on detailed characteristics of trade movements on Lakes Victoria and Tanganyika. Thematic comprehensive baseline assessments could be carried out and contribute to the strengthening of the Northern and Central Corridors' databases.

Lastly, major barriers to trade competitiveness (e.g. poor infrastructure, insecurity, road user charges, inland port handling charges, predictability and reliability of railway services) are to be removed. Streamlining of costs could be helped through improved infrastructure, better cross-border interconnectivity, greater access by rural populations to the road network. Regional integration can also help reduce costs through economies of scale and more effective public goods' management, risk sharing mechanisms, bigger and more competitive markets and enhanced regulatory coherence.

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<sup>101</sup> As an example, some experts think that the SGR could be a deterrent to cargo transport on Lake Victoria contrary to other opinions. Such in-depth analyses would help appropriate and factual decision making taking with respect to investment options.

## II.5. Tapping the Potential of Intra-African Services Trade

Although the focus of current discussions on the AfCFTA is on the liberalization of merchandise trade, liberalization of services trade could harbor great benefits for the region.<sup>102</sup> In fact, the economies of the majority of Member States, including Comoros, Djibouti, Madagascar, Rwanda and Seychelles, could be considered as being service sector driven. Despite occasions of turbulence, services exports are generally on the increase, with several countries registering more than a three-fold increase since 2005 (Table 21). For instance, with a value of just US\$ 119 million in 2005, Rwanda's services exports valued at over US\$ 998 million in 2017. For a number of countries (e.g. Comoros, Ethiopia, Rwanda and Seychelles), service exports are now the major source of foreign exchange earner.

*Intra-African liberalization of services trade could harbor great benefits for Eastern Africa.*

**Table 21: Services exports (current prices, USD million)**

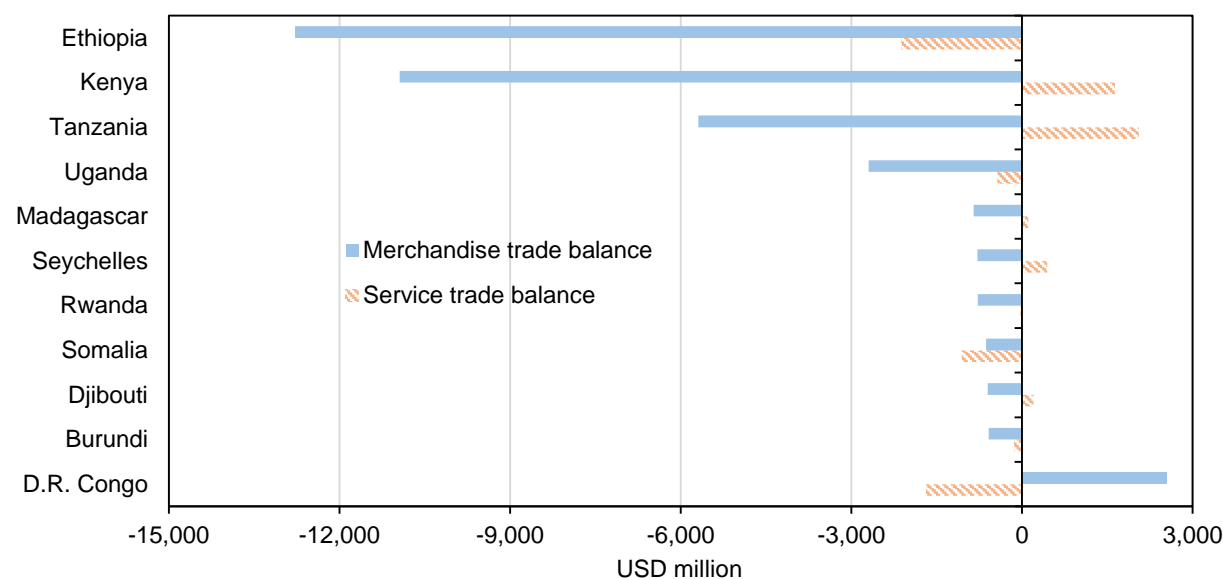
	2005-2009 average	2010-2014 average	2015	2016	2017
Burundi	47	96	57	73	-
Comoros	54	75	84	-	-
D.R. Congo	529	405	173	128	-
Djibouti	273	350	455	406	-
Ethiopia	1,393	2,751	3,087	3,095	-
Kenya	2,683	4,611	4,638	4,528	4,959
Madagascar	920	1,203	1,073	1,186	-
Rwanda	272	517	818	835	998
Seychelles	428	648	847	894	998
Somalia	-	268	355	373	393
South Sudan	-	36	97	178	194
Uganda	719	1,893	2,044	1,868	1,609
Tanzania	1,705	2,746	3,411	3,593	3,862
<i>Total</i>	<i>9,023</i>	<i>15,600</i>	<i>17,140</i>	<i>17,156</i>	<i>13,013</i>

Source: UNCTADStat (2018).

*Most countries have a better trade balance in services than merchandise trade.*

Regarding the services trade balance, Tanzania and Kenya actually have quite a large trade surplus in services. Even in the cases where there is a deficit in the services balance, those deficits are generally much smaller than that of the deficits being generated in merchandise trade (Figure 46). Kenya and Tanzania, for instance, have continued to maintain a surplus since 2005, rising from US\$ 730 million and US\$ 62 million in 2005 to over US\$ 1.6 billion and US\$ 2.1 billion in 2017.

<sup>102</sup> Our definition of services includes business, communication, construction and related engineering, education, environmental, financial, health related and social, tourism and travel related, recreational, cultural and sporting and transport (UNCTAD, 2015).

**Figure 46: Services trade balance and merchandise trade balance, 2017**

Note: The services trade balance of Ethiopia, Madagascar, Djibouti, Burundi and D.R. Congo are as of 2016.

Source: UNCTADStat (2018).

The steady rise in services trade has been driven by a number of sectors. In the case of Kenya, where the growth in services trade has surpassed that of manufacturing, financial services, ICT, transport and tourism have been the main drivers of growth (Khanna et al., 2016). The efforts towards regional integration in the EAC and the ensuing favorable environment have resulted in a number of Kenya financial institutions investing in the region. These include the Equity Bank, I&M Bank and the Kenya Commercial Bank. In fact, as a percentage of commercial services export, the share of financial services exports in Kenya grew from just 0.7 per cent in 2005 to 7 per cent in 2014 (World Bank, 2018e). Similarly, services trade in Ethiopia has been driven by the growth in air transport services, with the sector contributing over US\$ 2 billion annually and accounting for over 200,000 jobs (AUC, 2015). In line with this, the Single African Air Transport Market (SAATM) is expected to have a positive impact on the air transport services and consequently to the regional economy. Currently of the 23 member States in Africa, only Ethiopia, Kenya and Rwanda, have committed to SAATM in the region (AUC, 2018). Illustratively, a study by the International Association of Air Transport estimates that there could be 155,000 new jobs and an additional US\$ 1.3 billion of GDP if only 12 countries were to ratify SAATM (IATA, 2018). The education sector has also played an important role in Uganda's economy both in the past, when Makerere University attracted a number of scholars from the African continent, and currently with various institutions of learning drawing students mainly from Kenya, South Sudan and Rwanda. In 2013, the value of education related services was estimated at over US\$ 30 million, while currently services account for 48.7 per cent of Uganda's GDP (New Vision, 2017).

A services sector that has somewhat been ignored in pursuant of the STEM policies to address developmental goals in the region and the wider African continent, is that of the of the creative industries. In fact, as of 2012, the value of the Africa's creative industry exports was US\$ 1.9 billion or 0.4 per cent of the global total (UNCTAD, 2015a). It is very likely that Africa's share has increased since then, if some of the trends are to go by. For instance, there has been significant shift in entertainment preferences from the say, Western music and movies, to those produced by the African member States. For instance, Nigeria is now one of the leading movie producers in the continent and globally, with Nollywood ranked 2<sup>nd</sup> after Bollywood (India) and ahead of Hollywood (USA) (British Council, 2015). It is estimated in 2015 the creative industries comprising music, film, art and fashion, generated a total of US\$ 4.8 billion for Nigeria and that by 2019 the country will be earning over US\$ 8 billion (African Renewal, 2018). The potential of creative industries as such, has also been recognized by the South African government which has identified film and television as strategic economic sectors that could, for instance, generate over 5 million jobs in a ten-year period (UNCTAD, 2015b). This trend,



despite the lack of supportive policies, both at national and regional levels, is similarly beginning to have some impact in the region. For example, in terms of exports, the creative industry in Tanzania registered a significant increase from US\$ 2.5 million in 2003 to almost US\$ 70 million in 2012 (UNCTAD, 2015b). This was mainly driven by the growth in popularity of the *Bongo* music and movies. Of interest, and in the context of the AfCFTA, is that bulk of the creative industries trade takes place at the regional level with Nigeria and South Africa trading at 94 per cent and 61 per cent with the African continent respectively. Likewise, the level of Uganda's trade with Africa is at 80 per cent with its major partners being D.R. Congo, Rwanda, Kenya, Burundi and South Sudan. This trend is also the same in the case of Tanzania with 82 per cent of its trade being regional and its leading partners being Kenya, Uganda and Burundi. This could be attributed to the fact that creative products face less barriers and the role technology has played in the distribution of creative content (International Trade Forum, 2009).

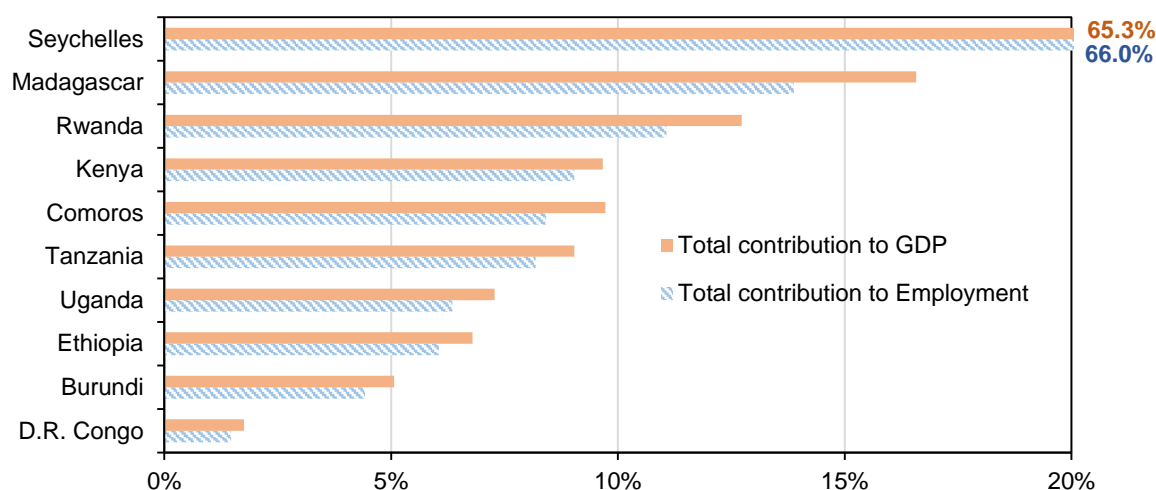
*Services trade, faces a number of challenges mainly related to policy and regulatory issues, slow implementation pace of key continental agreements and decisions, and human resource capacity dearth.*

The services sector, however, continues to endure a number of challenges that are an obstacle to fully realizing its potential in the region. Chief among these include the lack of appropriate policies both at the national and regional levels that could foster strong linkages with the rest of the economy. As a result, there is minimal, if any, say robust backward linkages that are necessary if the region is to be competitive in light of the

growing importance of GVCs (UNCTAD, 2017b). At the regional level, some member States have continued to maintain stringent regulatory regimes, coupled with unfavorable policies that resulted in the high cost of services, lack of human capital, accessibility, quality and competitiveness related issues. For instance, costs of communication services remain high across the region due to the high roaming charges on both voice and data. It is worth noting that there have been efforts to address this issue, such as the Northern Corridor One Area Network which covers Kenya, Rwanda, South Sudan and Uganda, though its implementation is currently facing some bottle necks (The EastAfrican, 2018d). In addition, the matter of free movement of persons, in particular, that of labour, remains contentious even in the case of the EAC despite the common market protocol coming into force over eight years ago (The Citizen, 2017). This has, therefore, meant that there is limited movement of say professional services across the region, from member States with an abundance to those where such skills may be minimal. The situation is exacerbated by the lack of recognition of professional qualifications. What is more, despite recognition of their continental importance, a number of agreements and decisions such as, Yamousoukro Decision, are yet to be fully implemented. The ratification of the AfCFTA could, therefore, provide an opportunity through which these challenges could be addressed.

### **II.5.1. The Tourism Case**

The tourism industry continued its growth trajectory in 2017 despite challenges faced by some member States in 2016. The industry total GDP contribution was over US\$ 24 billion in 2017, compared to US\$ 23 billion in 2016, accounting for around one-fifth of the continent total. With the exception of Seychelles, the region's outlier, tourism's contribution to GDP is sizeable in many countries. While the figures for Madagascar and Rwanda were at the high end at 16.6 per cent and 12.7 per cent respectively, tourism's share of GDP for Comoros, Kenya and Tanzania were about 9 to 10 per cent. Likewise, the tourism industry has an important role on employment creation (Figure 47).

**Figure 47: Total contribution of tourism to GDP and employment, 2017**

Source: WITC (2018).

The tourism industry further played a major role in boosting the foreign exchange earnings for the majority of Member States, with projected increases in 2018. The region accounted for 18 per cent of the continent's total export earnings valued at over US\$ 9 billion. Specifically, tourism accounted for over 30 per cent of total exports in Seychelles, Ethiopia, Comoros and Rwanda. Similarly, there has been an increase in capital investments across the region which were valued at US\$ 3 billion in 2017. However, the distribution of the investments has been rather uneven, with Kenya and Ethiopia taking the bulk of the share at US\$ 820 million and US\$ 770 million respectively (WITC, 2018).

Of special interest, in line with on-going initiatives, including the African Union Agenda 2063 and its focus on regional tourism, and the related on-going ratification of the AfCFTA, is the steady growth of both outbound and domestic tourism, both in terms of numbers and receipts. As a result, a number of member States and RECs, are now developing strategies to tap into these emerging markets in tandem with the global trends whereby at least 80 per cent of arrivals should be from the region. For instance, Kenya, Rwanda and Uganda, have national campaigns promoting domestic tourism, while Tanzania is currently working on its domestic tourism strategy. At the REC level, Intergovernmental Authority on Development (IGAD) is currently implementing its 10-year tourism master plan with an emphasis on regional tourism, while the EAC is also working on an intra-regional tourism marketing strategy.

In terms of outbound tourism expenditure, Tanzanians have maintained their top position since 2015 as the leading spenders at US\$ 900 million in 2017, followed by Ugandans at US\$ 470 million, Ethiopians at US\$ 430 million and Rwandans at US\$ 310 million (WITC, 2018). Intra-regional tourism, an example of growing intra-regional trade in services, has also now gaining prominence. For instance, the leading tourism market for Kenya is now Uganda, while Kenya is the leading tourism market for Tanzania (The EastAfrican, 2018e). Given the minimum investment in nurturing domestic and regional tourism, the region's full potential is yet to be fully realized. The industry could, hence, play an important role on promoting both intra and inter-regional services trade in the context of AfCFTA.

All of this brings to the forefront the potential role of the AfCFTA in further incentivizing greater intra-African tourism. Such recognition of the tourism sector has further been endorsed by the AU in its Agenda 2063 under the emblem of *The Africa we Want*. The AU, in this regard, identifies the sector as one of the avenues through which the continent could realize structural transformation, thereby shifting from agrarian-based economies towards those driven by manufacturing and services sectors. To realize this, the AU has established goals to be met by the 2063 on the basis of 10-year implementation targets. For instance, in its first 10-year implementation plan, 2014-2023, the AU seeks to double the sector's contribution to the continent's GDP by 2023 from the 2013 base year, translating to about US\$ 338 billion. In addition, the AU seeks to double intra-African tourism by 2023, that is, the travel of Africans

within the continent for tourism purposes. Like in the case of trade, intra-regional tourism is comparatively low by the prevailing global standards.

Despite its current position as a strategic economic sector on the continent, the tourism industry faces a number of challenges that could derail the realization of the AU targets. These include the high cost of air transport, coupled with the concomitant issue of poor connectivity, and the unfavorable visa regime. In fact, the African Development Bank's 2017 Visa Openness Report revealed that Africans on average were required to apply for visas before travel to 55 per cent of other African States, unlike say, their European counterparts. The EU, for instance, has among its fundamental freedoms, the free movement of people, while within the Schengen Area, an area with a membership of 26 European States, internal borders have been removed. This has resulted in the free movement of goods and services, and importantly the free movement of people. It is not by accident, therefore, that Europe hosts almost half of the international tourist arrivals numbering over 600 million.

Encouragingly, there have been a number of initiatives that could address the challenges that continent faces and some that tourism could help catalyze. Firstly, in January 2018, the AU launched the SAATM with the immediate signing of 23 Member States. It is expected that the SAATM will open up the African air space, thereby improving connectivity and lowering the cost of travel. Secondly, in March 2018, 30 African member States signed the Free Movement Protocol (the Right of Establishment), with an additional State joining in April 2018. It is, therefore, anticipated that this initiative will ease the movement of Africans within the continent a step forward towards realizing the AU intra-African tourism targets. Thirdly, over the same period in March, 44 African member States signed the Agreement establishing the AfCFTA.

The tourism sector stands to benefit in a number of ways. Under the Free Movement Protocol, the sector could gain from the free movement of labour given the disparities across the continent in terms skills and knowledge. Similarly, the sector could serve as a pathway through which potential opportunities of the AfCFTA could be maximized. To illustrate this, the norm has been that in the more developed tourism regions of the world, such as Northern America, Europe and Asia, 80 per cent of tourists travel within their respective regions. Similarly, the share regional trade in North America, Europe and Asia is 50 per cent, 69 per cent and 52 per cent respectively. The same, unfortunately, does apply to the African continent both in terms of intra-African tourism and trade. In fact, the share intra-African tourism and trade currently stands just 40 per cent and 18 per cent respectively.

Of interest, nonetheless, is that there is a consistent pattern between tourism and trade as evident in the case of the leading tourism destinations in the world and their respective trading partners. For example, the United Kingdom, Germany, Belgium, Italy and Spain are among the top 10 source countries for France, which has consistently been the leading tourism destination hosting over 82 million visitors in 2016 (of which 64.5 million were from Europe). Likewise, these countries are also among its top 10 trading partners. The same scenario applies to the United States which received over 75 million visitors in the same year with some of its top source market being Canada, Mexico, China, Japan and South Korea, which again are among its top trading partners. This appears to also be a trend in the emerging destinations in Asia. For instance, China, Malaysia, Japan, the United States and Germany were the top 10 sources for Thailand, which is a now a top ten destination of the world both in terms of arrivals (29.9 million) and tourism receipts (US\$ 49.9 billion). The same countries were indeed among its top trading partners.

Thus given the minimal level of both intra-regional tourism and trade in Africa, the foregoing analysis of the top tourist destinations and their respective trading partners suggests some sort of relationship, the higher the level of intra-regional tourism, the higher the level of intra-regional trade and vice versa. Although a deeper understanding of this relationship would require more in-depth analysis particularly in terms cause-effect relationship, some conclusions could be drawn.

*There is a consistent pattern between tourism and trade as evident in the case of the leading tourism destinations in the world and their respective trading partners.*

Tourism, more so intra-regional tourism, is about people travelling to other destinations, usually new ones, which opens up possibilities of cultural and ideas exchange, and in some cases identification of opportunities. The limited movement of Africans within the African continent has meant that very few, say, East Africans have been to Central or West Africa and vice versa, and hence there is no way of knowing what opportunities exist due the lack of African interaction. Promoting intra-African tourism as advocated for by the AU could, therefore, be a catalytic vehicle for the generation of opportunities within the context of the AfCFTA.

## II.6. A Call for Free Movement of Persons

Although much of the contemporary policy discourse is on extra-regional migration, intra-African migration is far more needs to be harnessed better for the benefit of Africa's integration and sustainable development (AUC and IOM, 2018). Intra-African migration is on the rise, up from 12.5 million in 2000 to 19.4 million in 2017. Indeed, African migration is largely intra-regional, with 80 per cent of African migration taking place in Africa, only 20 per cent is outward-bound. Table 22 shows that the smaller Eastern African economies largely driven by the service sector tend to have larger migrant stocks.

**Table 22: Number and share of international migrant, 2017**

	International migrant stock (thousand)	International migrant stock as a percentage of total population
Seychelles	12.9	13.6
Djibouti	116.1	12.1
South Sudan	845.2	6.7
Uganda	1,692.1	3.9
Rwanda	443.1	3.6
Burundi	299.6	2.8
Kenya	1,078.6	2.2
Comoros	12.6	1.5
Ethiopia	1,227.1	1.2
D.R. Congo	879.2	1.1
Tanzania	492.6	0.9
Eritrea	16.0	0.3
Somalia	44.9	0.3
Madagascar	33.8	0.1

Source: IOM, 2018.

The AU Free Movement of Persons Protocol (AUC, 2017a) represents an opportunity for the liberalization of movement of person across the Continent, in addition to promising investment and trade opportunities. The core idea behind the Free Movement Protocol is to improve the economic and cultural activities across all AU nations and thereby contribute to African integration. This Protocol applies directly to citizen's movement and that it will affect ordinary people directly (Gwatiwa and Sam, 2018). However, the signing of the Agreement on free movement of persons by 50 per cent of African member States in March 2018 highlights the division on this thorny issue. African States favour the AfCFTA (with 49 signatories) but grapple with opening up of borders (only 27 countries).

Structural transformation requires knowledge, skills and capabilities in higher value-adding sectors. Khan (2018) argues that lack of appropriate skills and capabilities can slow structural transformation processes and that investment in education does not correlate with the development of all types of knowledge. WEF (2017) notes that employers in 41 per cent and 30 per cent of all firms in Tanzania and Kenya identify inadequately skilled workforces as major constraints for their businesses.

To fill this gap, countries need to look beyond their borders to attract required skills. EY (2014) found that demand for expatriate skills had grown the strongest in Eastern Africa<sup>103</sup>, with firms expecting to recruit more expatriate executives, managers, professional and technical skills, even while 62 per cent of respondents believed that governments were making it difficult to employ expatriates. The survey

<sup>103</sup> Comprised of Ethiopia, Kenya, Rwanda, South Sudan, Tanzania and Uganda.

found that local talent, Africans and returning African diaspora were considered favourably to fill executive vacancies.

Talent mobility could help to develop human capital as skilled workers and students travel in the region for work and educational purposes. This will accelerate transfer of skills and hopefully spur the mutual recognition of professional qualifications which is still lacking.<sup>104</sup> However, talent mobility still remains a challenge in Africa. Policy frameworks for talent mobility would go a long way to alleviate attendant challenges and spur Africa on the growth path it has charted for itself, by allowing required skills to be where they are needed. The Intra-African Talent Mobility partnership program is also another avenue that accelerates movement and common policies around certain professions.

There are some signs that things are progressing in a positive direction. AfDB and AUC (2017) note that African countries are becoming more open to each other, facilitating intra-African travel. The 2016 Visa Openness Index shows that Eastern Africa hosts nine out of the 20 visa open countries. These countries have facilitated movement of persons into their territories. For example, Seychelles is a fully open country requiring no visa for anyone wishing to visit. AfDB and AUC (2017) notes that following relaxation of visa requirements to boost tourism, Seychelles has seen 7 per cent annual growth in international tourism arrivals between 2009 and 2014, while African travel to Rwanda has increased by 22%, its cross-border trade with Kenya and Uganda has increased by 50 per cent. Gwatiwa and Sam (2018) note this as evidence that free movement of labour and capital boosts economic activity.

Rwanda and Uganda do not require prior obtaining of visa for anyone, and allow entry using a dual system of no visa or visa on arrival. Comoros, Djibouti, Madagascar and Somalia are the only 4 countries in Africa which still do not grant visa on arrival.<sup>105</sup> While Kenya and Tanzania grant visa on arrival, they still make concessions for citizens of some countries and require visa for some citizens. Furthermore, EAC citizens of Kenya, Rwanda and Uganda move freely between the 3 countries using either their ID cards or the EAC passport<sup>106</sup>. This is a result of removal of mobility restrictions enacted by Heads of State in 2013. Despite restrictions, Eastern African countries still host international migrants.

A failure to liberalize labour mobility also encourages usage of precarious routes, putting women and girls at risk in particular. Small-scale traders, especially women in informal cross border trade (WICBT) are also likely beneficiaries of free movement of persons, with likely reduction in challenges they have been experiencing crossing borders including, harassment, confiscation of goods and others. Intra-African migration should therefore be carefully managed through the Protocol on Free movement of persons.<sup>107</sup>

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<sup>104</sup> In 2015, the AU Assembly adopted a declaration on migration where among others they sought to “establish a harmonized mechanism to ensure that higher education in Africa is compatible, comparable, with acceptability and enable recognition of credentials that will facilitate transferability of knowledge, skills and expertise.”

<sup>105</sup> As at the time of the publication. Developments in Ghana where African citizens can get visa on arrival suggest that progress may have been registered in this regard.

<sup>106</sup> EAC passport is currently applicable in and issued by the 3 member countries.

<sup>107</sup> The Protocol permits managed mobility within prescribed parameters.

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