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Macroeconomic and Social Developments in Eastern Africa 2016-17

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

Executive Summary

The economic performance of Eastern Africa has been impressive in recent years, with an average annual growth rate of 6.8 per cent between 2012 and 2015 – much higher than the African average and outpacing even East Asia. Also, people of the region now on average live longer and healthier, receive better education, and enjoy an improved quality of life compared with just a generation ago. These positive results are largely attributable to the rebuilding of the state, as governments in the region have rebuilt their institutions after the ‘lost decades’ of the 1980s and 1990s. Where state action has been effective, improvements have been largest.

Despite the positive developments, there are a number of challenges looming on the horizon. Amid a still uncertain outlook for the global economy and severe drought conditions which afflicted parts of the region, Eastern Africa recorded a marked moderation in its economic growth in 2016, down to 5.6 per cent. According to UNECA calculations, the regional economic growth is expected to be little changed at 5.6 per cent in 2017, with a modest recovery at 6.1 per cent being forecast for 2018. However, as this report stresses, this performance is still well below the ambitious developmental goals that many member states have set themselves, and the region is not on track to meet targets of middle-income status. Meanwhile, job creation and poverty reduction have not kept pace with a rapidly growing population and workforce. Policymakers have to contend with a large informal sector and some of the fastest rates of urbanization in the world.

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

- Firstly, a weak manufacturing sector has made the regional economy less resilient. Compared to the rapid expansion of the services sector, the development of the manufacturing sector has been lagging behind, as evidenced by the stagnant or even declining share of manufacturing value added over the last decade. Despite the fact that some service sub-sectors (e.g. tourism) in the region have shown considerable dynamism and job creation potential, an excessive dependence on the services sector may not generate sufficient employment opportunities to sustain inclusive growth. Other than Ethiopia, which has implemented an ambitious programme of export-oriented industrial parks, industrial policies have not thus far managed to promote robust growth in the manufacturing sector. This also partly explains why the economic performance has fallen short of national growth targets.
- Secondly, this report stresses the need to continue improving the business environment. Across the region, private sector development has been relatively lackluster. In some countries, the bulk of productive investments are accounted for the public sector and the private sector has generally lagged behind. Growth would be stronger and more resilient if policies were made to bolster private sector activity. One key constraint to achieving this, as reflected in repeated business surveys carried out in the region, is the lack of access to credit. Although central banks generally maintain an accommodative monetary policy in 2017, credit growth remains sluggish and the cost of borrowing often prohibitive. The interest rate cap introduced by the Central Bank of Kenya in 2016 was an interesting initiative intended to address these problems, and did succeed in bringing down lending rate and loans-deposit spread. Yet the impact of the interest rate cap in terms of improving long-term access to credit is unclear.

- Thirdly, the prospects for economic diversification and industrial growth are greatly improved by the necessary investments in infrastructure. In recent years, the region has been doing well in terms of providing a much-needed boost to infrastructural investment. A promising development came in 2013, with the announcement of China's *Belt and Road Initiative*, which has directly implicated a number of economies in the region (e.g. Djibouti, Ethiopia, and Kenya). In 2016-17, two large-scale projects were completed with the financial support from China – Kenya's Nairobi-Mombasa railway and the Addis Ababa-Djibouti railway. Economic activity has undoubtedly been boosted by this infrastructure investment boom. However, the increased public expenditure has also started to stretch budgets and a number of countries have experienced rising debt levels in recent years. For instance, Kenya's public debt is projected to rise to around 55 per cent of GDP in 2017, compared with 44 per cent in 2013. Djibouti was rated by the IMF as a country at a high risk of debt distress and the risk has increased significantly in recent years, something that could constrain future growth and increase vulnerability. These trends clearly need monitoring.
- Fourthly, in the context of structural current account deficits, regional economies have to better manage exchange rate fluctuation. Most countries in the region have now adopted either floating exchange rate or 'managed' float. Many recorded notable depreciations against the US dollar between 2014 and 2016. The pass-through of currency depreciations together with the spike in food prices due to severe drought conditions exerted upward pressure on inflation over this period. Following a subsequent fall in the value of US dollar and an easing effect of a prolonged dry season, both exchange rate and inflation pressures subsided in mid-2017.
- Fifthly, the region is still underperforming in terms of exports, as evidenced by the large trade deficits sustained by most countries. The structure of trade also remains little changed compared to the situation a decade ago. Specifically, exports are still excessively concentrated on primary commodities, leaving the region in the lower rungs of the global value chains and highly vulnerable to commodity price shocks. The report highlights the role not only of goods exports, but also of services, and in particular tourism, which is a major foreign exchange rate earner in a number of countries across the region (e.g. Comoros, Ethiopia, Rwanda, and Seychelles) and is a significant earner in several others (e.g. Kenya, Madagascar, Tanzania, and Uganda).

This leads us to a more general discussion about the regional trade performance and its determinants. Trading relations have been complicated by a number of new developments in recent years, with both positive and negative implications. Firstly, countries in the region have been diversifying their trade away rapidly from traditional markets (e.g. Europe) towards new trading partners (e.g. China and India). The rise of China and India as a source of imports has been particularly notable, accounting more than a third of all imports into the East African Community (EAC) in 2016. This may be good news for both consumers and purchasers of capital goods, as it has reduced the relative price of some consumer and machinery imports, but it also implies greater competition in domestic markets, especially for local manufacturers. It is an unfortunate characteristic of these new trading relations with China and India that exports from the region are still based essentially on primary commodities.

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

Finally, the region has had to confront numerous humanitarian crises in 2016 and 2017. Around 31 million people suffered from severe food insecurity as of May 2017. The region is also one of the biggest recipients of refugees in the world which hosted around 3.5 million refugees at the end of 2016, with Uganda and Ethiopia accommodating around half of them. In addition, there were 5.8 million internally displaced persons (IDPs), mainly in D.R Congo, South Sudan, and Somalia due to political instability and/or civil conflict. The recent communicable disease outbreaks, combined with the increasing number of vulnerable populations, could have significant implications on the public health.

To sum up, the region has clearly performed well over the last decade, but is beginning to confront a new set of challenges. To sustain the impressive development, this report recommends member states to (i) better leverage inflows of foreign direct investment (FDI) into the manufacturing sector to facilitate a more rapid technological upgrading; (ii) actively implement reforms to create a thriving business environment, especially by way of a more effective and accessible financial sector; (iii) continue investing heavily in infrastructure, but in financially sustainable ways; (iv) review trade agreements and develop local and regional value chains via improving local production capacity; and (v) take advantage of hitherto un- or under-exploited natural assets, e.g. the *Blue Economy* which encompasses a range of water-related resources and productive activities.

1. Macroeconomic Performances

1.1. Moderated Growth Momentum in Eastern Africa

The world economy was sluggish in 2016, with an expansion of just 2.3 per cent. Supported by the modest strengthening of global economic activity since the end of 2016 (e.g. trade and industrial production), the world economy is expected to grow by 2.9 per cent in 2017 and 2018 (UNDESA, 2017a).

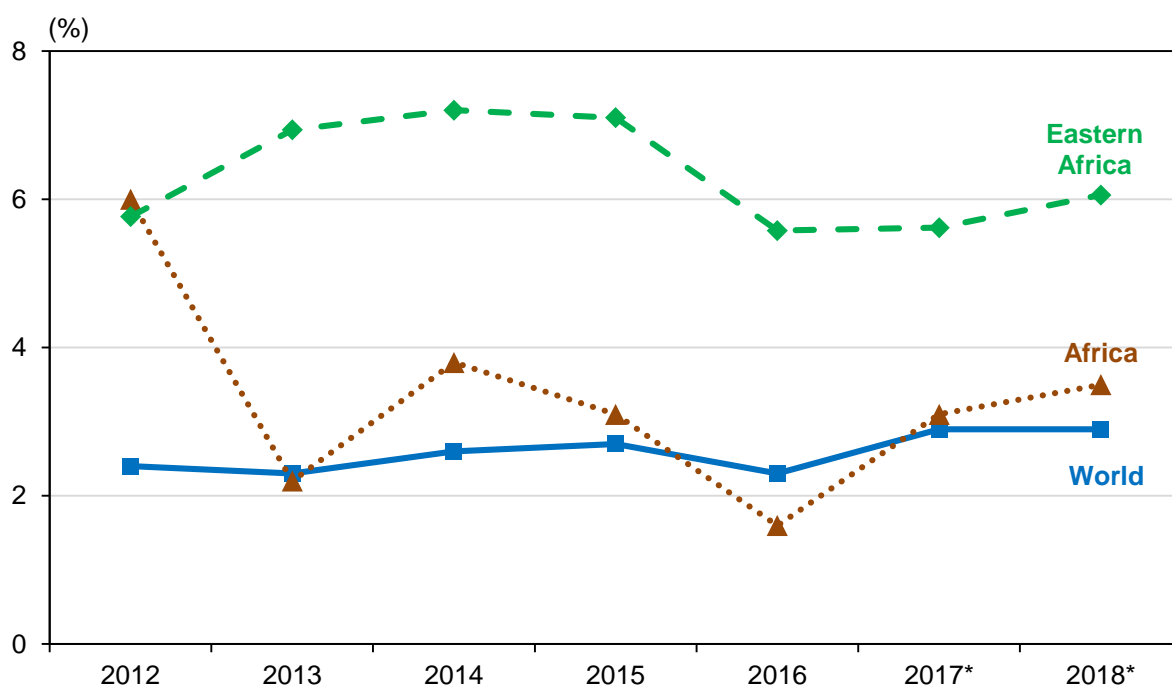
The slowdown in economic growth was more notable in Africa, down from 3.1 per cent in 2015 to 1.6 per cent in 2016. The low growth rate was due to adverse weather conditions, subdued global economic recovery, low commodity prices, and political instability. In particular, the growth rate of oil exporters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

Regarding Eastern Africa¹, despite the still quite challenging global context, the growth performance has been impressive. The average growth rate between 2012 and 2015 was 6.8 per cent, much higher than the African average (3.8 per cent) and the world average (2.5 per cent) and outpacing East Asia (6.1 per cent) over the same period. Nonetheless, growth in the region moderated to 5.6 per cent in 2016. One particularly important reason for the slowdown was the fact that several countries in the region (e.g. Kenya, Uganda, and Rwanda) experienced a sharp decline in agricultural performance, due to severe drought conditions. The regional economic growth is expected to be little changed at 5.6 per cent in 2017, with a modest recovery at 6.1 per cent being forecast for 2018 (Figure 1).

The economic performance of Eastern Africa has been impressive, with the average growth rate between 2012 and 2015 outpacing East Asia, yet GDP growth moderated notably in 2016.

¹ For the United Nations Economic Commission for Africa (UNECA), Eastern Africa is a geographical region comprised of 14 countries, that are Burundi, Comoros, D.R Congo, Djibouti, Ethiopia, Eritrea, Kenya, Madagascar, Rwanda, Seychelles, Somalia, South Sudan, Tanzania, and Uganda.

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



Notes: (*) Forecast.

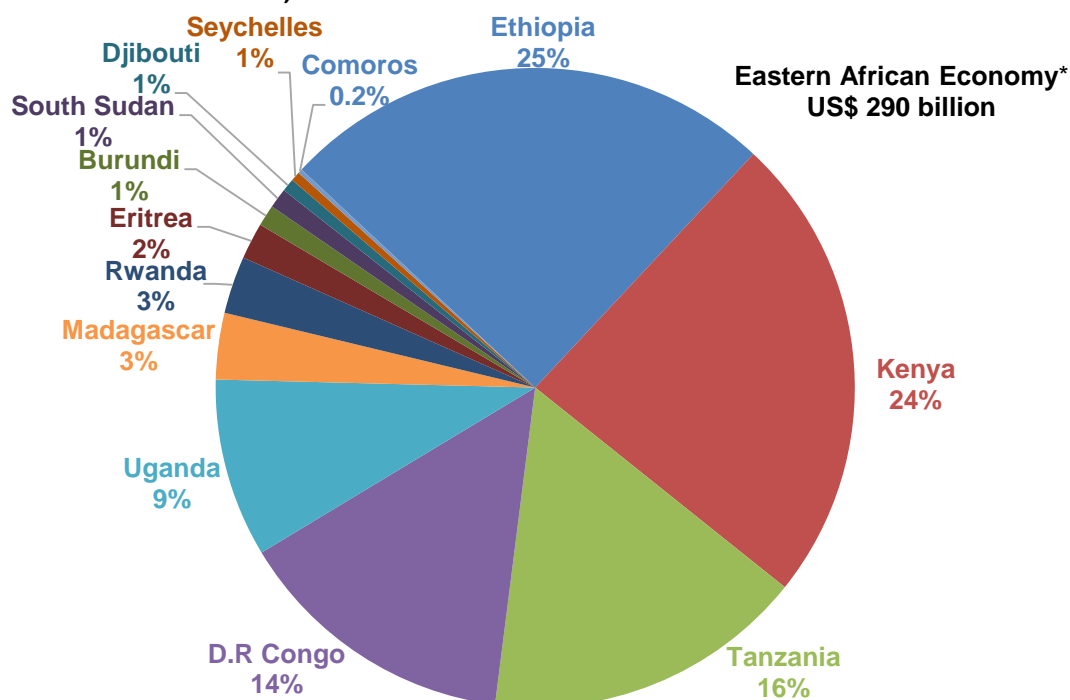
Data for Eastern Africa is the weighted average (based on current prices gross domestic product (GDP) figures) of the 12 countries (excluding Somalia and South Sudan).

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

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

² Given that Eastern Africa is home to around one-third of Africa population, the region is under-represented in terms of GDP.

Figure 2: Nominal GDP share, 2016

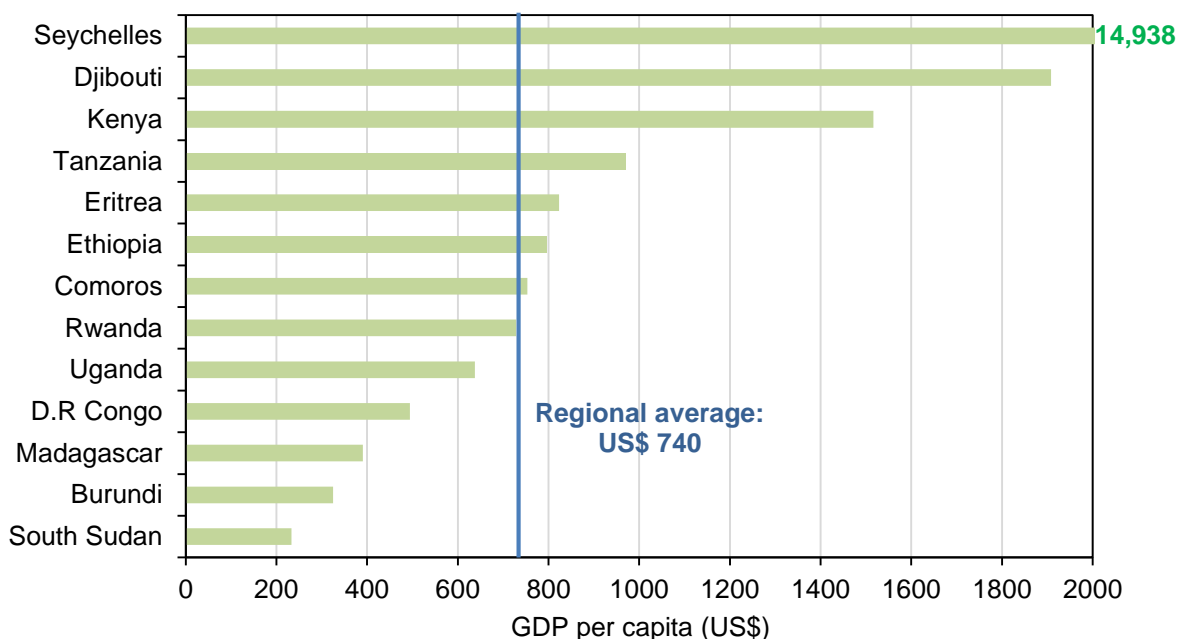


Note: (*) Somalia is not included.

Source: IMF (2017a).

The situation is different in terms of GDP per capita. Seychelles continues to be the highest income country in the region, enjoying a per capita income of around US\$ 15,000 in 2016. Djibouti and Kenya are the second and third highest income per capita countries respectively, while all other countries in the region are classified by the World Bank as low-income (Figure 3).

Figure 3: GDP per capita, 2016



Source: IMF (2017a).

Regarding the economic performance of different countries in the region, Ethiopia, Rwanda, and D.R Congo experienced the fastest expansion in the past five years. Nevertheless, the growth moderated in 2016 due to lower agricultural production amid the El Niño induced drought and declines in commodity prices. As for the other major economies in the region, Tanzania and Kenya sustained solid growth in 2016, while the Ugandan economy lost momentum due to poor agricultural and manufacturing performances (Table 1). In terms of economic prospects for 2017, the most recent statistics do not present a promising picture. For example, Rwanda's economy expanded by 4.0 per cent in the second quarter of 2017, compared to 7.5 per cent in the second quarter of 2016.³ During the same period, the growth rate of Kenya also moderated from 6.3 per cent to 5.0 per cent.

The most recent statistics do not present a promising picture to the economic prospects for 2017.

Table 1: Real GDP Growth (% annual change)

	2012	2013	2014	2015	2016	2017*	2018*	Average Growth Rate (2012-2016)
Ethiopia	8.7	9.9	10.4	10.4	8.0	7.1	7.3	9.5
Rwanda	8.8	4.7	7.6	8.9	5.9	6.2	6.8	7.2
D.R Congo	7.1	8.5	9.5	6.9	2.4	2.8	4.5	6.9
Tanzania	5.1	7.3	7.0	7.0	7.0	7.0	6.8	6.7
Djibouti	4.8	5.0	6.0	6.5	6.7	6.8	6.8	5.8
Kenya	4.5	5.9	5.4	5.7	5.8	5.4	5.9	5.5
Seychelles	3.7	5.0	6.2	4.3	5.9	4.1	3.4	5.0
Eritrea	7.0	3.1	5.0	4.8	3.7	3.2	3.5	4.7
Uganda	3.2	4.7	4.6	5.7	2.3	5.2	5.7	4.1
Madagascar	3.0	2.3	3.3	3.1	4.2	4.3	4.5	3.2
Comoros	3.0	3.5	2.1	1.0	2.2	3.0	3.4	2.4
Burundi	4.4	4.9	4.5	-3.9	-0.5	0.1	0.1	1.9

Notes: (*) Forecast.

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

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

³ The slowdown was mainly due to the completion of large construction projects. The economic performance is expected to rebound in the latter part of 2017 given a recovery of agriculture and an increase in exports revenues.

Box 1: Did Economic Growth Meet National Targets?

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

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

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

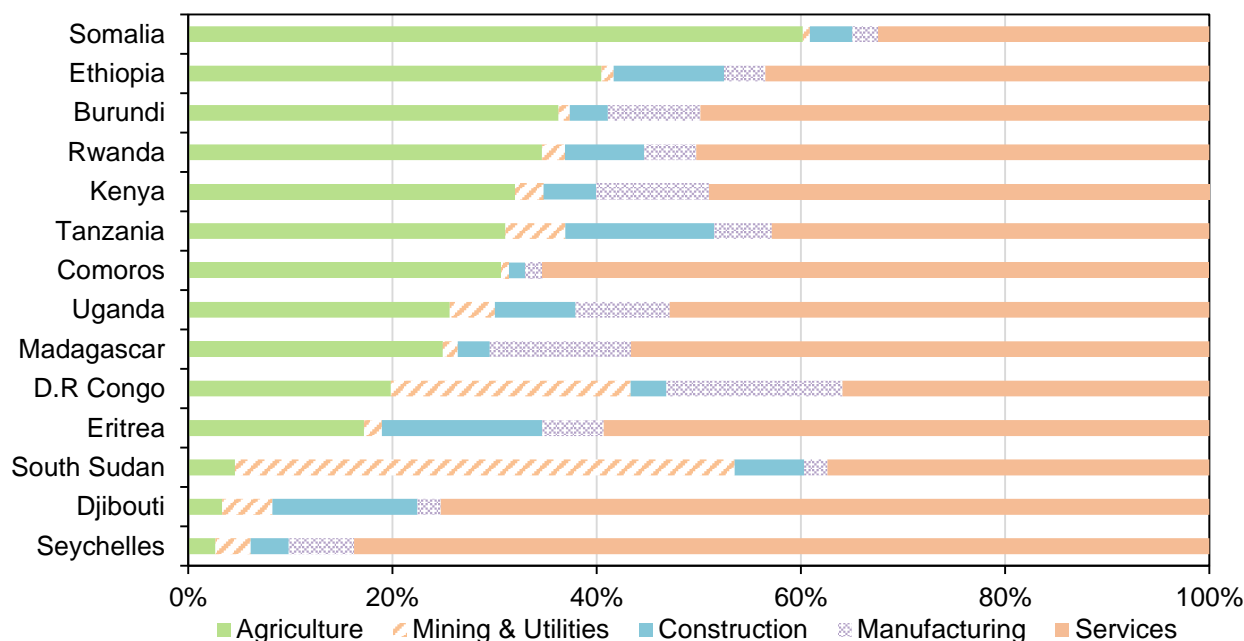
Tanzania: Vision 2025 was adopted in 1999, with the aim of achieving high quality living standards for its people, good governance through the rule of law, and a strong and competitive economy. It was envisioned that Tanzania will transform into a middle-income country by 2025 and achieve a growth rate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

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

Sectoral analysis provides a clear picture on the economic structure as well as the key drivers of growth.⁴ Figure 4 shows that agriculture retains its preeminent role in many countries, on average accounting for around 30 per cent of total value added in the region, with a modest annual growth rate of around 4 per cent in recent years. Given the fact that most of the labour force still works in the agriculture sector, its performance remains crucial to people’s livelihoods.⁵ As the sector is highly vulnerable to weather-related shocks, it is not only one of the main constraints in terms of maintaining a strong economic performance, but also one of the major causes of humanitarian crisis in the region. The successive episodes of drought in 2016 and 2017 stand out in scale and severity, resulting in significant drops in agricultural production and contributing to food insecurity in some countries (see section 2.2 for a more detailed discussion). Moreover, the spread of the fall armyworm to Eastern Africa in early 2017 has affected about 200,000 hectares of crops in Kenya and more than half of the country in Uganda (FAO, 2017).

Most of the labour force still works in the agriculture sector, its performance remains crucial to people’s livelihoods.

Figure 4: Sector shares, 2015



Source: UNdata.

For the industrial sector, mining and utilities represents a significant share of the economy in resource-rich countries such as D.R Congo and South Sudan. On the back of the rapid infrastructure development in the region, the construction sector recorded double-digit growth in the past decade or so, and accounted for a growing share of GDP in countries such as Djibouti, Ethiopia, and Tanzania. The construction boom is associated with the mega-trend of rapid urbanization, with Eastern Africa being the fastest urban population growth region in the world at around 5 per cent annually over the past decade (UN-Habitat, 2016). As discussed in the *Economic Report on Africa 2017*, urban and industrial development in Africa are disconnected. The challenge confronting Africa is thus to

⁴ UNECA has been advocating the development of the Blue Economy, a new framework anchored in the principles of sustainable development. It covers aquatic and marine spaces, including oceans, seas, coasts, lakes, rivers, and underground water, and it comprises a range of productive sectors, such as fisheries, aquaculture, tourism, transport, shipbuilding, energy, bio-prospecting, and underwater mining (UNECA, 2016a).

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

accelerate structural transformation⁶ by harnessing the rapid urban transition to enhance growth and productivity, reduce poverty, as well as promote social development.

Manufacturing is a crucial sector for enhancing productivity and job creation. It contributes not only to the trade balance, but a critical minimum level of manufacturing is required for country to attain a sustainable rate of economic growth.

As for the manufacturing sector, its share of value added is below 10 per cent for most of the countries and has been in a declining trend in the last decade. Manufacturing is a crucial sector for enhancing productivity and job creation. It contributes not only to the trade balance, but a critical minimum level of manufacturing is required for country to attain a sustainable rate of economic growth (Fosu, 1990 and 1996). Despite the various industrial policies

and ambitious targets set by the governments, the levels of implementation have been generally low. In fact, other than Ethiopia that experienced remarkable growth in manufacturing production from a low base, the sector played a very limited role in boosting economic growth in the region.

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

Box 2: Lessons on Implementing Industrialisation Policy from Ethiopia

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

In implementing its vision of industrial development, Ethiopia has committed to attracting FDI whereby foreign firms play a major role in terms of job creation and, crucially, providing technological upgrading and managerial capacity, particularly with regard to export industries. Such an initiative has been used in other 'late industrialisers' – countries such as China and Vietnam which have used foreign investment not so much for the financial contribution the investment makes, but rather to facilitate a more rapid assimilation of foreign technologies and modern managerial practices. However, the advantages of FDI are far from automatic and depend on mediating characteristics of the domestic economy (UNIDO, 2015). Also, it remains to be seen the

⁶ By structural transformation, UNECA means the fundamental changes in economic and social structures that drive inclusive and sustainable development.

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

There are a number of tangible and impressive achievements to point to from the implementation of industrialisation policies. Over the last decade, Ethiopia has developed thriving leather, floriculture, and cement industries, with plans in the pipeline to increase the number of industrial hubs. In countries with poor infrastructure and challenging business environments, special economic zones or industrial parks can be used to overcome barriers to firm entry, attract FDI, and encourage industrial clusters. The development of industrial parks aims to transform Ethiopia into a major manufacturing hub in Africa and has three intertwined objectives, namely, employment creation, foreign exchange generation, and technology and skill transfer. In 2016 alone, the country opened no less than three industrial parks. The flagship Hawassa Industrial Park, for instance, is a 300-hectare industrial park focused on textile and garment production. Officially inaugurated in July 2016, eighteen companies have already started operations in the industrial park and, six of them are presently exporting their products to the global market. Once operational at its full potential, the park is expected to create about 60,000 jobs and generate US\$1 billion annually.

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

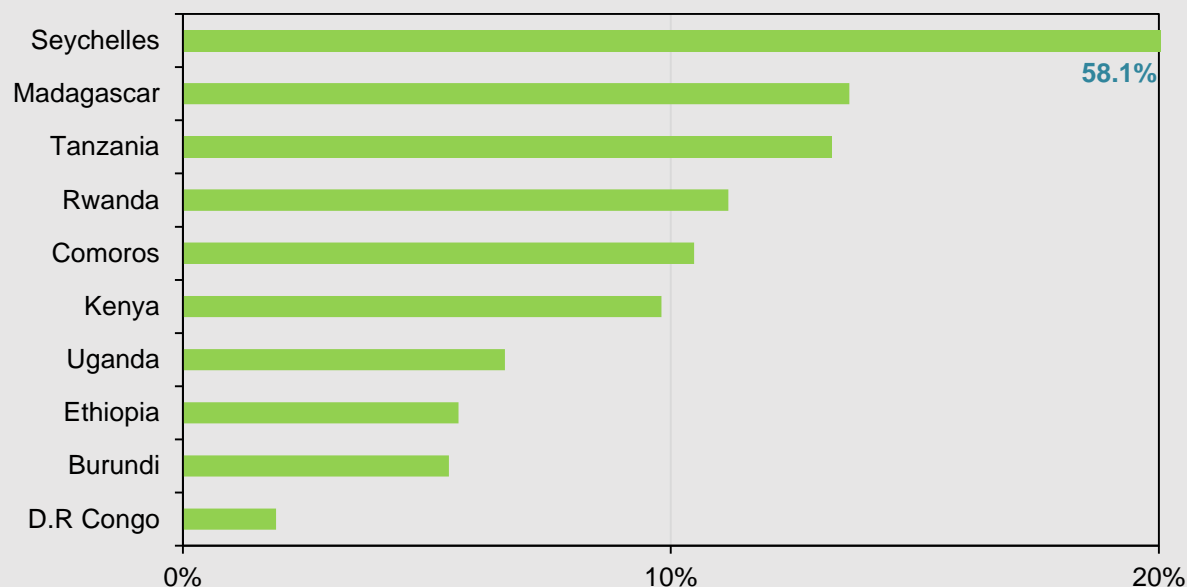
Source: UNECA (2017a).

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

Box 3: Contribution of Tourism to Eastern African Economy

Despite a turbulent year, the tourism industry continues to play an important role to the economy of the region⁸. The industry accounted for over US\$ 22 billion to the region's GDP in 2016, or around 13.6 per cent of GDP, much higher than the continent's average of 7.8 per cent. Tourism's contribution has been sustained with Seychelles, the usual outlier, at 58.1 per cent, while D.R Congo was at the lower end at 1.9 per cent (Figure 5). Nonetheless, 2016 saw a decline in tourism growth for a number of countries, with Ethiopia registering the largest decline of 8.1 per cent compared to the previous year.

Figure 5: Contribution of tourism to GDP, 2016



Source: WTTC (2017).

The tourism industry is one of the leading foreign exchange earners⁹, representing around US\$ 10.3 billion (or around 19 per cent) of total exports in the region in 2016, despite a slight decline of 1.6 per cent. The deceleration was mainly due to the sharp decrease of 25.4 per cent in Ethiopia, which could be attributed to the perception of instability across the country in 2016. Another emerging trend has been the gradual increase in outbound tourism. Outbound tourism spending in the region valued at more than US\$ 2 billion, up by 9.6 per cent in 2016. Specifically, Seychelles registered the highest growth rate at 47.1 per cent, followed by D.R Congo at 18.5 per cent. Meanwhile, Comoros had the highest outbound tourism share of GDP at 6.7 per cent. Similarly, hitherto largely ignored, domestic tourism has been evolving as an important segment with an average growth rate of 3.5 per cent across the region in 2016. Specifically, Rwanda and Kenya registered the highest growth rates at 7.8 per cent and 6.8 per cent respectively, thanks to the sustained national campaigns and incentives towards promoting domestic tourism.

The region is also an attractive destination for capital investment, accounting for around US\$ 6.6 billion in 2016. In fact, Kenya was ranked as Africa's hottest investment spot, where 24 multi-billion five-star hotel projects are currently underway (Business Daily, 2017). In addition, the industry remains an important source of employment, generating more than 6 million jobs in 2016 and accounting for about 13.4 per cent of total employment across the region. However, notable declines in employment were recorded in Ethiopia (down by 10.5 per cent) and Kenya (down by 6.2 per cent).

In spite of the positive outlook of the industry, the region has continued to endure challenges that hinder its growth potential. According to the Travel and Tourism Competitiveness Index, the region has not been ranked favourably with the exception of Seychelles (Table 2). The major areas of concern have been relating to the lack of tourism and physical infrastructure (including air and ground), and issues related to human resources as well as safety and security. For instance, in terms of the quality of the prevailing tourism infrastructure, Burundi, D.R Congo, and Ethiopia were ranked at 136th, 134th, and 129th in 2017 respectively, while Tanzania and Uganda were at 131st and 115th in terms of human resources quality. Being ranked at 129th, safety and security related issues continue to hinder tourism growth and development in Kenya. On a positive note, some countries have made progress on a number of areas including visa openness, for example, Uganda was ranked at 7th globally, prices competitiveness in the case of Tanzania and Madagascar at 34th and 55th, and availability of skilled employees in the case of Kenya at 26th. The region also did quite well in terms of the quality of prevailing natural resources, with countries like Tanzania, Kenya, and Uganda being ranked at 8th, 15th, and 44th.

Table 2: Tourism and Travel Competitiveness Index

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

Source: WEF.

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

According to the Global Infrastructure Hub, the total infrastructure investment forecast for Africa to 2040 is projected to be US\$ 174 billion per year under the current trends, and an additional US\$ 66 billion per year is required to raise the performance to match the best performing peers. Specifically,

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

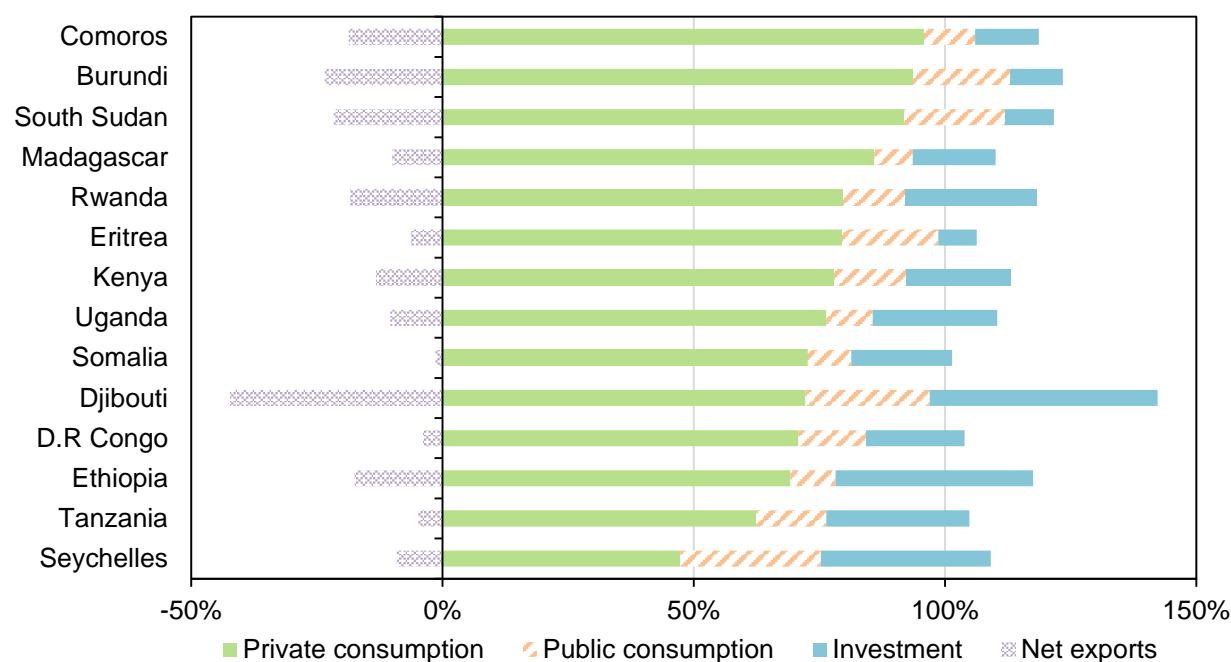
⁹ It is a major foreign exchange rate earner in a number of countries across the region (e.g. Comoros, Ethiopia, Rwanda, and Seychelles) and is a significant earner in several others (e.g. Kenya, Madagascar, Tanzania, and Uganda).

¹⁰ The Commission on Growth and Development suggested that a necessary condition for sustained high growth is an overall investment rate of at least 25 per cent of GDP, while the average share of investment as of GDP in the region was around 25 per cent in 2015.

transport investment requires much larger inputs as it only accounted for 27 per cent of total infrastructure spending between 2007 and 2015 in Africa compared to the world average of 45 per cent. While the infrastructure investment boom, especially with the support from China's *Belt and Road Initiative*, is expected to boost economic growth, it has raised concerns about debt sustainability as the projects were financed primarily by external borrowing (see section 1.5 for a more detailed discussion). Meanwhile, whether the projects are value for money (e.g. higher economic payoffs than the costs) is to be monitored.

While the infrastructure investment boom, especially with the support from China's Belt and Road Initiative, is expected to boost economic growth, it has raised concerns about debt sustainability

Figure 6: Demand shares, 2015



Source: UNdata.

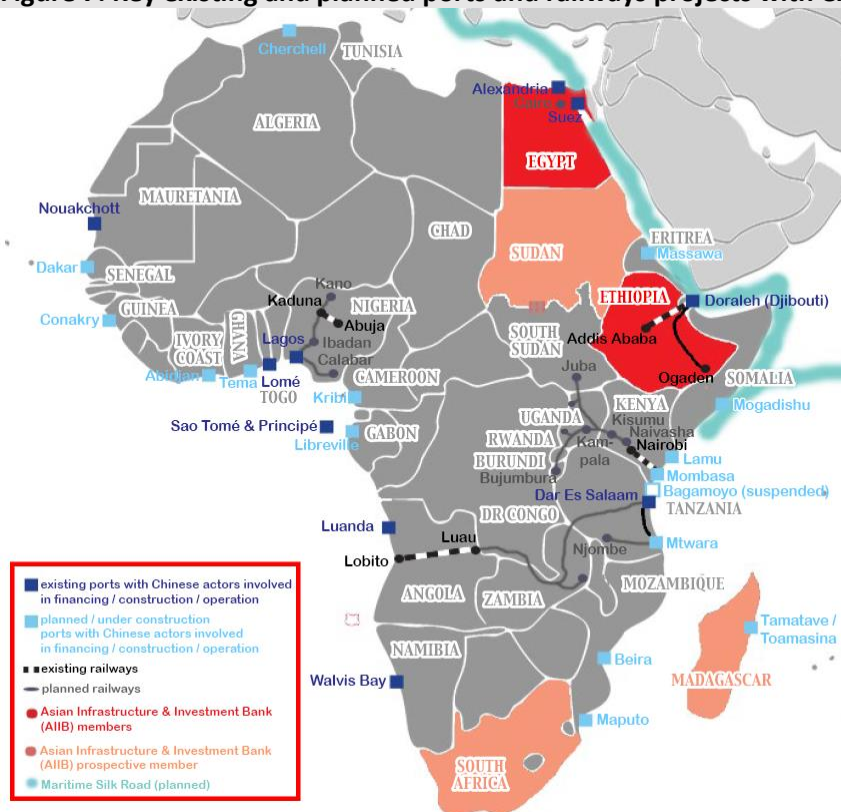
Box 4: Opportunity from China's Belt and Road Initiative

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

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

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

Figure 7: Key existing and planned ports and railways projects with Chinese actors in Africa



Source: Stiftung Asienhaus (2017).

The infrastructure investment would boost connectivity within Africa, thereby facilitating intra-continental trade. Moreover, Africa could trade with the world easier and at lower transportation costs, especially with China via the ports along the Maritime Silk Road.

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

1.2. An Unconventional Path of Structural Transformation

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

By decomposing gross valued added (GVA) per capita growth into labour productivity growth, changes in employment rates, and demographic change¹¹, the pace and depth of structural transformation in the region can be better accessed. In particular, labour productivity growth can be decomposed into (i) the within-sector component, which relates to labour productivity improvements achieved through enhanced skills, better resource relocations, and/or adoption of technological progress within a specific sector, as well as (ii) the between-sector component, which relates to labour productivity gains accrued by the shift of labour from lower-productivity to higher-productivity sectors and usually serves as a proxy for structural transformation.

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

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

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

Sources: Martins (2015), and UNECA calculations.

In Eastern Africa¹², the solid growth during 2002 to 2013 was mainly due to labour productivity improvements, both within- and between-sectors. Compared to other regions in Africa, its contribution to structural change was more significant (Table 4). However, it should be noted that

¹¹ GVA per capita can be expressed as $Y/N = (Y/E) \times (E/A) \times (A/N)$ where Y is the total value added, N is total population, E is total employment, and A is the working-age population. GVA per worker (i.e. Y/E) can then be decomposed by sectors into within-sector and between-sector effects.

¹² In the following two tables, Eastern Africa comprises Burundi, Comoros, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Mozambique, Rwanda, Tanzania, Uganda, Zambia, and Zimbabwe as defined in Martins (2015). The coverage is a bit different from that of UNECA.

Eastern Africa has the lowest labour productivity across major sectors and the highest share of employment in the least productive sector (i.e. agriculture), thereby providing large potential for within-sector improvement and better labour reallocation.

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

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

Source: Martins (2015).

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

Structural transformation provided a sizeable contribution to economic growth in Eastern Africa over the past decade, but mainly through the services sector rather than manufacturing.

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

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

Source: Martins (2015).

1.3. Accelerating Industrialisation via Infrastructure Development

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

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

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

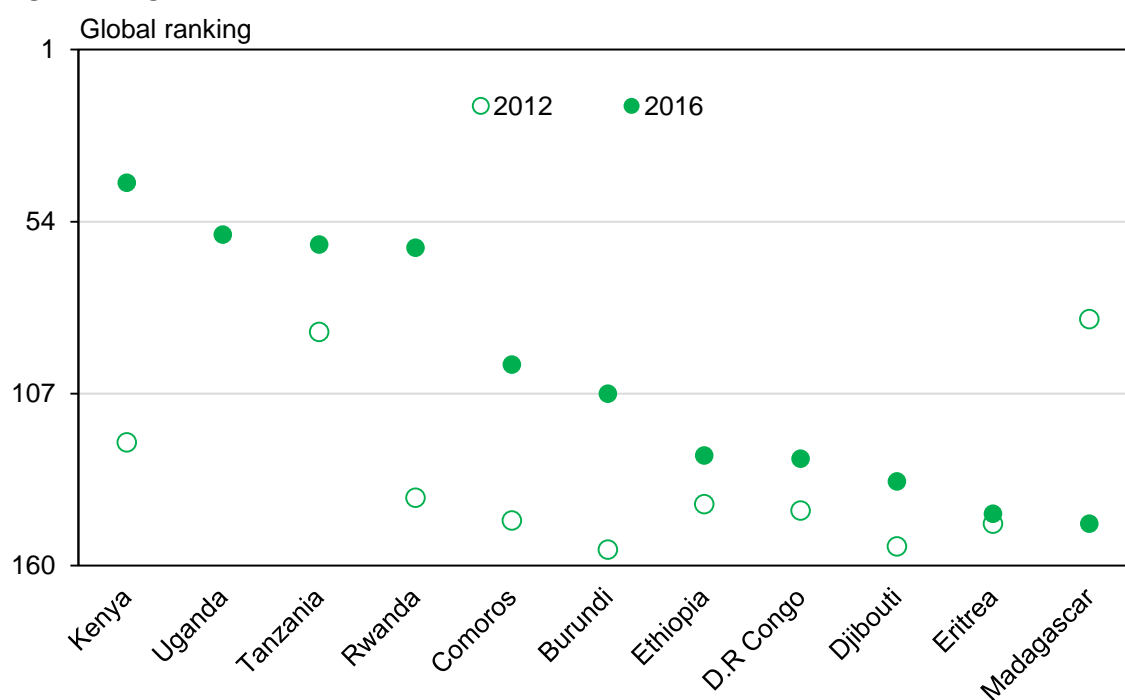
Development and financing of infrastructure in Eastern Africa will continue to be crucial for strengthening the case for industrialization.

The Africa Peer-Review Mechanism (APRM) Major Bottlenecks Facing Africa report calls for an infrastructure investment level of 10 per cent of GDP by 2020. Development and financing of infrastructure in Eastern Africa will, therefore, continue to be crucial for strengthening the case for industrialisation. UNECA assesses that energy demand in Africa will rise from 125

GW in 2010 to 700 GW by 2040, with significant increases in Eastern Africa at a rate above 10 per cent per year (UNECA, 2017b). Addressing these growing infrastructure requirements in a policy environment poised for pursuing rapid industrialisation remains a key challenge that requires policy consideration and implementation.

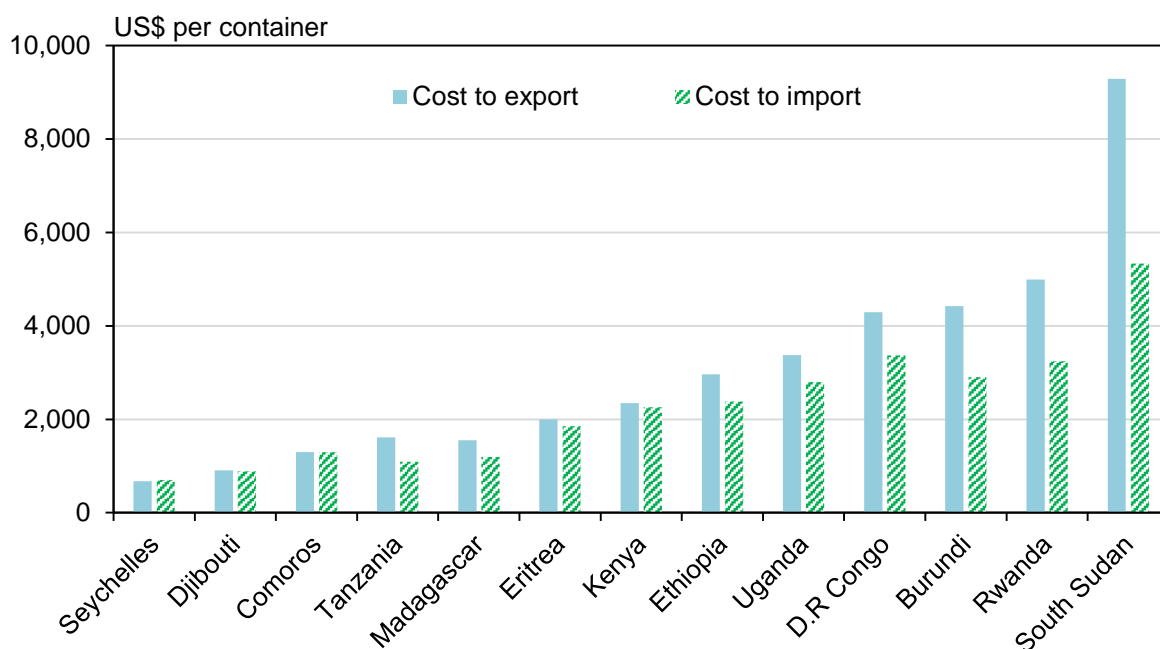
In fact, industrial competitiveness is affected by the overall state of infrastructure development. Analysis of logistical performance data for Eastern Africa indicates that while there are major gains in logistical improvement since 2012, especially in Kenya and Rwanda, the overall ranking for most member states above 100 demonstrates the need to speed up infrastructure development to support efficient logistics for industrialisation (Figure 8). The infrastructure component of the ranking similarly demonstrates that while there have been major ranking gains in the region, there is a prevailing infrastructure-based logistical gap constraining the agenda of industrial growth in the region.

Figure 8: Logistics Performance Index



Source: World Bank (2017a).

Industrial development is also directly affected by import and export costs, driven by logistical (including infrastructure) development and efficiency. Coastal countries in the region are expected to have lower import and export costs, as indeed is the case. However, the cost of trade increases rapidly in landlocked countries, such as Burundi and Rwanda (Figure 9). Regional infrastructure development is, therefore, inherently linked to industrial performance and development.

Figure 9: Cost to export and import, 2014

Source: World Bank (2017b).

In order to meet the infrastructure gap for industrialisation, it is important to invest in infrastructure in financially sustainable ways with an integrated planning. Bridging the current low level of infrastructure input for industrialisation, particularly energy, requires investment and development of the sector. The region already puts major public investment into infrastructure, about 40 per cent of which into energy (Deloitte, 2015). Sustaining such investment in infrastructure is crucial to make major gains in closing the gap and create a conducive environment for industrialisation.

Yet energy sector financing will constitute a major challenge for the region. Under the International Energy Agency (IEA) energy development scenario for East Africa¹³ (2014-2040), average annual total investment in the energy sector is expected to grow from US\$ 4.2 billion in the 2014-20 period to US\$ 12.2 billion in the 2036-40 period. During the same period, grid infrastructure investment is also expected to increase from US\$ 2.4 billion to US\$ 6.3 billion per year (IEA, 2014). While the financial analysis comprises selected countries in Eastern Africa, the financial requirement for power sector investment for the whole region will be much higher.

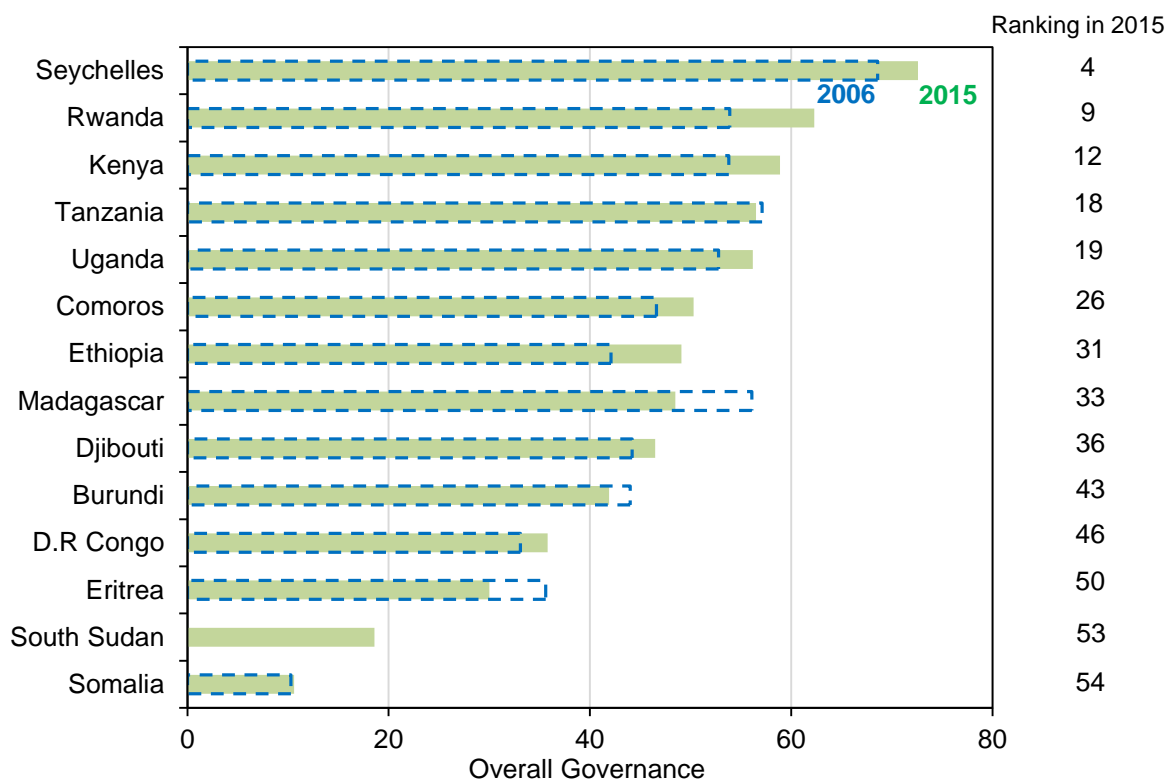
Moreover, industrial and infrastructure development should be pursued in tandem. Economic development planners need to consider infrastructure assets in industrial design, while energy and infrastructure planners need to anticipate and respond to emerging industrial development aspirations. Integrated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

¹³ Under the IEA regional classification for this analysis, East Africa is constituted by Eritrea, Djibouti, Somalia, Kenya, Uganda, Rwanda, Burundi, South Sudan, and Sudan.

1.4. Improved Governance and Business Environment

Good governance and a conducive business environment play a prominent part in economic growth. According to the *2016 Ibrahim Index of African Governance* which covers 54 countries, the overall governance performance at the continental level improved slightly from an average score of 49 in 2006 to 50 in 2015. Within Eastern Africa, the performance of different countries varies hugely, ranging from the top ranked countries (e.g. Seychelles and Rwanda) to the bottom ranked countries (e.g. South Sudan and Somalia). For the more notable changes, Rwanda and Ethiopia registered impressive progress between 2006 and 2015, mainly thanks to improvement in human development including education, health, and welfare. In contrast, Madagascar recorded sharp deterioration due to a protracted political crisis from 2009 to 2014 (Figure 10). Moreover, presidential elections are an important factor that can cause political uncertainty and affects business confidence. For example, Kenya’s business conditions deteriorated sharply in August 2017 when its general election was held, with some trading activities shifted to ports nearby over Mombasa and shops closed in major towns amid uncertainty and fears of violence over the election. As the Supreme Court invalidated the results of the August presidential election, a rerun of the election is scheduled in October 2017.

Figure 10: The 2016 Ibrahim Index of African Governance



Source: Mo Ibrahim Foundation (2017).

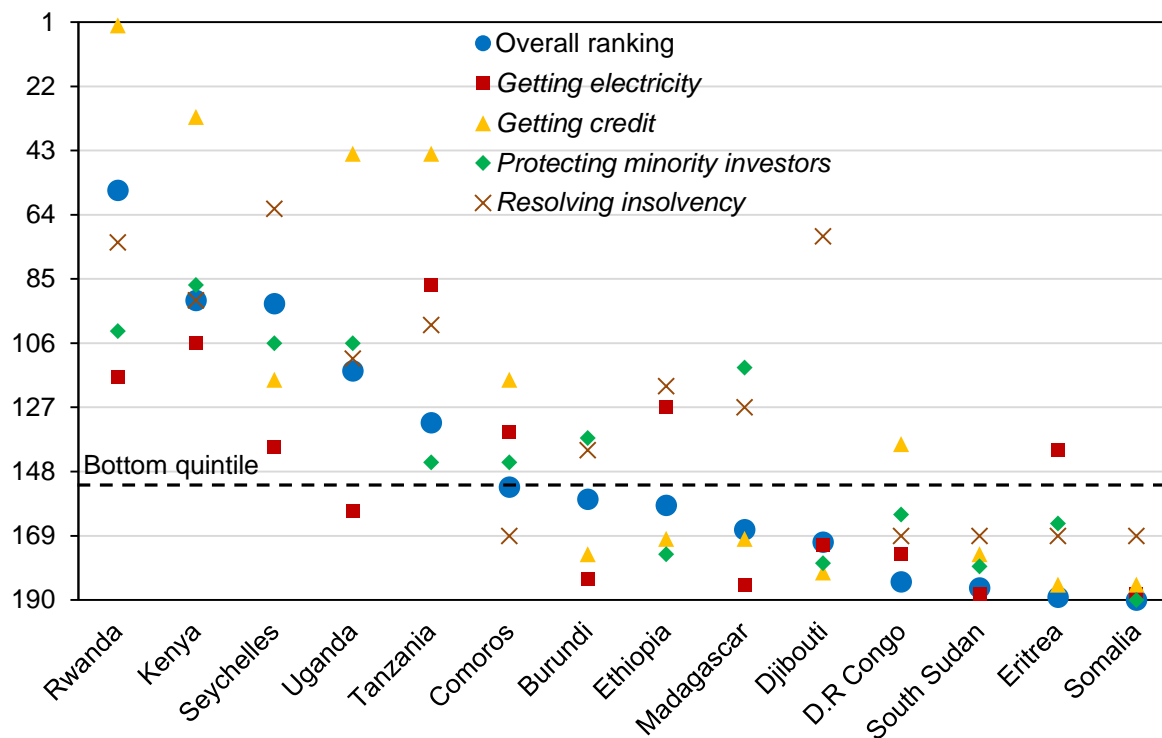
All the countries in the region recorded improvement in the Ease of Doing Business Index 2017, yet many of the areas are still significantly behind international standard.

Eastern Africa countries have been actively implementing reforms to create a thriving business environment. In the 2017 edition of the *Doing Business* report, all of the 14 countries in the region recorded improvement and the highest-ranked country was Rwanda, in 56th place out of 190 countries. Tanzania had the largest increase in score

thanks to the significant improvement in the expansion of borrower coverage. Meanwhile, Kenya was selected as one of the top ten reformers worldwide, the various reforms including removing stamp

duty fees for certain articles, streamlining the process of getting electricity by introducing the use of a geographic information system, and making resolving insolvency easier. Having said that, most of the countries in the region still have relatively low scores, with more than half of them in the bottom quintile. In particular, the performances in getting electricity, getting credit, protecting minority investors, and resolving insolvency are significantly behind international standard, thereby constraining the development of private sector (Figure 11).

Figure 11: Ease of Doing Business Index 2017



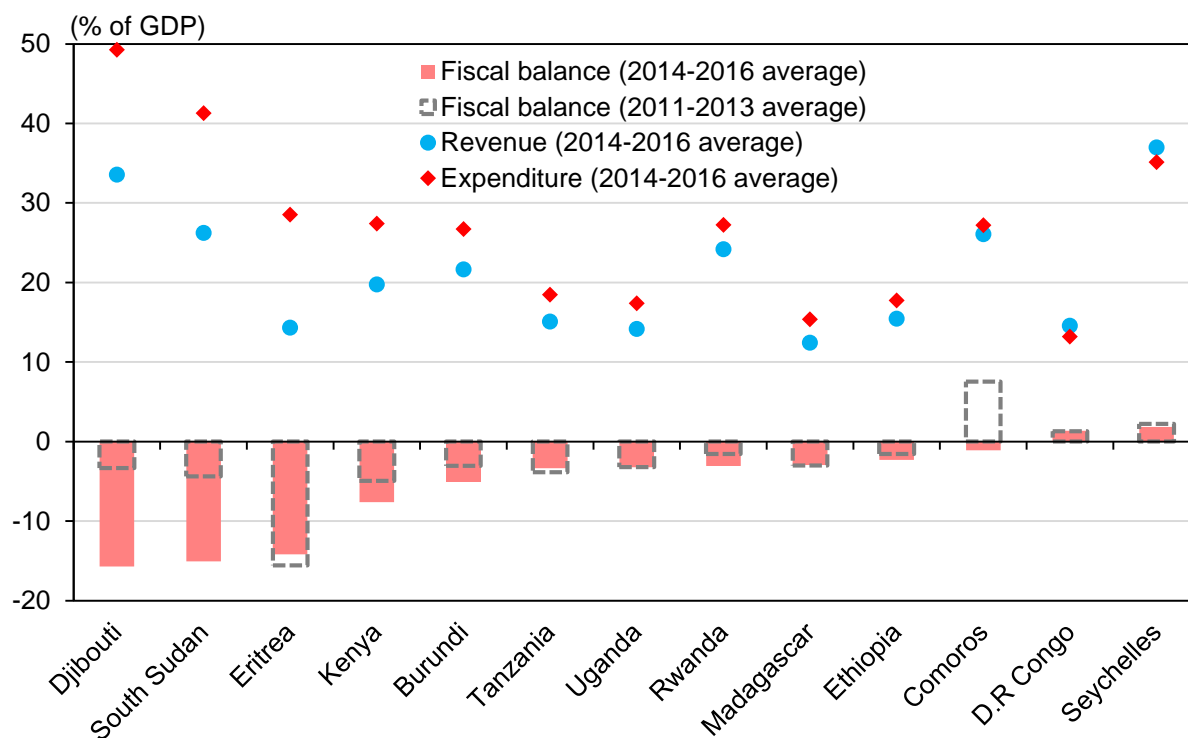
Source: World Bank (2017c).

1.5. Widening Budget Deficits Under Elevated Infrastructure Expenditure

Budget deficits have widened in a number of countries in recent years amid elevated infrastructure development spending (Figure 12).¹⁴ The increase in infrastructure expenditure was particularly notable in Djibouti (construction of several new ports, a railroad and a water pipeline from Ethiopia) and Kenya (a new railway and increased transfers to the counties).¹⁵ While countries have been trying to achieve fiscal sustainability by curbing recurrent expenditures and raising revenues, the generally low tax base and high share of informal activities have limited the scope for revenue collection.¹⁶ In addition, financial support from international donors has been declining, especially in Burundi following the socio-political crisis. Against this backdrop, countries have been strengthening domestic resource mobilization via enhancing tax administration and collection as well as introducing new taxes and cancelling tax exemptions. For instance, Tanzania has developed the Government e-Payment Gateway System and a new Electronic Revenue Collection System to facilitate revenue collection, and started collecting property tax in the 2016/17 financial year (MOF, 2017).

Countries have been strengthening domestic resource mobilization via enhancing tax administration and collection as well as introducing new taxes and cancelling tax exemptions.

Figure 12: Fiscal balance



Source: IMF (2017a).

¹⁴ The fiscal surplus of Comoros during the period 2011 to 2013 was due to an extensive irrevocable debt relief in 2013 as a result of the Heavily Indebted Poor Countries (HIPC) initiative as well as the increase in domestic revenue from the Economic Citizenship Program in 2012.

¹⁵ The budget-making process has also raised concerns, especially when budget deficits are underestimated (The East African, 2017).

¹⁶ Certain new trade agreements that imply lower customs duties would also weaken the revenue mobilization capacity.

The widening fiscal deficits, coupled with weak exchange rate, have resulted in rising external debt levels in the region. Based on the latest IMF debt sustainability assessment, the risk of debt distress in Kenya¹⁷, Rwanda, Tanzania, and Uganda remained low, whereas Comoros, D.R Congo, Ethiopia, and Madagascar carried a moderate risk. Burundi and Djibouti were rated as high risk, due to the high external debt-to-exports ratio of the former¹⁸ and the rapid accumulation of debt from 2014 to 2016 of the latter. Despite moderate levels of public external debt, South Sudan fell into debt distress amid the economic crisis and continued political instability (Table 6).

Table 6: Debt sustainability assessment

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

Source: IMF (2017c).

In terms of the source of financing, there has been a shift of debt from concessional to non-concessional sources (including bilateral and commercial credits, as well as international bond market) and from advanced economies to China in some countries (e.g. Djibouti, Kenya, Tanzania, and

The associated risks and greater market volatility of financing from international capital market warrant prudent debt management.

Rwanda).¹⁹ The international capital market, which does not enforce conditionalities on bilateral and multilateral loans, seems to be an appealing source of finance amid the extremely low global interest rates. Yet the associated risks (e.g. currency mismatch) and greater market volatility warrant prudent debt management.

¹⁷ Yet Kenya's public debt is projected to rise to around 55 per cent of GDP in 2017, compared with 44 per cent in 2013 (IMF, 2017c).

¹⁸ Burundi has relied more heavily on domestic borrowing after the withdrawal of financial support from international donors.

¹⁹ For example, the recent major infrastructure investment projects in Djibouti, including multipurpose Port Doraleh, Addis Ababa - Djibouti railway, and water pipeline with Ethiopia, were largely financed by the Export-Import Bank of China. At the end of 2016, 68 per cent of the external debt was government-guaranteed debt, of which 77 per cent was owned to the Export-Import Bank of China (IMF, 2017d). As for Kenya, the share of bilateral credits from China accounted for 17.4 per cent of external debt in 2016 compared to 4.8 per cent in 2012, partly due to the construction of the Standard Gauge Railway. During the same period, the share of international sovereign bond went up from zero per cent to 15.5 per cent (KNBS, 2017a and IMF, 2017c).

1.6. Accommodative Monetary Policy Amid Easing Inflation and Exchange Rate Pressure

Inflation rates showed signs of picking up in Eastern Africa in 2016. Despite the low fuel price, the spike in food prices after the long spell of the drought and pass-through of currency depreciations exerted upward pressures on inflation. The latest statistics show that inflation continued to rise in early 2017, but gradually decelerated in mid-2017 as the effect of a prolonged dry season on food prices eased. For instance, Tanzania's headline inflation rate moderated from 6.4 per cent in March 2017 to 5.2 per cent in July 2017. For most of the countries in the region, it is expected that the annual inflation rate in 2017 would be at a similar or slightly higher level than that in 2016 (Table 7).

Table 7: Inflation (% annual change)

	2012	2013	2014	2015	2016	2017*	Average (2012-2016)
Ethiopia	24.1	8.1	7.4	10.1	7.3	6.3	11.4
Burundi	18.2	7.9	4.4	5.6	5.5	12.4	8.3
Tanzania	16.0	7.9	6.1	5.6	5.2	5.1	8.2
Eritrea	6.0	6.5	10.0	9.0	9.0	9.0	8.1
Kenya	9.4	5.7	6.9	6.6	6.3	6.5	7.0
Madagascar	5.7	5.8	6.1	7.4	6.7	6.9	6.4
Uganda	12.7	4.9	3.1	5.4	5.5	6.3	6.3
D.R Congo	0.9	0.9	1.2	1.0	22.4	15.0	5.3
Rwanda	6.3	4.2	1.8	2.5	5.7	7.1	4.1
Seychelles	7.1	4.3	1.4	4.0	-1.0	2.2	3.2
Djibouti	3.7	2.4	2.9	2.1	3.0	3.0	2.8
Comoros	5.9	1.6	1.3	2.0	2.0	2.0	2.6

Note: (*) Forecast.

Source: IMF (2017a).

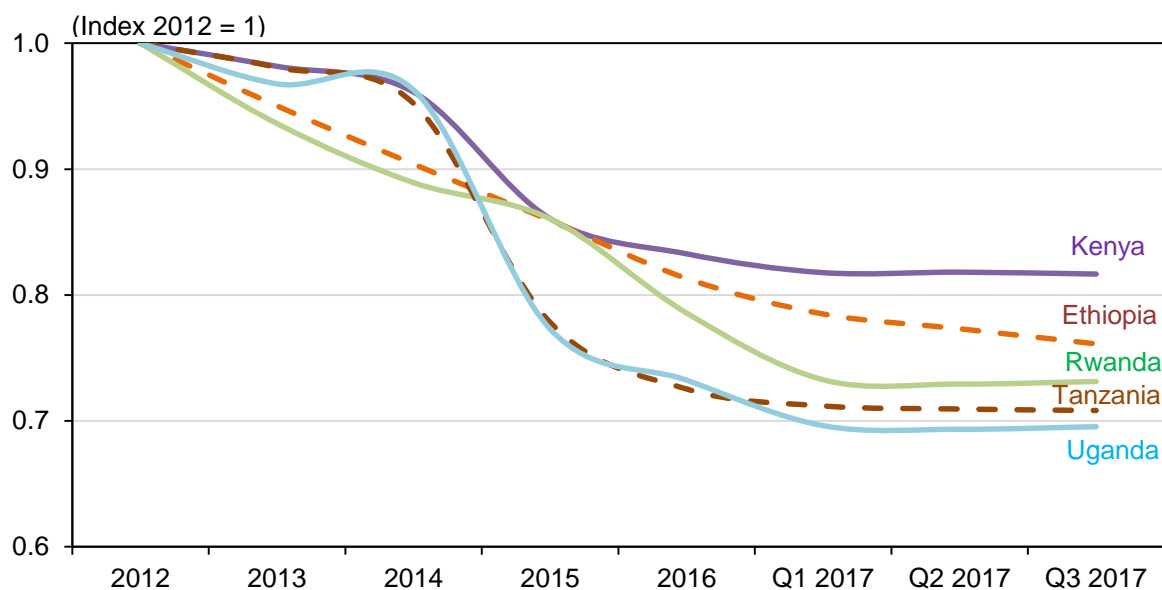
On the other hand, many of the local currencies depreciated notably against the US dollar in recent years, especially from 2014 to 2016 given the significant strengthening of the US dollar. Specifically, the local currency of Tanzania and Uganda depreciated by around 30 per cent against the US dollar between 2012 and 2016. In 2017, exchange rate pressures subsided amid the plunge of US dollar, partly owing to rejuvenated economic growth in Europe (Figure 13).²⁰

Inflation continued to rise in early 2017, but gradually decelerated in mid-2017. Exchange rate pressures also subsided amid the plunge of US dollar in 2017.

The worst inflationary and exchange rate performance was experienced by South Sudan which faces significant economic challenges due to internal conflict. Inflation averaged at around 160 per cent in the fiscal year 2015/2016 and is expected to reach 336 per cent in 2016/17. Meanwhile, the official fix exchange rate became increasingly hard to maintain as oil revenues and foreign exchange receipts fell sharply over the years and the gap between the official and parallel market rates widened markedly. Following the switch to a de jure floating exchange rate in December 2015, the South Sudanese pound depreciated against the US dollar by more than 90 per cent in 2016 (IMF, 2017e).

²⁰ In October 2017, the National Bank of Ethiopia announced a devaluation of the country's currency by 15 per cent to boost export earnings.

Figure 13: Nominal exchange rate, local currency vs US dollar

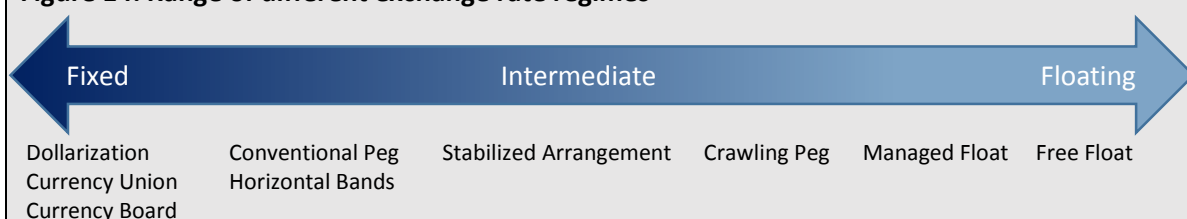


Source: IMF (2017f).

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

Exchange rate regimes range from fixed to freely floating (Figure 14). For a fixed exchange rate regime, a country uses a foreign currency as legal tender (Dollarization²¹) or multiple countries issue the same currency (Currency Union), whereas a currency board arrangement guarantees unlimited currency conversion at a fixed rate which is backed by foreign-exchange reserves. On the other hand, the currency’s value under a freely floating exchange rate is purely determined by market forces. Intermediate regimes are hybrids of the two extremes. A conventional peg does not commit to full parity, but admits a tight band around the central rate, while a crawling peg tolerates small adjustments to account for inflation differentials. In a managed float, the authorities smooth the path of the otherwise market determined exchange rate in order to prevent excessive fluctuations.

Figure 14: Range of different exchange rate regimes



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

²¹ Even though it is called ‘Dollarization’, the adopted means of payment may be any foreign currency.

Table 8: Exchange rate regime classification in Eastern Africa

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

Source: IMF (2017i).

The table above depicts 'de facto' regimes according to IMF's Annual Report on Exchange Arrangements and Exchange Restrictions. Comoros and Djibouti are the two economies in Eastern Africa with long lasting fixed exchange rate regimes. Since the Monetary Cooperation Agreement in 1979, the Comorian Franc has been pegged to the French Franc (and Euro since 1999). This arrangement is guaranteed by the French Central Bank and has remained stable.²² As for Djibouti, its limited central bank experience reasoned the peg of the Djibouti franc to the US dollar in 1949, and it is now one of the world's oldest currency board arrangements.

Consistent with the theory, inflation in both countries has been significantly lower than the rest of Eastern Africa, after accounting for other factors.²³ Although Eritrea also preserves a conventional peg to the US dollar since 2000, repetitive devaluations did not generate the credibility needed to enable price stability. Instead, scarce foreign exchange reserves and large current account deficits spur inflation, while the real overvaluation of the Nakfa constrains private sector activity in Eritrea.

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

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

According to studies by the IMF (2016) and AfDB (2016), the Ethiopian birr is overvalued by 20 to 40 per cent and an improvement of the misalignments could improve Ethiopia's external competitiveness and support export diversification. In October 2017, the National Bank of Ethiopia announced a devaluation of the country's currency by 15 per cent to boost export earnings. However, it should be noted that a strong devaluation could undermine the infrastructure-led growth strategy and the exchange rate pass through into inflation could be substantial. In contrast, the exchange rate of Tanzania remained significantly undervalued during the mid-2000s and contributed to their positive growth performance.

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

Regarding the monetary policy, Central banks in the region generally maintained an accommodative monetary policy with the aim of supporting the financing of the economy. However, the cost of credit remains high and access to credit often difficult. For example, the National Bank of Rwanda reduced its policy rate twice by 0.25 percentage point in December 2016 and June 2017 to 6.0 per cent. Yet

new authorized loans by the banking sector contracted modestly in the first half of 2017, and more worryingly, higher loan delinquencies were observed across major economic sectors (BNR, 2017). The Central Bank of Kenya also lowered the Central Bank Rate (CBR) from 11.5 percent to 10.5 percent in June 2016, and then to 10 percent in December 2016. It is worth noting that the Banking Act was amended in August 2016 to put a cap on lending rate at no more than 4 percentage points above the CBR and a floor on the deposit rate at 70 per cent of the CBR. As a result, both the lending rate and loans-deposit spread declined sharply. While the latest statistics show that credit growth remains sluggish, the impact of the interest rate cap in terms of improving long-term access to credit is to be monitored.²⁴

²² The parity agreement between the Comorian Franc and the Euro imposes the Comorian Central Bank to have 65 per cent of its reserves deposited in the French Central Bank. Convergence criteria are also set up to maintain inflation below 3 per cent as well as limit budget deficits and debt stocks.

²³ The IMF (2016) suggests that, in sub-Saharan Africa, inflation rates in a pegged regime are on average 4 to 7 percentage points lower than in other regimes.

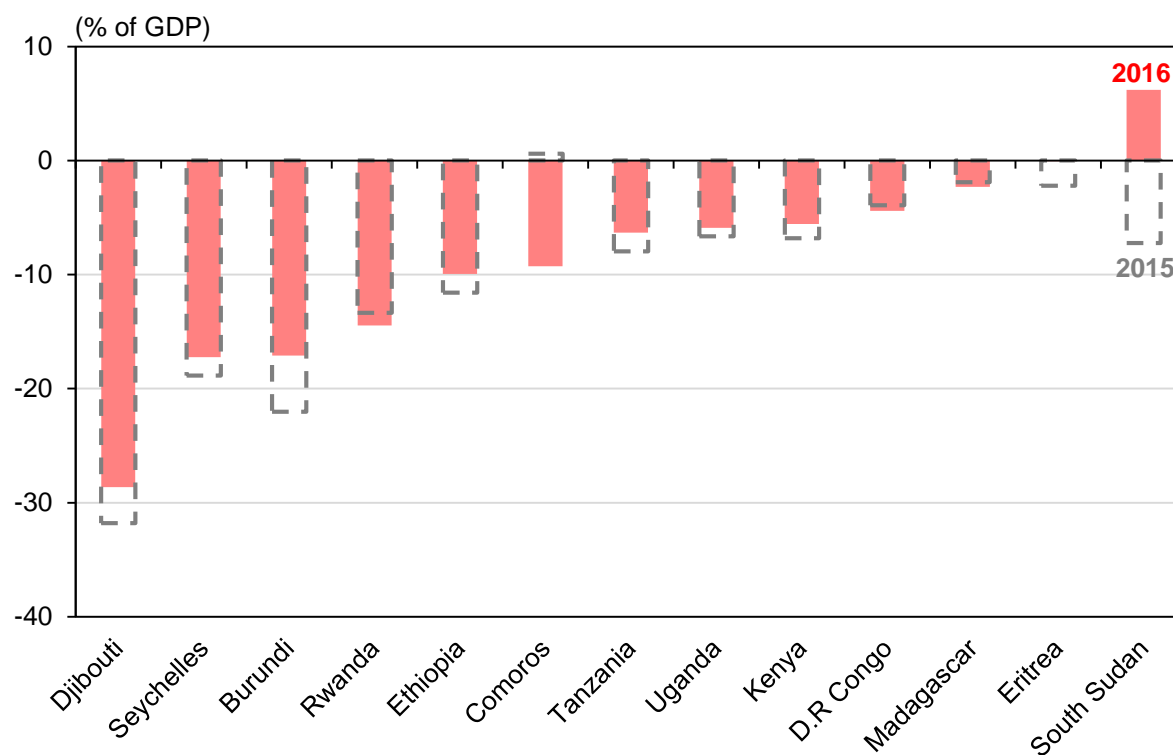
²⁴ Small and medium enterprises (SMEs) and borrowers with low credit quality may be excluded from accessing loans as banks cannot increase the lending rate to reflect the risks involved. While banks have increased their lending to the government and other public sector, the contraction of credit in agriculture, manufacturing, and business services in recent months has raised concerns as these sectors consist a large number of SMEs and are key drivers of job creation (CBK, 2017).

1.7. Structural Current Account Deficits and Imbalanced Trade Structure

The current account balance of most of the countries in the region improved slightly in 2016, partly owing to a decline in imports. In the case of Burundi, the narrowing current account deficit in 2016 was due to a decrease in imports amid the protracted crisis. On the other hand, the more drastic change of current account balance in Comoros was largely owing to a one-off support from Saudi Arabia to resolve the crisis of payment of wage arrears in 2015, whereas South Sudan is estimated to regain current account and trade surplus in 2016 given the recovery in oil prices and production. Despite the latest development, many of the countries still register large structural current account deficits, mainly due to the sizeable trade deficits (Figure 15). That coupled with fiscal deficits (i.e. twin deficits) could constrain growth and increase vulnerability in the long run.

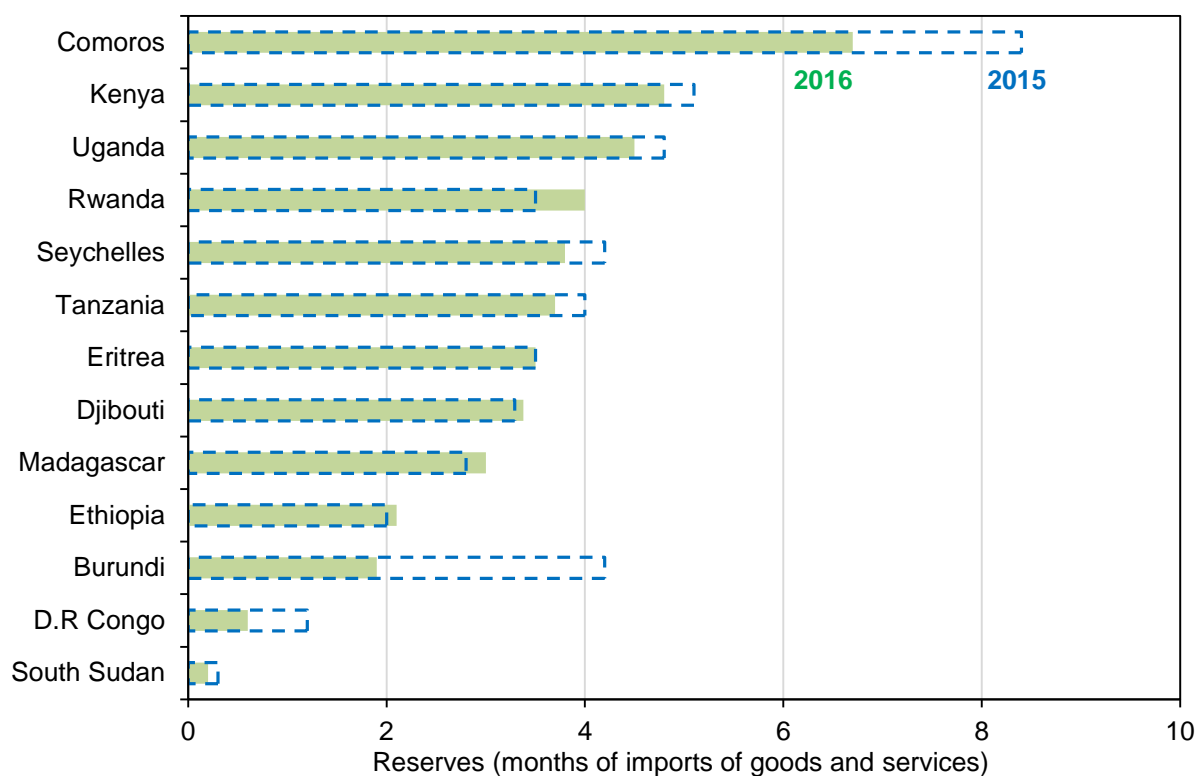
Many of the countries still register large structural current account deficits, mainly due to the sizeable trade deficits.

Figure 15: Current account balance



Source: IMF (2017a).

Countries have to rely on external borrowing and investment as well as deplete international reserves amid current account deficits. In particular, Comoros and Burundi recorded notable declines in reserves in 2016 equivalent to around two months of imports of goods and services. Yet the situation in Comoros remains stable, with the reserves still accounting for more than six months of imports, in contrast to the record low of reserves in Burundi. Meanwhile, countries with relatively low official foreign exchange reserves (e.g. Ethiopia, D.R. Congo, and South Sudan) could be more vulnerable to current account shocks (Figure 16).

Figure 16: Official foreign exchange reserves


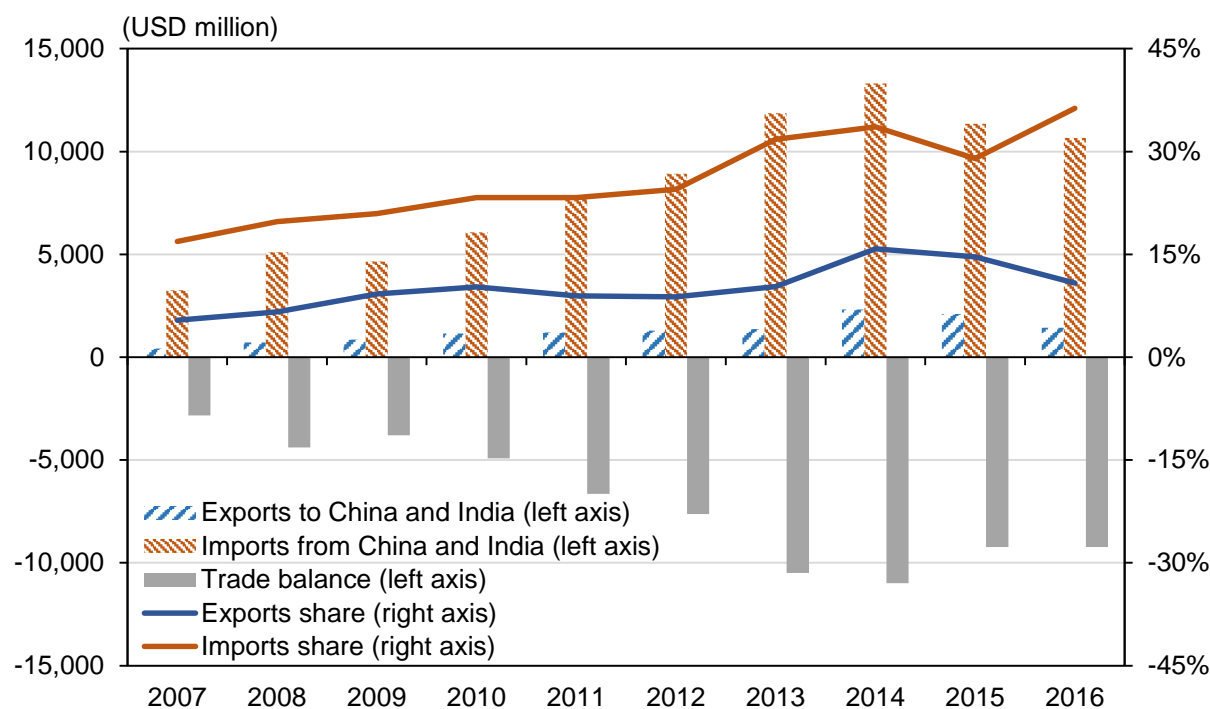
Source: IMF (2017b).

Regarding the trade in goods, there have been substantial trade expansion and diversification of partners. The value of Eastern African exports and imports doubled over the past decade to around US\$ 27 billion and US\$ 61 billion in 2016 respectively, yet slower than the growth of Eastern African economy which almost tripled during the same period, resulting in a narrowing trade deficits as a share of GDP. On the other hand, countries in the region have been diversifying their exports away from traditional markets (i.e. advanced economies, e.g. Europe) towards new trading partners (especially developing countries in Asia, such as China, India, and Vietnam), thereby increasing their resilience to economic shocks. While the share of exports to the two largest consumption markets in Asia (i.e. China and India) is still low, the significant increase in importance as imports sources is striking. Figure 17 shows that exports to China and India accounted for around 11 per cent of EAC total exports in 2016, in contrast to the imports share of around 36 per cent. The unbalanced growth over

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

the past decade resulted in huge trade deficits between the EAC and China and India. In 2016, the trade imbalance was around US\$ 9.2 billion, representing around 57 per cent of EAC overall trade deficits. The rise of China and India as a source of imports may be a good news for consumers, but it also implies greater competition in domestic markets, especially among local manufacturers.

Figure 17: Trade balance between the East African Community and China and India



Note: Figures do not include South Sudan.

Source: IMF (2017g).

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

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

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

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

The simulations suggest that EAC imports from the EU would increase significantly by 12.7 per cent. In contrast, exports from EAC to the EU would only increase marginally.²⁵ There is also a slight deterioration of the terms of trade for all countries in the EAC. With regard to GDP, the simulation suggests that the EPA reduces GDP by 0.2 to 0.5 per cent across the four EAC countries considered in the exercise (Table 9). It is worth noting that imports from all other regions would decline (i.e. the trade diversion effect). Perhaps more importantly, intra-EAC imports would decline by US\$ 42 million (mainly in manufacturing), while tariff revenues accruing from imports would decline by US\$ 169 million in EAC (Table 10).

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

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

Source: UNECA (2017c).

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

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

Source: UNECA (2017c).

These simulation results contrast with the results presented by the European Commission which suggests net gains for EAC member (EC, 2017), despite the fact that both studies use the same underlying database (i.e. GTAP 9.0).²⁶ It is notable, however, that in macroeconomic terms, both studies show relatively small effects. For instance, UNECA estimates suggest that the GDP impacts

would be negligible. This is generally the case with this kind of modelling, particularly when one party (the EAC) is not gaining any significant enhanced access compared with existing arrangements. The modelling exercise does, however, alert us to the possibility that any potential gains with regards to trading relations with Europe may be at the expense of trading relations with other EAC partners and the rest of the world.

Beyond the direct impacts, questions have also been raised about the way the EPA could potentially constrain the development of EAC industrial policy. The agreements contain various articles relevant to EAC industrial policy objectives. Some are trade related; others impinge on the way domestic support measures may be provided. Regarding the former, these mechanisms do enable temporary emergency restrictions on imports of specific products in the case of a surge in imports or a sharp decline in import prices. However, the trade-related safeguard provisions are limited in scope and their implementation is, arguably, cumbersome. Particularly relevant are Articles 3 (Rendezvous Clause), 12 (Standstill Clause), 14 (Export Duties and Taxes), 49 (Bilateral safeguards) and 50 (Multilateral Safeguards). For instance, Article 3 “the Rendezvous Clause” gives the negotiating parties a five-year deadline after the entry into force of the EPA to conclude negotiations on matters regarding trade in services, competition policy, investment, environment, procurement and intellectual property rights. Yet an agreement on procurement or investment might prevent EAC countries from effectively implementing their “Buy East Africa, Build East Africa” strategy as well as similar national strategies (such as “Made in Rwanda” or “Buy Uganda, build Uganda”) (SEATINI, 2017). Similarly, Article 12 “the Standstill Clause” may prevent the EAC from later applying a higher tariff rate on capital goods or other manufacturing products like pharmaceutical products. While many of these products are currently imported from Europe in any case, in the future EAC countries might be in a position to produce them, as industrialisation of the region moves forward, and hence member states would require a higher level of protection for their nascent industry. Other analysts have also stressed the complexity of the implementation procedures for bilateral safeguards (Article 49) arguing that the measures are limited “to the mitigation of the damage caused by import surges [in existing sector], but not for the building up of new sectors” (CUTS International, 2011).

Concerns are not one-sided. Some member states of the EU have also expressed their reservations on some aspects of the proposed EPA. German Chancellor, Angela Merkel, echoed Tanzania’s concerns and criticised the current state of negotiations with Africa. She called for talks on possible renegotiation to commence at the 5th EU Africa-EU Summit to be held in November 2017. Even more vocal is the German Africa Commissioner, Günter Nooke, who has publicly decried the EPA, claiming the agreements directly contradict Europe’s development policy efforts in Africa. Merkel’s comments, along with increasing conversation around the EU-EAC EPA, present perhaps an opportunity for an improved agreement that is more in harmony with both national and regional industrial policy.

Source: UNECA (2017a).

²⁵ This is a consequence of the fact that the EPAs will not result in any substantially improved market access to the EU market, as EAC countries already benefit from the Everything But Arms (EBA) agreement, which provides for non-reciprocal market access for all products except armaments and a few select agricultural products (e.g. sugar and rice).

²⁶ The reasons for the differences are probably tied up in a number of factors, including the fact that the EC study uses a baseline scenario which presupposes a return to standard Generalized System of Preference tariffs for Kenya and uses a dynamic rather than static modelling approach. The precise reasons for the differences could not be ascertained as the EC study does not contain details such as the model closure, the elasticities utilized, etc.

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

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

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

Despite the big hopes initially pinned on AGOA, the reality is that most countries in Eastern Africa, in practical terms, benefited very little from the provisions of AGOA.²⁷ In 2016, total Eastern Africa (seven eligible countries) AGOA exports to the United States, excluding exports under Generalized System of Preferences (GSP), totalled just US\$ 584 million, which was only about 6.2 per cent of total African AGOA exports. The biggest beneficiary in Eastern Africa was Kenya which exported US\$ 391 million, representing around 7 per cent of its merchandise exports.²⁸ The low levels of Eastern Africa exports under AGOA may reflect a more general problem related not only to the limited supply-side capacities on the part of beneficiary countries, but also perhaps more fundamental problems in the form of the agreement itself – including phytosanitary standards, the time-bound nature of the concessions, and rules of origin (UNECA, 2014).

If these EAC countries stick to their second-hand clothing ban, they could potentially stand to take over market share of all used-clothes importers. Even with the possibility of losing AGOA eligibility²⁹, the clothing ban could on balance benefit the textile and apparel industry. However, it should be noted that this cost benefit analysis does not account for the loss of tariffs due to the ban nor the potential welfare losses to the people who strongly rely on used clothing for a decent quality of life. Ultimately, the outcome of the used clothing ban depends on whether EAC textile and apparel manufacturers can effectively meet demand. Their success, in turn, is at least partially dependent on the support of the governments to provide the optimal conditions for manufacturers to fill the supply gap.

Source: UNECA (2017a).

²⁷ The situation was quite different in Madagascar. The agreement was concomitant with a boom in the textile industry supported by incentive policies towards exports processing zones. Exports under AGOA accounted for around one-fifth of merchandise exports before the agreement was suspended in 2010 in the wake of political crisis. Madagascar's eligibility was reinstated in 2014 after the return of political stability.

²⁸ AGOA exports to the United States accounted a small fraction of the country exports. In 2016, the share was 4.3 per cent in Madagascar, 1.3 per cent in Ethiopia, 0.8 per cent in Tanzania, 0.1 per cent in Rwanda, and 0.01 per cent in Uganda (The United States Department of Commerce).

As for intra-regional trade, the share of intra-EAC exports stayed largely stable at around 20 per cent over the past decade, whereas the share of intra-EAC imports hovered at around 6 per cent. Although the level of intra-regional trade is far below that of the Organisation for Economic Cooperation and Development, the Asia-Pacific Economic Cooperation, and the EU (with a share of intra-regional exports above 60 per cent), the EAC has the highest share of intra-regional trade among the eleven major regional economic communities in Africa³⁰ and is close to the level seen among Association of Southeast Asian Nations (ASEAN) countries (UNCTADstat). Regional trade integration is a cornerstone of EAC policy and partner states are expected to benefit from enhanced trade flows and improved production efficiency in the community. In this regard, the protracted trade dispute between the two major traders (i.e. Kenya and Tanzania) as well as the increase in the number of non-tariff barriers have raised concerns on regional trade integration.³¹

Despite the rapid growth in trade and diversification of trading partners over the past decade, Eastern Africa's exports to the world remains dominated by primary commodities and that leaves the region highly vulnerable to commodity price shocks.

In fact, the exports revenues of countries such as Burundi, Ethiopia, Kenya, Rwanda, and Uganda were seriously affected by the decline in coffee and tea prices in recent years, whereas Eritrea, D.R Congo, and Tanzania had been hit hardly by lower prices of gold and metals (Figure 18). Meanwhile, the exports of mainly raw materials rather than proceeded goods puts countries in the lower rungs of the global value chains and is not conducive for enhancing structural transformation.

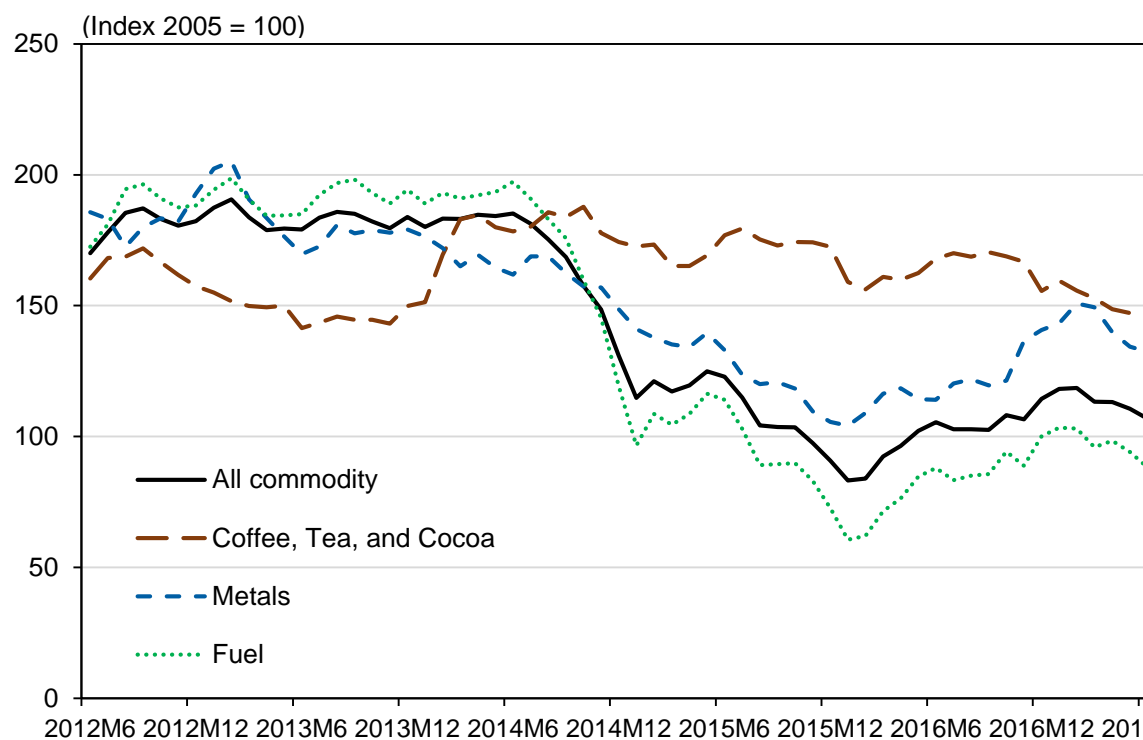
The exports of mainly raw materials rather than proceeded goods puts countries in the lower rungs of the global value chains and is not conducive for enhancing structural transformation.

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

²⁹ In 2013, in anticipation of a possible revision of AGOA, UNECA prepared a report to measure the potential impact on AGOA eligible countries if AGOA was discontinued (UNECA, 2013b). It provides a useful insight into what Rwanda, Tanzania, and Uganda could lose if its eligibility is revoked. Interestingly, the report's simulations showed that the three countries could expect marginal losses to exports and real wages: less than 0.2 per cent decrease in total exports, assuming a return to GSP trade provisions, and a negligible decrease in real wages.

³⁰ The eleven major regional economic communities in Africa include Arab Maghreb Union (UMA), Common Market for Eastern and Southern Africa (COMESA), Community of Sahel-Saharan States (CENSAD), Economic Community of Central African States (ECCAS), Economic Community of West African States (ECOWAS), Inter-Governmental Authority on Development (IGAD), Southern African Development Community (SADC), Economic and Monetary Community of Central Africa (CEMAC), East African Community (EAC), Southern African Customs Union (SACU), and West African Economic and Monetary Union (UEMOA).

³¹ For example, Tanzania imposed tariffs on Kenya's milk products and Kenya imposed a ban on importation of liquefied petroleum gas from Tanzania recently. Meanwhile, according to the *East African Community Common Market Scorecard 2016*, Kenya's doubled the use of non-tariff barriers from 10 in 2014 to 23 in 2016, and Tanzania's more than tripled from 7 to 24.

Figure 18: Commodity prices

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

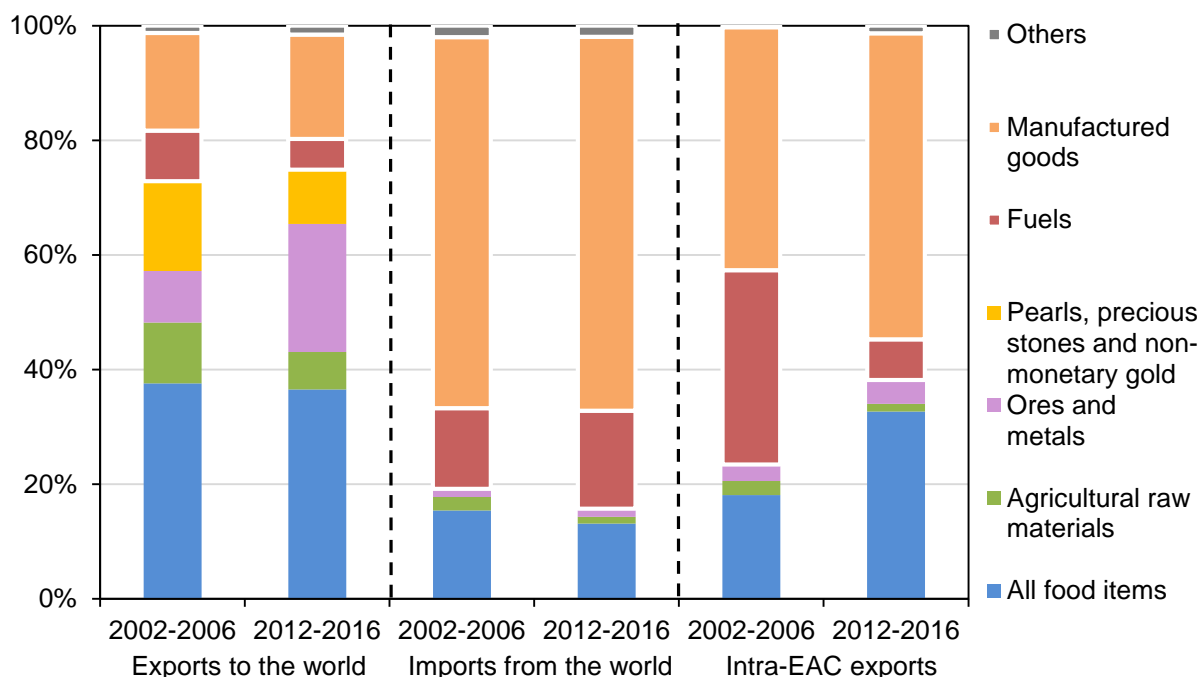
Source: IMF (2017h).

A detailed breakdown of the trade products shows that half of the exports were food items and agricultural raw materials during 2002 to 2006, whereas ores and metals as well as pearls, precious stones and non-monetary gold accounted for one-fourth, and fuels represented another one-tenth. In contrast, less than one-fifth of the exports were manufactured goods. The overall exports composition was little changed over the past decade, other than the notable increase in exports share of ores and metals and a decline in pearls, precious stones and non-monetary gold. Compared to the concentration of exports in primary commodities³², countries rely heavily on manufactured goods imports (Figure 19). Meanwhile, it should be noted that the level of technological sophistication in manufacturing exports for most of the countries in the region is much lower than the major import sources (e.g. China, India, and Vietnam), except Ethiopia which experienced rapid industrial development in recent years (Figure 20). Against this backdrop, manufactured goods accounts for a significant share of intra-EAC exports, suggesting that there is great complementarity between manufactured sectors in the region. The intra-regional trade in manufacturing intermediates offers a broader scope for regional value chains and countries with more advanced manufacturing sectors are expected to hugely benefit from related trade.

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³² For more than half of the countries in the region, the top ten products constituted 75 per or more of their total exports (UN Comtrade).

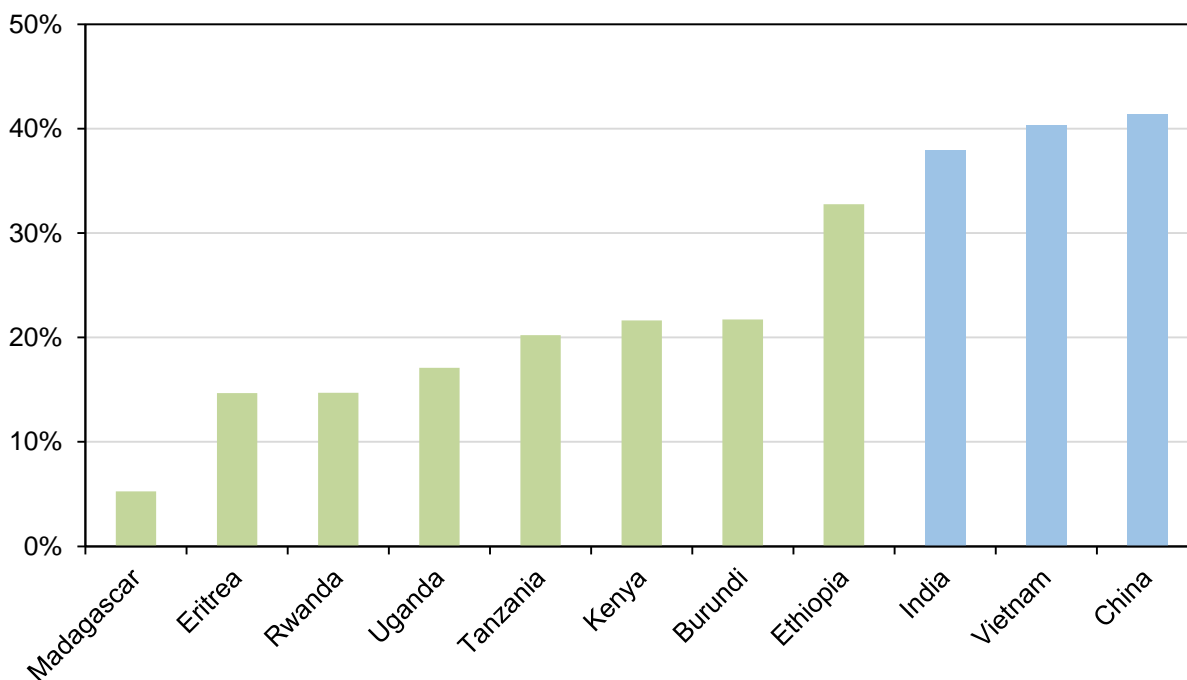
Figure 19: Composition of Eastern African trade by main products



Note: Figures do not include Somalia.

Source: UNCTADstat.

Figure 20: Medium and high technology manufactured exports share in total manufactured exports, 2015



Source: UNIDO (2017).

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

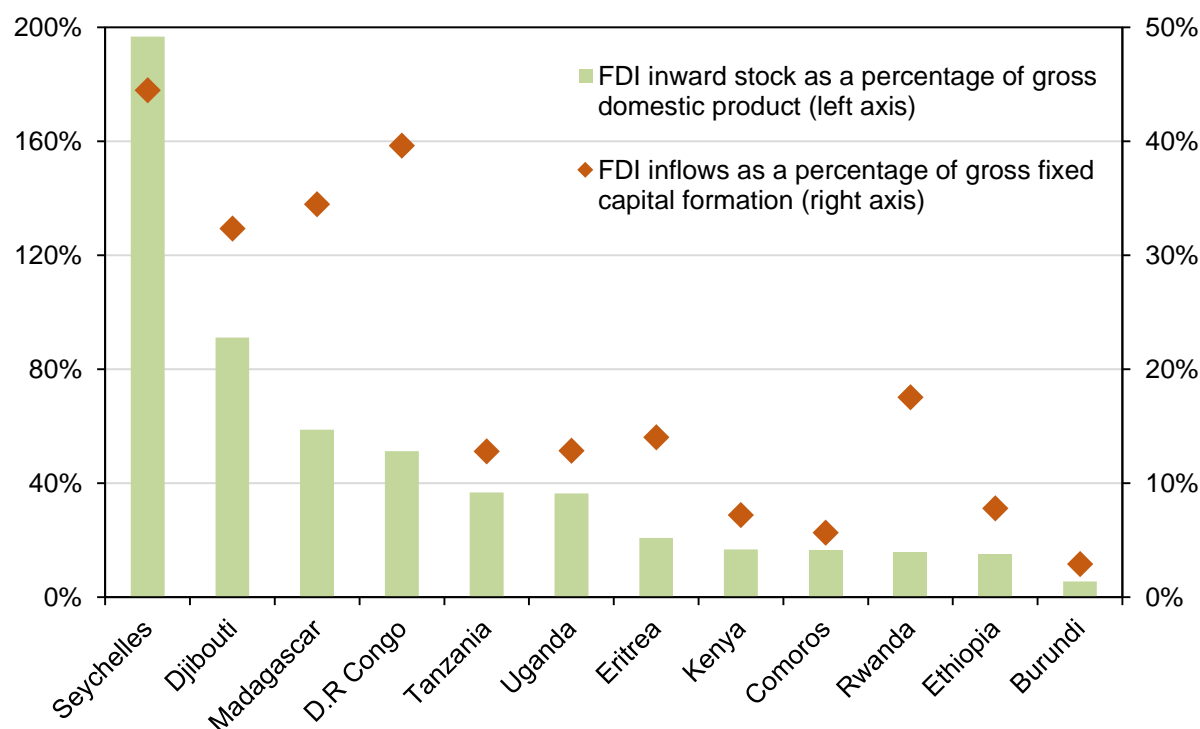
Countries have been actively taking measures to increase the export-orientation of foreign investment and reduce reliance on imported inputs.

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

1.8. Leveraging the Foreign Direct Investment

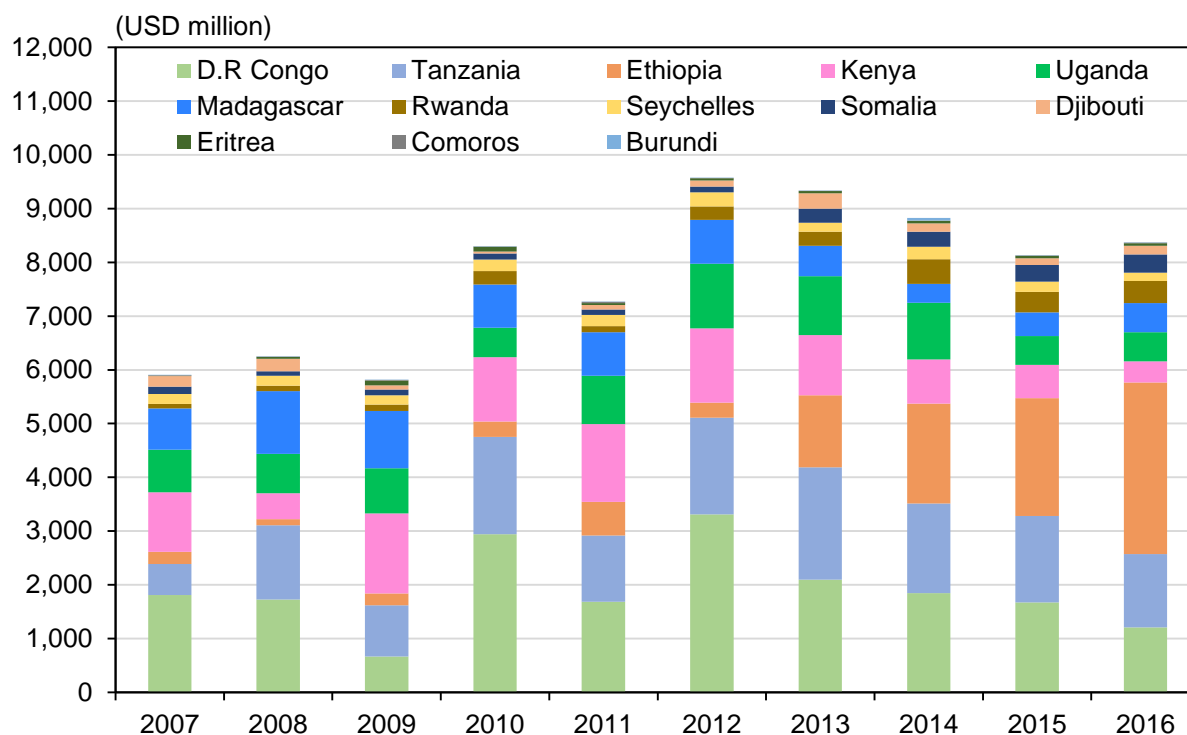
FDI has become an important source of external finance in a number of the countries. The share of FDI inward stock as a percentage of GDP rose rapidly over the past decade, with Seychelles and Djibouti standing out at a level of around 200 per cent and 100 per cent respectively. Meanwhile, the FDI inflows contributed significantly to gross fixed capital formation, especially for countries such as Seychelles, Djibouti, Madagascar, and D.R Congo (Figure 21).

Figure 21: Foreign direct investment, 2012-2016 average



Source: UNCATD (2017b).

Over the past decade, FDI inflows to Eastern Africa experienced huge volatility. FDI inflows to the region stagnated during the global financial crisis and increased notably afterward given the promising macroeconomic prospect. FDI inflows peaked in 2012 and declined steadily till 2015, partly due to the decrease in commodity prices during the same period that weighted on resources seeking investment. While FDI inflows to Africa continued to slide in 2016, that to Eastern Africa recorded a slight rebound to around US\$ 8.4 billion, largely driven by the prominent increase in FDI inflows to Ethiopia. Detailed breakdowns by country show that the four major FDI recipients (i.e. D.R Congo, Tanzania, Kenya, and Uganda) registered visible decline in FDI inflows in recent years, in contrast to the sharp increase in Ethiopia and Rwanda (Figure 22). The rapid growth of FDI inflows to Ethiopia could be attributed to the government efforts in improving the legal framework and institutional capacities (e.g. setting up of the Ethiopian Investment Commission) as well as the development of industrial parks.

Figure 22: Foreign direct investment inflows to Eastern Africa


Source: UNCATD (2017b).

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

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

China's FDI outflows to Eastern Africa surged by more than twelvefold from less than US\$ 100 million in 2007 to around US\$ 1.2 billion in 2015, representing more than 40 per cent of China's FDI outflows to Africa in 2015

On a positive note, Chinese FDI in Africa is rather diversified, with increasing investment in the manufacturing sector.³³ Attracting foreign investment into the manufacturing sector could help introduce new technology, promote knowledge and skills transfers, as well as improve production capacity, thereby accelerating structural transformation and boosting productivity.³⁴ In this regards, countries in the region have been actively launching different strategies. As discussed in Box 2, Ethiopia has committed to attracting FDI in implementing its vision of industrial development. Special economic zones have also been established in various countries with the aim of attracting FDI and promoting exports. These initiatives usually offer generous incentives such as tax exemption, import duty exemptions, and favourable land leases to encourage foreign investment. In order to ensure that

FDI is more than capital and technology transfer, but how the related costs and benefits could best align and complement the wider national development strategies

the government subsidies would pay off rather than undermining tax revenues too much or falling into a regional 'race-to-the-bottom' amid heightened competition for FDI, the related costs and benefits should be well balanced. To this end, governments could grant subsidies with clear conditions and sunset clauses to reduce the risk of poor selection of beneficiaries and promotion of assistance-dependent firms with low productivity. Also, regular policy monitoring and

outcomes evaluation are essential to improve policy design and implementation in light of development objectives. From the perspective of national policy, FDI is more than capital and technology transfer, but how the related costs and benefits could best align and complement the wider development strategies.

³³ According to a recent report by McKinsey & Company, Chinese firms operate across many sectors of the African economy, with around one-third involving in manufacturing, a quarter in services, and around a fifth in trade, construction and real estate. In contrast, statistics from the U.S Bureau of Economic Analysis show that foreign investment from the United States has been heavily skewed towards the mining sector. In 2014, around 80 per cent of the value added and 90 per cent of profit of the affiliates in Africa came from the mining sector.

³⁴ Having said that, the impact of FDI on economic development must be viewed in the context of existing domestic economic structures. For example, the production of new foreign subsidiaries may be a benefit, but there would be offsetting costs if it displaces existing local firms (UNCTAD, 2005)

2. Social Developments

2.1. Overview of Human Development

The Human Development Index (HDI), which integrates three basic dimensions of human development (i.e. health, education, and standard of living), provides an overview of regional performance over an extended period. Although the Eastern Africa region remained at low level of human development in 2015, with all of the countries in the region being classified in the bottom quintile (except Seychelles), there have been impressive progresses in the past decade. People of the region now on average live longer, receive better education, and enjoy an improved quality of life. Specifically, Burundi recorded the largest increase in HDI value over the last decade, albeit from a very low base. During the same period, the HDI growth in Ethiopia and Rwanda was also remarkable, at over 20 per cent, mainly thanks to the rapid economic growth and notable improvement in education (Table 11).

Table 11: Human Development Index and its components

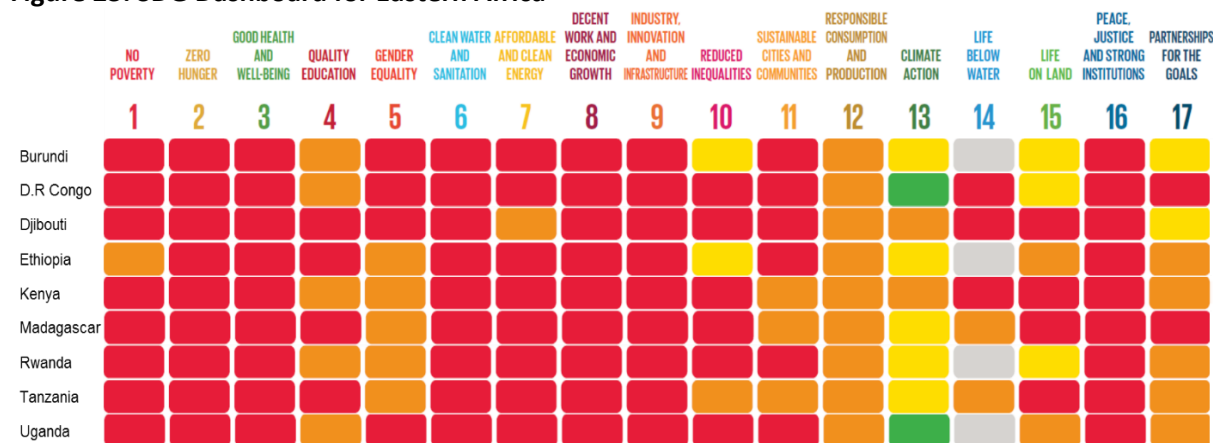
HDI Rank (2015)	Country	HDI value		Life expectancy at birth (years)		Mean years of schooling (years)		Expected years of schooling (years)		Gross national income per capita (2011 PPP\$)	
		2005	2015	2005	2015	2005	2015	2005	2015	2005	2015
		63	Seychelles	0.728	0.782	72.3	73.3	7.7	9.4	13.1	14.1
146	Kenya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

Source: UNDP (2016).

For a more comprehensive assessment of the development progress, the SDG Dashboard highlights the progress of meeting the 17 SDGs, thereby helping countries identify priorities for early action. Building upon the successes of the Millennium Development Goals, the 17 SDGs were adopted by all member states of the United Nations in 2015, which serves as a universal agenda of sustainable development that combines economic development, social inclusion, and environmental sustainability. Figure 23 summarises the performance of the region. Despite the tremendous progress under Millennium Development Goals, the region still faces almost across-the-board challenges in achieving the SDGs. Specifically, most of the countries encounter major challenges in ending extreme poverty (SDG 1) and hunger (SDG 2), health (SDG 3), access to basic infrastructure (SDGs 6-9), as well as peace, security, and institutions (SDG 16), while fare better on sustainable consumption and production (SDG 12), climate change (SDG 13), and terrestrial ecosystem (SDG 15).

There have been tremendous progresses in terms of human development over the past decade, yet the region still faces almost across-the-board challenges in achieving the SDGs

Figure 23: SDG Dashboard for Eastern Africa



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

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

Apart from the overall picture that HDI and SDG Dashboard present, the following sections focus on three recent social developments (i.e. drought and food insecurity, refugee crisis, and communicable disease outbreaks) for more in-depth discussion.

2.2. Drought and Food Insecurity

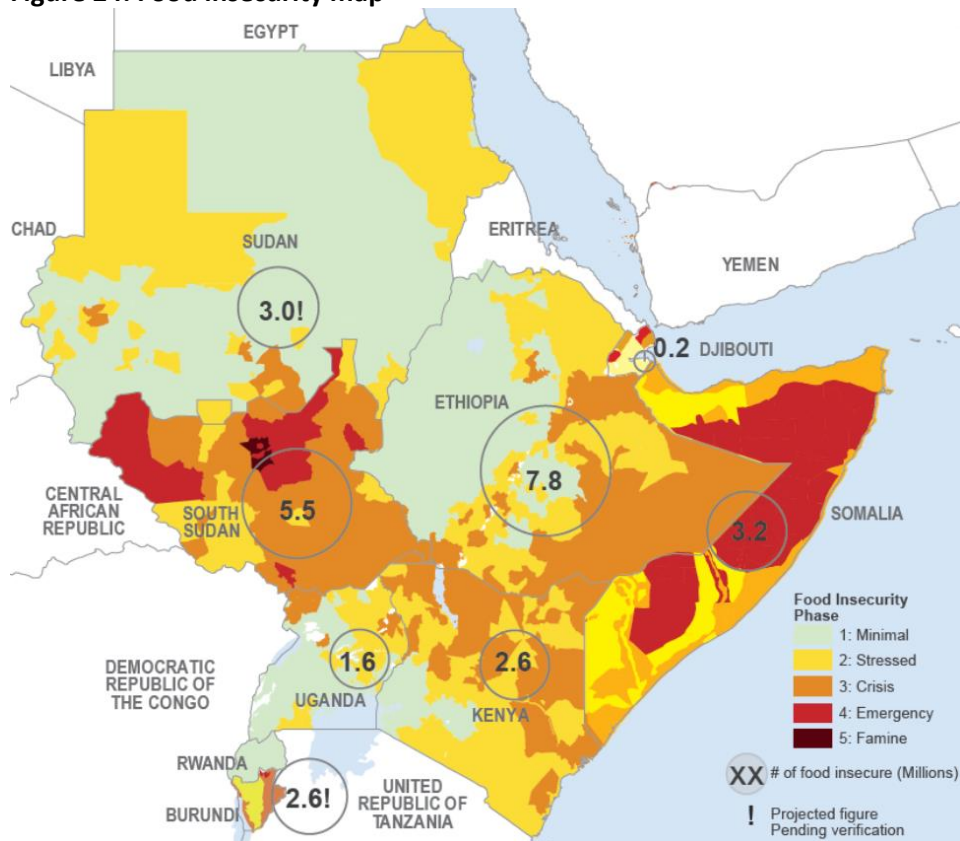
The region has been experiencing serious food insecurity challenges, exacerbated by the successive episodes of drought in 2016 and 2017 that resulted in extensive growing season failures and livestock deaths.³⁵ As of May 2017, the number of people in Integrated Phase Classification Crisis (IPC) phase 3 (crisis), 4 (emergency), and 5 (famine) increased significantly to over 31 million (Figure 24).³⁶ As a share of population, the ratios were highest in South Sudan³⁷ and Somalia, at around 46 per cent and 23 per cent respectively. Of major concern are Somalia, Ethiopia, and Kenya which accounted for around half of the food insecurity population and may face another season of below average rainfall. In particular, some parts of Somalia face an elevated risk of famine.

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

³⁵ Food self-sufficiency is a key focus of Africa. The President of the AfDB indicated that Africa’s annual food import bill is estimated to rise to US\$ 110 billion by 2025, thereby weakening African economies, and decimating its agriculture and exports jobs from the continent (AfDB, 2017). Meanwhile, subsistence and cash crop farming coupled with rearing of animals characterizes most rural agricultural activities in Eastern Africa and agricultural performance is highly vulnerable to weather-related shocks.

³⁶ While the food insecurity situation in D.R Congo is not presented in this map, around 11 per cent of the total rural population (i.e. 7.7 million) are classified in IPC Phases 3 and 4 in June 2017, mainly due to inter-communal conflicts (IPC, 2017a). Several districts of Madagascar are classified as in IPC "Serious" Malnutrition for the period March to May 2017 (IPC, 2017b).

³⁷ Food insecurity in South Sudan was mainly due to continued conflict and insecurity. In February 2017, a famine affecting 90,000 people in Leer and Mayendit counties was declared. Famine is no longer occurring in Leer and Mayendit counties as a result of immediate and sustained multi-sector humanitarian assistance delivered to the affected population since March 2017. Yet 1.7 million people in South Sudan are still facing emergency levels of hunger (IPC, 2017c).

Figure 24: Food insecurity map


Source: UNOCHA (2017a).

Food insecurity is not only life-threatening, but also has long-term consequences on physical health and cognitive functions, especially for children. These disadvantages in human capital could lead to poor prospects in the labour market, including lower wages and higher poverty. The prevalence of undernourishment in Eastern Africa increased to around 34 per cent in 2016 compared with the African average of 20 per cent (FAO, IFAD, UNICEF, WFP, and WHO 2017).³⁸ In parts of northern Kenya, South Sudan, and Somalia, the level of acute malnutrition is worryingly high and above emergency thresholds.

Apart from the induced humanitarian needs, the impact of the drought compounds the challenges to maintain robust economic growth and stable price levels

Apart from the induced humanitarian needs, the impact of the drought compounds the challenges to maintain robust economic growth and stable price levels³⁹. For example, the production of most food crops recorded notable decline in Kenya, resulting in a sharp slowdown of growth in agriculture, forestry and fishing to 1.4 per cent in the second quarter of

2017 from 7.1 per cent in the corresponding quarter in 2016 as well as a surge in food prices (KNBS, 2017b). Also, drought could lower hydroelectric power generation, exacerbate health challenges, and slow poverty eradication efforts.

³⁸ In fact, multiple forms of malnutrition coexist, with countries experiencing simultaneously high rates of child undernutrition and adult obesity. It should be noted that the coverage of Eastern Africa is a bit different here, which comprises Burundi, Comoros, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Mozambique, Rwanda, Seychelles, Somalia, South Sudan, Tanzania, Uganda, Zambia, and Zimbabwe.

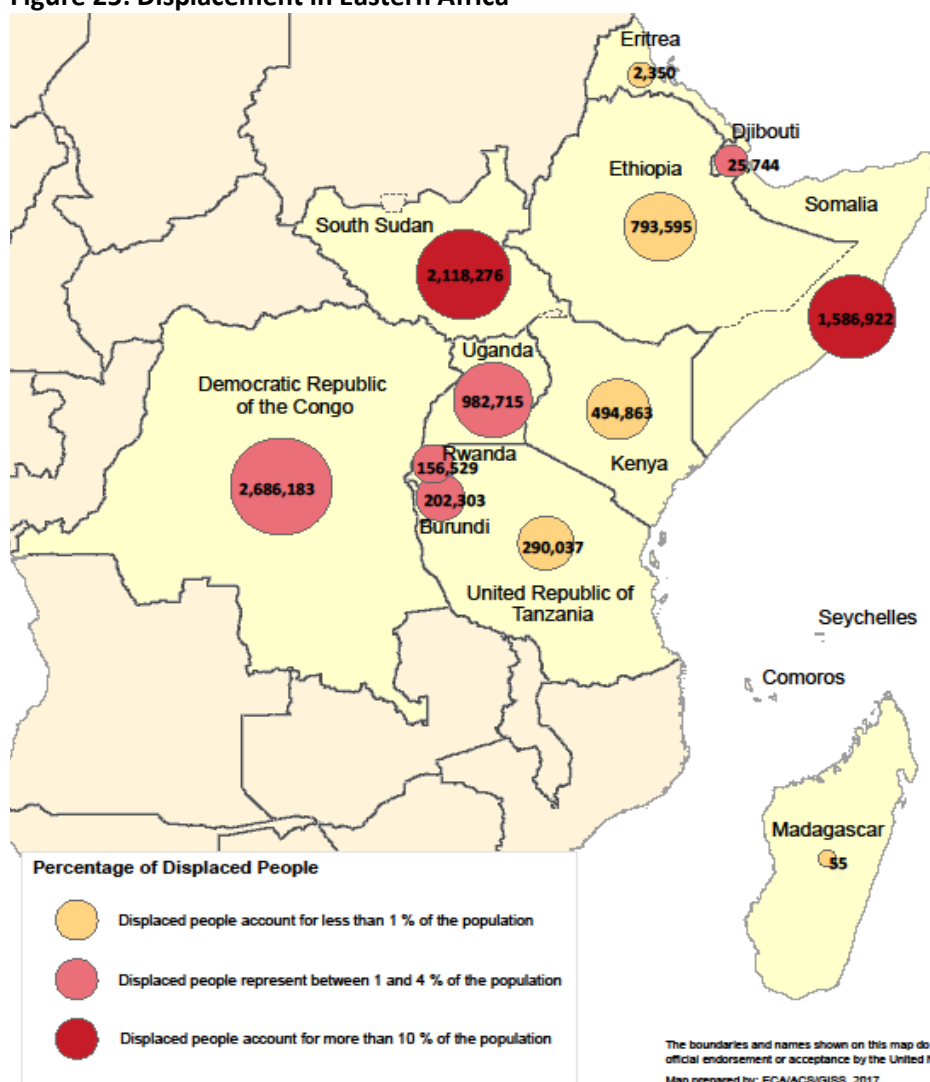
³⁹ For example, maize supplies are generally below-average, resulting in above-average prices across most of the Eastern Africa (FEWS NET, 2017b).

2.3. Intensifying Refugee Crisis

Eastern Africa is one of the regions in the world which currently accommodates the highest number of refugees, asylum seekers, and IDPs. The humanitarian crisis in the region has been largely driven by conflict, climate and natural disasters (e.g. drought), and economic shocks. At the end of 2016, there were approximately 9.3 million displaced people in the region, of which 3.5 million were refugees and asylum seekers, and 5.8 million were IDPs (UNHCR, 2017). Uganda and Ethiopia hosted the highest number of refugees and asylum seekers, accounting for around half of the regional total, while D.R Congo, South Sudan, and Somalia had most of the IDPs in the region (around 98 per cent). As a share of population, the percentage of displaced people in South Sudan and Somalia were the highest, at over 10 per cent (Figure 25).

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

Figure 25: Displacement in Eastern Africa



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

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

The refugee crisis in South Sudan is the fastest growing in Africa, with more than 1.8 million people having fled to Uganda, D.R Congo, Ethiopia, Sudan, and Kenya. Since the beginning of the conflict in

2013⁴⁰, more than two million people have been internally displaced. The government has been making efforts to foster reconciliation through an ongoing national dialogue⁴¹. However, neither the ceasefire which has been unilaterally declared by the government nor the 2015 peace agreement have been broadly respected and implemented (UNSC, 2017a). Conflict is fueled by a dire humanitarian situation linked to recurrent droughts and a severe economic crisis. Meanwhile, the situation is becoming difficult in Uganda, which is hosting the highest share of South Sudanese refugees. For the past year, 1,800 refugees fled to Uganda daily, given its progressive open-door policy toward refugees.⁴² In the northern regions bordering South Sudan, pressure has increased on natural resources, land, and social services, amidst rising insecurity (IRIN News, 2017).

Somalia is moving towards political stability and economic recovery after more than 25 years of civil war⁴³. The new National Development Plan adopted in December 2016 focuses on recovery, democracy, and prosperity. However, the security and humanitarian situation remains fragile because of the recurrent Al-Shabaab attacks, clan clashes and a severe drought which hit the country in the beginning of 2017 (UNSC, 2017b). As a result, more than 10 per cent of the population is still internally displaced in the country. Insecurity concerns and drought have also slowed down the voluntary return programme of Somali refugees from Kenya.⁴⁴

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

The intensifying refugee crisis seriously affects the well-being of people and puts a severe strain on host's countries resources and economic development.

The intensifying refugee crisis seriously affects the well-being of people in the region and puts a severe strain on host's countries resources and economic development. Worryingly, the induced humanitarian needs continue to be underfunded, with largest funding gap in Ethiopia, Somalia, South Sudan, and D.R Congo amounting more than US\$ 2.8 billion in 2017 (FTS, 2017).

⁴⁰ The crisis erupted in December 2013, after political infighting between the President Salva Kiir and the then First Vice-President Riek Machar. Political unrest led to ethnic conflict and clashes between armed groups. The UN compounds in South Sudan have been opened to protect fleeing civilians and are now protecting more than 200,000 IDPs in United Nations Mission in the Republic of South Sudan (UNMISS) protection of civilians' sites.

⁴¹ The Intergovernmental Authority on Development is trying to hold peace negotiations while Ugandan President Museveni is also facilitating peace talks. Meanwhile, the UN Security Council decided to create a 4,000-strong regional protection force in charge of securing the capital city, main roads, and UNMISS premises.

⁴² Refugees in Uganda are given a small plot within the local host community, construction materials and tools to work. They have access to the same services as Ugandan nationals, have the right to work and freedom of movement. This approach is supposed to reduce dependency on aid and favour social cohesion with the local communities (UNHCR, 2015).

⁴³ Parliamentary elections were held in 2016 under a unique system of power sharing between clans, the new President Farmajo was elected in 2017 and an inclusive government was formed.

⁴⁴ In 2013, a Tripartite Agreement was signed between the UNHCR, the Kenyan and Somali governments to initiate a voluntary repatriation process. So far, 73,400 refugees have returned to Somalia since the process started.

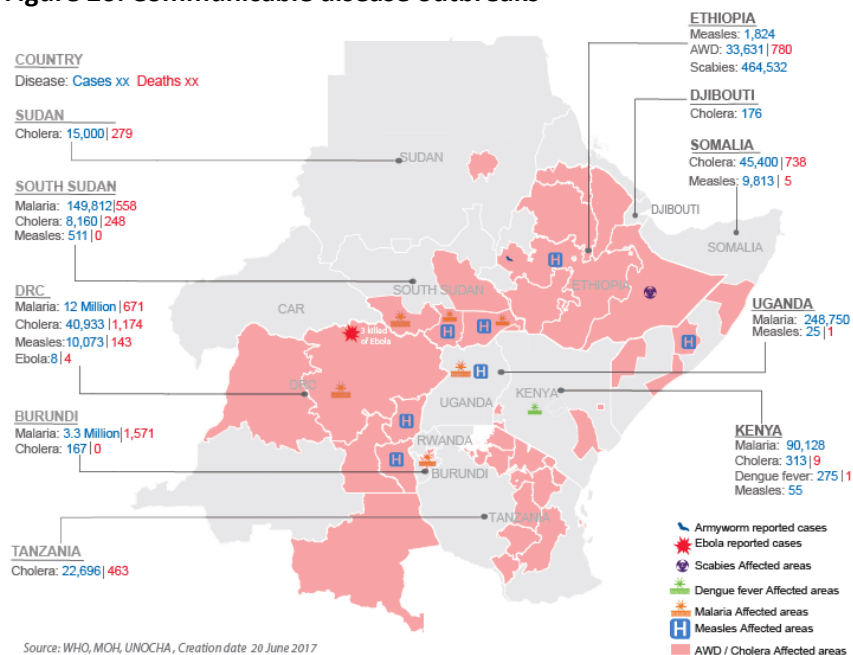
2.4. Communicable Disease Outbreaks: A Worrying Sign of the Improved Healthcare System

Thanks to the enhanced provision of basic health services, people of the region now on average live longer and healthier. Statistics from the World Health Organization (WHO, 2017) show that both life expectancy and healthy life expectancy at birth increased substantially.⁴⁵ In particular, Eritrea, Rwanda, and Uganda recorded the largest increase, with the two figures up by around one year per annum from 2000 to 2015.⁴⁶ Moreover, both the incidence rate and mortality rate of communicable disease dropped notably. For instance, malaria incidence rate fell by 21 per cent in Africa between 2010 and 2015, whereas malaria mortality rate declined by 31 per cent (WHO, 2016).⁴⁷ Despite the remarkable improvement, the recent outbreaks of communicable disease in the region send a warning signal to the healthcare system.

The recent outbreaks of communicable disease send a warning signal to the healthcare system.

Burundi has faced an outbreak of malaria since 2015, with around 17 million cases and over 7,800 deaths reported. In March 2017, a malaria epidemic was declared. Meanwhile, cholera outbreaks have occurred in D.R Congo, Ethiopia, South Sudan, Kenya, and Somalia. Water shortages further exacerbated the ongoing cholera outbreaks in Ethiopia and Somalia. Moreover, several cases of Ebola were confirmed in D.R Congo in June 2017 (Figure 26). The recent communicable disease outbreaks, combined with the increasing number of vulnerable displaced populations, could have significant implications on the public health in the region.

Figure 26: Communicable disease outbreaks



Source: UNOCHA (2017a).

⁴⁵ Nevertheless, the disease burden has also increased, as reflected by the widening gap between life expectancy and healthy life expectancy.

⁴⁶ As a higher proportion of birth was delivered by a skilled provider in a health facility, maternal mortality reduced markedly during the same period, especially for Rwanda, Ethiopia, and Tanzania whose ratio was down by more than 50 per cent (WHO, 2017).

⁴⁷ Yet malaria incidence and mortality rates in Burundi, D.R Congo, and Madagascar actually increased during the same period, whereas malaria incidence rates in Kenya and Rwanda also went up.

3. Conclusions

This report has provided an overview of the key macroeconomic and social developments in Eastern Africa over the period 2016-17. With the aim of setting the scene for more in-depth policy discussions, it has also reviewed the major structural changes over the past 10 to 15 years. Countries are benchmarked against the regional performance, highlighting their main achievements, challenges, and opportunities for future growth and development. Examples of successful initiatives in different countries have been discussed to promote peer-learning.

Our analysis has revealed that the economic performance of Eastern Africa during the last two years has weakened, principally due to drought, decline in commodity prices, and (in some cases) growing political instability and/or civil conflict. However, compared with the rest of Africa, the region is still growing at a healthy pace, principally due to the robust growth of the construction sector and parts of the services sector (particularly transport and finance).

Nonetheless, several structural issues are to be addressed in order to unlock the full growth potential of the region. Firstly, a weak manufacturing sector has made the regional economy less resilient. At the same time, a dependence on the expansion of the services sector may not generate sufficient employment opportunities to sustain inclusive growth, amid rapid population growth and urbanization.

In order to achieve the national development targets and attain a sustainable rate of economic growth without engendering constant foreign exchange shortages and balance of payments problems, the expansion of the manufacturing sector is crucial. The sector facilitates faster productivity growth, strengthens forward and backward linkages between sectors, and helps balance the tradeable goods deficits that characterize the regional economies. Our argument is not categorical, however, and this report stresses that there are sub-sectors of the service sector which show great potential for value-addition and/or job creation (e.g. tourism). In fact, some countries in the region have adopted explicit 'service sector-based' strategies (e.g. Djibouti in trade and Rwanda as a service sector hub) with an important measure of success. Similarly, it would be wrong to neglect the role that the primary sector has in generating higher incomes and employment growth through, for instance, exploiting better and sustainably the region's 'blue economy' assets. Hence not all countries in the region should attempt to specialise in manufacturing – but our argument is that there is a critical minimum level of manufacturing below which no country should fall.

Not all countries in the region should attempt to specialise in manufacturing – but our argument is that there is a critical minimum level of manufacturing below which no country should fall.

Secondly, by general consensus the private sector in the region is relatively weak. The reasons for this are complex, but in this report we single out a leading constraint – the lack of access to credit as a result of the poor performance of the banking sector in terms of providing long term affordable finance to businesses. Thirdly, the widening fiscal deficits coupled with structural current account deficits have been constraining growth and have increased economic vulnerability. Fourthly, the region is still underperforming in terms of exports. In particular, exports are excessively concentrated on primary commodities, leaving the region in the lower rungs of the global value chains and highly vulnerable to commodity price shocks. This again brings us back to the importance of boosting the performance of the manufacturing sector.

In view of these challenges, this report recommends member states to (i) better leverage inflows of FDI into the manufacturing sector to facilitate a more rapid technological upgrading; (ii) actively implement reforms to create a thriving business environment, especially a more effective and accessible financial sector; (iii) continue investing in infrastructure in a financially sustainable way; (iv) review trade agreements and develop local and regional value chains via improving local production capacity; and (v) take advantage of hitherto un- or under-exploited natural assets, e.g. the *Blue Economy* which encompasses a range of water-related resources and productive activities.

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