

# East Africa Economic Outlook 2018

Macroeconomic  
developments

Manufacturing's  
comparative  
advantage and  
competitiveness



AFRICAN DEVELOPMENT BANK GROUP



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# EXECUTIVE SUMMARY

**T**he *East Africa Economic Outlook* reviews economic performance in 2017 and forecasts the next two years by highlighting the region's key drivers of growth, opportunities, and challenges. It covers major macroeconomic developments in the region's 13 countries and discusses structural issues affecting future growth, poverty, and inequality. It also presents in part II a synopsis of manufacturing activity in the region, drawing on a previous study of seven of the region's countries. The outlook selects manufacturing as the sector to cover due to its potential to drive future growth and employment in the region.

Economic growth in East Africa was a robust 5.9 percent in 2017 and is forecast to continue in 2018 and 2019.

The agriculture sector is generally the main driver of East Africa's growth, followed by industry. Agriculture grew 5 percent in 2017, while industry grew 10.5 percent. Within the industry sector, the mineral sub-sector's role in driving growth is increasing. On the demand side, household consumption was the main driver of growth, followed by public investment in infrastructure, mineral exploration, and construction.

Global opportunities include the recovery in commodity prices and continuing flow of foreign investment and finance from both traditional and nontraditional sources. Regional opportunities include ongoing public spending on infrastructure and mineral exploration and exploitation, the rebound of agriculture from last year's drought, and strong domestic demand from a growing middle class.

Inflation stood at 13.1 percent in 2016, and 14.4 percent in 2017, the highest in Africa. It is, however, expected to slow down to 8.9 percent in 2018 and 7.8 percent in 2019. The exchange rate was generally stable in 2017

and continues to remain so in 2018 and 2019. Inflation and exchange rate trends show that the region is tackling macroeconomic stability, reflecting appropriate fiscal and monetary policies and a stable macroeconomic environment for growth.

All countries in East Africa had relatively high fiscal deficits, which were projected to decline in 2017 and remain at the 2017 level in 2018 and 2019. The deficits partly resulted from weak domestic resource mobilization in addition to high public investment spending. With average regional domestic saving at 12.8 percent of GDP and the investment-to-GDP ratio at 24.2 percent, the domestic resource gap in 2017 stood at about 11 percentage points.

The domestic resource gap widened the current account deficit. To address resource gaps, countries generally resorted to external borrowing. External debt ranges from 21.2 percent of GDP in Burundi to about 50 percent in Ethiopia and Somalia. Although these debt levels are not very high, they could be burdensome in relation to the countries' capacity to repay, and they are extremely high and unsustainable in conflict-ridden and post-conflict countries.

East Africa's high growth has led to only limited poverty reduction, a challenge the region shares with the rest of Africa. In general, growth has not been accompanied by a commensurate reduction in unemployment or poverty, but by persistent inequality, features not projected to change much in 2018 or 2019.

Policy makers should, therefore, make a concerted effort to create jobs and reduce poverty. They need to, specifically, undertake economic structural transformation, a policy direction that has so far been missing. In addition, given conflict's association with inadequate growth and persistent inequality, addressing economic imbalances would minimize the risk of conflict.

# THE EAST AFRICAN ECONOMY

## ECONOMIC PERFORMANCE AND OUTLOOK

In 2017, average real GDP for the region grew at an estimated 5.9 percent, but with considerable country variations. Ethiopia has consistently grown at above 8 percent while countries embroiled in civil conflict and insecurity have grown much more slowly. Different economic performances highlight regional and global shocks as well as individual country policies and circumstances. In the fastest growing economies, growth resulted from strong domestic private consumption, public investment in infrastructure, growth in light manufacturing, and growth in agriculture, particularly during periods of good rainfall. Some commodity-dependent economies, notably South Sudan, have suffered from weak commodity prices coupled with fragility and insecurity.

### Real GDP growth and the key drivers

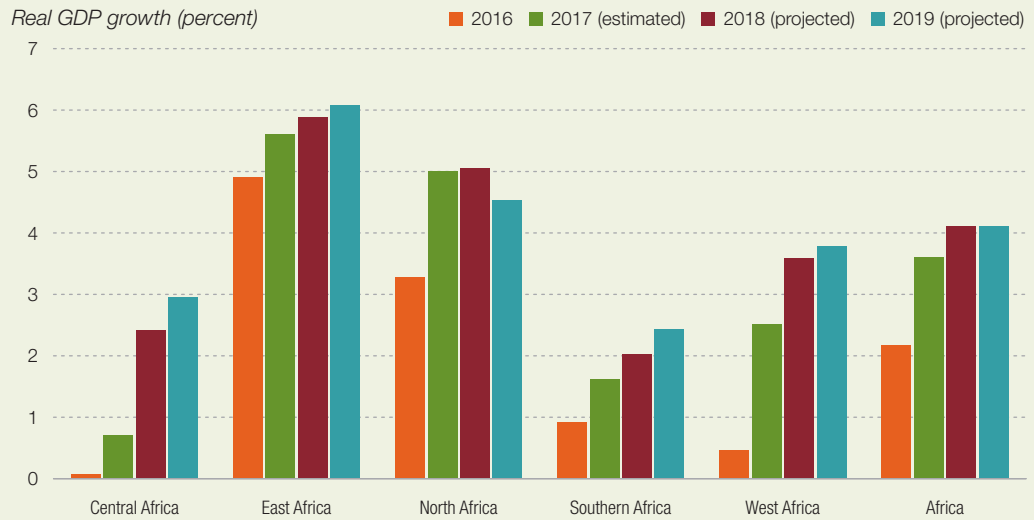
East Africa's robust 2017 GDP growth is forecast to continue in 2018 and 2019 (figure 1). The main contributors to the region's growth are Ethiopia, Tanzania, Djibouti, Rwanda, Seychelles, and Kenya, in that order (figure 2). Although growth in Seychelles and Ethiopia is projected to slow in 2018 and 2019, other countries in the region are expected to continue to register strong growth. A combination of factors explains the region's economic performance. For most countries in the region, recovery from drought in 2017 was expected to shore up agriculture. In Djibouti and Ethiopia, continued investment in public infrastructure will further bolster growth, as will service sector expansion and strong private consumption in Rwanda.

In South Sudan, weighed down by conflict, continued economic contraction will

counteract the region's overall growth. Since the onset of the current civil war in 2013, South Sudan's economy has contracted by an average 6.8 percent a year, making it the worst performing country in the region. Sudan's economy lost three-quarters of its oil revenues following South Sudan's 2011 independence. Uganda and Kenya, with major trade and investment links in South Sudan, have also faced spillovers from the latter's economic contraction. Although South Sudan accounts for less than 1 percent of the region's GDP, the severity of its economic contraction has reduced regional average economic growth (see figure 2). Burundi, Somalia, and Sudan, despite marginal improvement forecast for 2018–19, will also contribute less to the region's growth. Somalia, in particular, still suffers from fragility. Thus, negative growth in East Africa's fragile states, especially in South Sudan, has slowed growth.

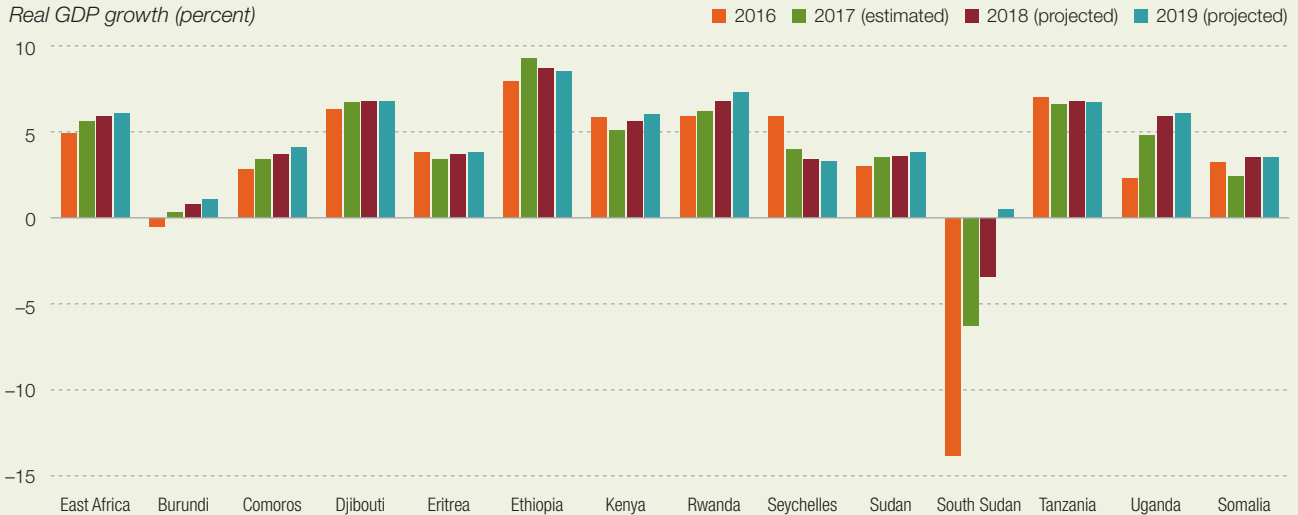


**FIGURE 1** Regional economic growth in Africa, 2016–19



Source: AfDB statistics.

**FIGURE 2** Regional economic growth in East Africa, 2016–19



Source: AfDB statistics.

### Sectoral GDP growth

Growth in East Africa has historically been driven by growth in agriculture due to its major contribution to GDP and employment in most countries. Agriculture's leading role has persisted. It contributed 41 percent of East Africa's average real GDP growth in 2017 (table 1). However, industry's

importance is picking up as the sector contributed about 39 percent of the region's average real GDP growth. This is particularly so in Ethiopia, Rwanda, and Tanzania, where the sector contributed remarkably to GDP growth. If that pattern persists, East Africa may experience textbook

**TABLE 1** Sectoral GDP growth rate and contribution, 2017

Country	GDP growth rates (%)	Growth in sector value added (%)			Contribution to GDP growth (%)		
		Agriculture	Industry	Services	Agriculture	Industry	Services
Burundi	2.0	1.1	1.5	2.6	0.2	0.3	1.5
Comoros	3.4	2.9	3.2	3.8	1.1	0.5	1.8
Djibouti	6.7	8.4	4.3	2.9	5.5	0.6	0.6
Eritrea	3.4	-1.8	4.6	11.2	-0.9	0.9	3.4
Ethiopia	8.1	1.7	23.8	6.1	0.7	5.1	2.4
Kenya	5.1	3.9	4.8	5.7	0.8	1.1	3.2
Rwanda	6.2	5.9	9.0	5.0	3.0	1.6	1.6
Seychelles	3.5	4.0	-1.6	-0.7	3.7	-0.2	0.0
Sudan	3.4	3.1	5.3	2.2	1.6	1.2	0.6
Tanzania	7.2	8.0	8.9	4.4	3.9	2.1	1.2
Uganda	5.1	5.1	5.5	4.6	2.4	1.5	1.2
East Africa: Average	5.9	5.0	10.5	4.3	2.4	2.3	1.3

Source: AfDB statistics.

From the demand side, household consumption is the main driver of growth

growth in light manufacturing, urbanization, and nonagricultural employment.

### Major sources and drivers of growth: Demand decomposition

From the demand side, household consumption is the main driver of growth. For instance, its contribution is about 80 percent to growth in Ethiopia, and about 88 percent in Kenya. Second most important is public investment, generally in infrastructure, mineral exploration, and construction. In Ethiopia for instance, public investments contributed about 33 percent of growth. These demand-side sources should persist and support growth over 2018–19.

### Opportunities and risks

The opportunities that outweighed risks and brought about robust growth in the region were expected to persist in 2018 and 2019. Ethiopia, as a driver of regional growth, is expected to benefit from continued public spending on infrastructure and industrial parks as well as FDI, particularly in infrastructure and manufacturing. The region's rebound from last year's drought is another opportunity for growth. And strong domestic demand from a growing middle class remains an

opportunity for growth both in Ethiopia and Kenya. (Government final consumption expenditure did not change much.)

Kenya, Rwanda, and Tanzania are expected to drive the region's growth further in 2018 and 2019. Enhanced regional integration through the East African Community and the Common Market for Eastern and Southern Africa (COMESA) and potential exploitation of the oil and gas discoveries in Uganda, Kenya, Tanzania, and Ethiopia offer growth opportunities. In addition, urbanization and information and communications technology (ICT) development can support industrialization and structural transformation, given an appropriate economic policy environment. In Rwanda, projected improvements in global demand, ongoing efforts to promote and diversify exports, and tariff reductions provide opportunity for growth.

However, continued political uncertainty in postelection Kenya and sporadic violent political protests in Ethiopia are likely to restrain investment and economic growth in the near term. Ethiopia faces a possible foreign exchange shortage that has been lingering for almost a decade. Tanzania risks slower growth from uncertainty in the business environment and a recent reduction in foreign and domestic investment, particularly in the

Low inflation and stable, optimal exchange and interest rates, crucial to macroeconomic stability, have preoccupied policy makers

extractive sectors following regulatory changes and several high-profile disputes with international investors. Countries with substantial rain-fed agriculture, such as Ethiopia, Rwanda, and Tanzania, depend on favorable weather and on global markets.

In general, in the region's other countries, opportunities are expected to offset potential risks and bring improved growth. Djibouti's continuing investment in ports is increasing income bolstered by strong growth in Ethiopia. Seychelles enjoys growing tourism income. Sudan's export earnings from sesame and livestock are rising.

However, state fragility and insecurity constrain growth in South Sudan and to some degree in Burundi, Somalia, and Sudan. Risks arise from fragile states' inability to provide infrastructure (power, transport, water, and ICT); an unstable macroeconomic framework; reduced productive capacity; and diminished human, physical, social, and financial capital. Regional spillover effects in neighboring countries are major risks. These challenges, constraining investment and growth, damaged East Africa's performance in 2017, and may do so again in 2018 and 2019.

## MACROECONOMIC STABILITY AND OUTLOOK

Growth depends, among other factors, on a stable macroeconomic environment. Low inflation and stable, optimal exchange and interest rates, crucial to macroeconomic stability, have preoccupied policy makers (especially central banks) in East Africa.

### Price movements

#### *Inflation dynamics*

In 2016, inflation in the region stood at 13.1 percent, and in 2017 at 14.4 percent. The double-digit regional average inflation rates have been largely driven by Sudan's inflation and, to some degree after 2016, Burundi's. At these rates, East African inflation has been the highest on the continent.

However, the region's inflation is expected to slow to single digits at 8.9 percent in 2018 and 7.8 percent in 2019. Anticipated monetary

tightening in Ethiopia, Tanzania, and Uganda, and a neutral monetary policy in Kenya, as well as fairly stable exchange rates in all countries, are expected to slow inflation in the coming two years.

Rwanda began 2017 with 7 percent inflation. Though single-digit, the rate was well above 2016's 4.7 percent. But the end of 2017 saw pressure easing with inflation decelerating to about 4 percent, below the central bank's 5 percent target. Such low inflation, observed in most countries in the region in 2017, is also expected in 2018 and 2019.

Inflation in South Sudan, however, has been in triple-digits—380 percent in 2016 and 182 percent in 2017—largely due to the relapse of civil conflict and weak fiscal policy management. The civil war disrupted oil production and exports, accelerating exchange rate depreciation. Because of the country's high dependence on imported food and intermediate goods, an inflation-depreciation spiral followed. Sustained large government budget deficits, financed by domestic borrowing, including from the central bank, also contributed to hyperinflation. Inflation is, nonetheless, projected to sharply decline to 45 percent in 2018 and 16.6 percent in 2019 with improved fiscal and monetary policy management.

#### *Exchange rate evolution*

The region's inflation and exchange rates in 2017 show success in attaining macroeconomic stability. They reflect the pursuit of appropriate fiscal and monetary policy by countries in the region. Except for Eritrea and South Sudan, the region's exchange rates are generally stable. In Kenya, the region's dominant and sophisticated economy, the shilling remained stable in the range of KSh100–104/\$ in 2017. Similarly, the Somalia shilling remained at 23,000/\$, despite the central bank's inability to control supply of the shilling because the private sector prints money in Somalia. Dollarization has also contributed to the shilling's stability.

Eritrea, Ethiopia, and South Sudan face pressure for exchange rate depreciations. Eritrea has fixed its domestic currency, the nakfa, at 15.4/\$ for the past 10 years, causing its overvaluation against major currencies. This continued in 2017 in



the face of a chronic foreign exchange shortage in the country. In Ethiopia, pressure for depreciation persisted throughout 2017. The central bank continued to pursue gradual depreciation of the birr by 6 percent in 2016/17, from ETB 21.8/\$ in 2015/16 to ETB 23.1/\$ in 2016/17. Ethiopia's devaluation of the birr by 15 percent at the end of October 2017 reversed a two-year policy resisting international financial institutions' pressure.<sup>1</sup> The devaluation, according to the government, aims at revitalizing the country's exports. It has put pressure on inflation, which moved to double digits even before the devaluation and is expected to continue in 2018. The government has put in place measures, such as restricting credit expansion to the non-export oriented sectors, to address inflationary pressures from the devaluation. In both South Sudan and Sudan, exchange rates became unstable and depreciated in 2017. The South Sudan pound depreciated from 2.95 SSP/\$ in 2014 to more than 170 SSP/\$ in October 2017. Given a depressed oil price, low oil production, and the ongoing conflict, continuing pound exchange rate volatility is expected over the near term.

In Sudan, currency depreciation pressures were felt in 2017 and are expected to persist in 2018, owing to challenges in the external sector and to the expected currency reform unifying the

multiple exchange rate practice (MCP) in 2017. The market-based exchange rate fell, notwithstanding the adjustment of the commercial bank rate by 13 percent in November 2016 and a further 13 percent at 2016's end.

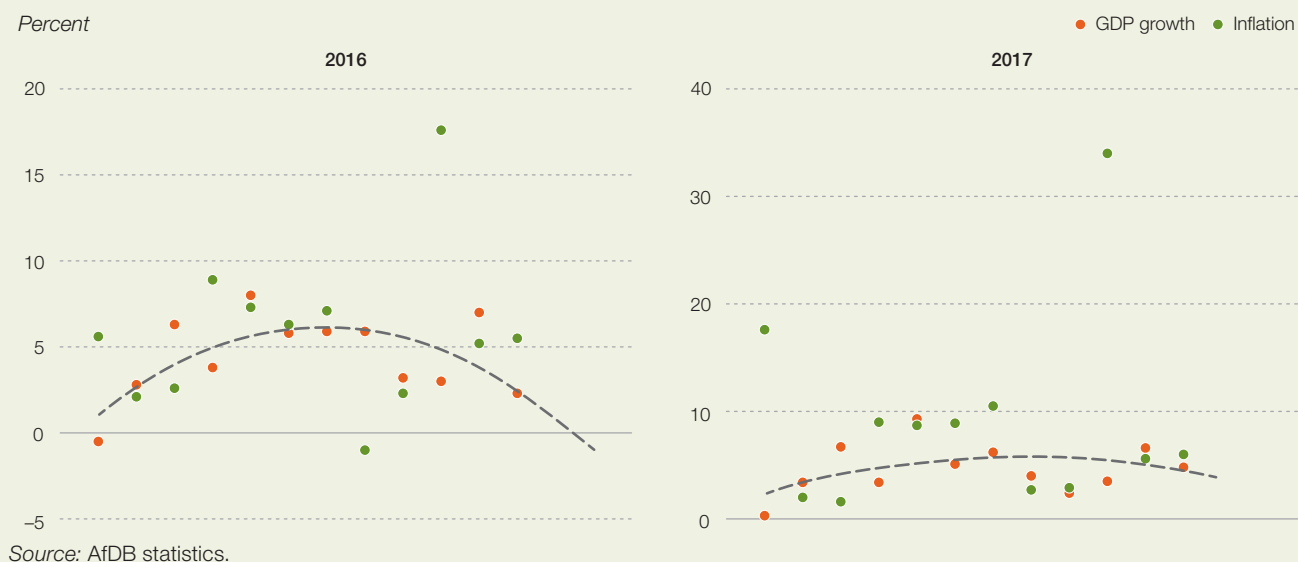
#### Macroeconomic stability and growth nexus

Economic growth, central for poverty reduction, depends on a stable macroeconomic environment, which in turn depends on whether growth is shared or not. Fiscal and balance of payment deficits, exchange rate volatility, and inflation generally indicate macroeconomic instability. Of these, inflation is the most important, however, because it provides a summary reflection of the fiscal deficit, balance of payments deficit, and exchange rate depreciation.

Growth and inflation dynamics in East Africa show the importance of a stable macroeconomic environment for growth. Figures 3a and 3b show the pattern of inflation and growth in 2016 and 2017. Economic growth is generally negatively related to inflation though this pattern weakened in 2017 (figure 3). The region seems to have a growth-maximizing inflation of around 7 percent. If some outlier countries are excluded, the strong negative relationship between inflation (macroeconomic instability) and growth becomes more

Growth and inflation dynamics in East Africa show the importance of a stable macroeconomic environment for growth

**FIGURE 3** The nexus between growth and macroeconomic stability



Countries with above-average deficits have little fiscal space to maneuver, and therefore need to realign expenditures with revenue streams

apparent. The stable exchange rate and low inflation help explain the region's growth.

Macroeconomic instability also follows conflict and state fragility. The East Africa region is home to seven fragile and post-conflict states: Burundi, Comoros, Eritrea, Ethiopia, Somalia, South Sudan, and Sudan. In these countries, macroeconomic stability is important not only to bring about growth but also, perhaps more important, to ensure state legitimacy and reduce the risk of relapse into conflict.<sup>2</sup> Thus, macroeconomic stability is also a matter of peace and political stability.

### Fiscal and current account deficits and sources of finance

#### Public expenditure and fiscal deficits

In 2016, the East Africa region saw three categories of fiscal deficit: high—over 14 percent in Djibouti, Eritrea, and South Sudan; medium—6 to 8.7 percent in Burundi, Comoros, and Kenya; and low—below the region's average 4.2 percent in Ethiopia, Rwanda, Seychelles, Sudan, Tanzania, and Uganda (table 2). In all categories, the deficit is estimated to have declined in 2017, and forecast

to remain at the 2017 level in 2018 and 2019. In Burundi, however, the fiscal deficit is forecast to rise.

Government consumption did not change much compared to capital expenditure in 2017. The regional average government final consumption expenditure declined from 11.6 percent to 9.7 percent while gross capital formation markedly dropped (table 3).

Countries with above-average deficits have little fiscal space to maneuver and therefore need adjustments to realign expenditures with revenue streams. Some countries have already put fiscal consolidation measures in place. In Eritrea, fiscal policy has been less expansionary due to limited fiscal space, and the government began major fiscal reforms in 2017. In Kenya, the government reduced expenditure by 4 percent in the 2016/17 budget. In South Sudan, the civil war and deep economic crisis have taken a heavy toll on government finances, compounded by low oil prices, together cutting fiscal revenues by about half since 2014. Continuing oil price weakness, lingering civil war, and the humanitarian crisis will continue to harm the country's fiscal position.

**TABLE 2** Overall fiscal balance, including grants (*percent of GDP*)

	2016	2017 (estimated)	2018 (projected)	2019 (projected)
East Africa	-4.0	-3.8	-3.8	-3.7
Burundi	-6.2	-8.2	-8.9	-9.1
Comoros	-7.2	-5.8	-5.2	-4.4
Djibouti	-18.2	-15.5	-13.5	-12.2
Eritrea	-14.0	-13.8	-12.6	-12.4
Ethiopia	-2.4	-3.4	-2.6	-2.8
Kenya	-8.0	-7.8	-6.3	-5.6
Rwanda	-3.8	-4.1	-3.8	-3.7
Seychelles	0.9	0.6	-0.6	-0.4
Somalia	0.0	0.0	0.0	0.1
South Sudan	-23.1	5.8	-1.5	-1.4
Sudan	-1.8	-2.1	-2.3	-2.3
Tanzania	-3.7	-2.1	-4.4	-4.8
Uganda	-4.0	-3.3	-4.6	-4.7

Source: AfDB statistics.

In Uganda, public investment in infrastructure created fiscal stress. To contain it, the government began reforms to strengthen government agency capacity to plan and execute infrastructure projects. In Tanzania, fiscal policy was expansionary in 2017, although weaker-than-expected revenues led to a lower-than-budgeted fiscal deficit of about 3 percent of GDP, compared with the planned deficit of 4.5 percent. The pattern is similar in the region's other countries, and this prudent fiscal policy stance is expected to prevail in 2018 and in 2019.

In line with this pattern, Sudan's deficit given in table 3 is moderate. But its actual deficit is much larger (7.7 percent of GDP) according to the International Monetary Fund, because subsidies linked to official exchange rates are recorded only on the central bank's balance sheet. The fiscal stance is, thus, likely to be expansionary in 2018, thanks to the planned currency unification.

#### *Domestic resource mobilization*

The fiscal deficit across the region's countries results partly from weak domestic resource mobilization, the case throughout 2015–17. With the average regional domestic saving at 12.8 percent of GDP and the investment-to-GDP ratio at 24.2 percent, the domestic resource gap in 2017 stood at about 11 percentage points. With the

exception of Seychelles, government revenue and tax revenue as a share of GDP were generally very small, ranging from 10.4 percent to 17.7 percent for the former, and 10.2 percent to 16.3 percent for the latter (table 3).

Given the considerable gap between investment and saving, several countries have embarked on a concerted effort to raise saving, enhance tax collection, avoid tax evasion, and increase efficiency of public spending. In Ethiopia, government-driven bank branch expansion, a saving scheme to facilitate access to credit for low-income residential housing investment, and various tax-collecting reforms brought considerable results in 2016 and 2017. In Rwanda, over 65 percent of the resources to fund the 2016 budget came from domestic tax and non-tax revenue and domestic financing. Increased tax revenue resulted partly from enhanced collection of VAT and direct taxes and partly from introducing the “Electronic Billing Machines for All” project—a project aimed at increasing the collection of VAT and direct taxes. Even in Somalia, revenue improved from an estimated 0.6 percent of GDP in 2012 to 1.8 percent in 2016 due to better tax administration and stronger engagement with big private sector firms to sensitize them on paying their taxes. However, the Somali government's capacity to generate sufficient revenue, stabilize the macroeconomic

Several countries have embarked on a concerted effort to raise saving, enhance tax collection, avoid tax evasion, and increase efficiency of public spending

**TABLE 3** Government expenditure and revenue (percent of GDP)

	General government final consumption expenditure		Gross capital formation		Revenue, excluding grants	Tax revenue
	2016	2017	Total	Private	2015	2015
Burundi	25.0	26.2	22.2	14.8		
Ethiopia	10.2	10.3	39.9	13.0	15.0 <sup>a</sup>	12.0 <sup>a</sup>
Kenya	12.0	12.1	15.8	12.6	17.7	16.3
Rwanda	12.9	15.6	27.8	14.1	16.6	13.7
Seychelles	25.2	25.1	46.1	39.7	28.3	27.0
Sudan	6.6	5.5	13.8	10.7		
Tanzania	15.8	15.4	30.4	24.9	12.9 <sup>a</sup>	11.9 <sup>a</sup>
Uganda	9.8	9.9	27.0	21.9	10.4	10.2
East Africa	11.6	9.7	24.2	14.8		

Source: AfDB statistics.

a. 2015/16.



Resource gaps persist across countries despite efforts at domestic resource mobilization

environment, and collect taxes remained limited due to widespread insecurity and institutional constraints in 2017. In Tanzania, the government plans to mobilize domestic resources by increasing the efficiency of public expenditure. Tanzania also plans to reduce corruption and tax evasion and improve tax revenue administration. Tanzania will also be able to mobilize international resources when it obtains a credit rating.

In sum, resource gaps persist across countries despite efforts at domestic resource mobilization, showing the importance of both domestic and foreign resources for investment, growth, and a stable regional macroeconomic environment.

**Current account deficit, terms of trade, and debt dynamics**

Owing to governments' drive for high growth, investment remained greater than domestic savings in all countries in 2017. The domestic resource gaps led to considerable current account deficits (table 4). Large current account deficits are a major challenge for Burundi, Djibouti, Ethiopia, Rwanda, Seychelles, and Somalia. But Eritrea, Kenya, South Sudan, Sudan, Tanzania, and Uganda faced smaller deficits.

Depressed global prices since 2013, which have deteriorated the terms of trade for countries exporting primary commodities such as coffee, tea, oil, and sesame, contributed greatly to the current account deficit.

Countries in East Africa generally resorted to external resources—FDI, remittances, aid, and borrowing—to address these resource gaps. Borrowing from both traditional lenders and nontraditional ones (in particular China) is raising debt in the region considerably, ranging from 21.2 percent of GDP in Burundi to 46 percent in Somalia. Although these levels are not very high, they are heavy compared with countries' capacity to repay, as is seen in high debt-to-export and debt service ratios (table 5).

Debt affected many countries in 2017 and will continue to do so in 2018 and 2019. For instance, Ethiopia's risk of external debt distress was raised from low to moderate in 2015 and remained moderate in 2016. Ethiopia's debt reached 54.2 percent of GDP in 2016, and external debt about 32 percent, due to stagnating export revenue and a large gap between imports and exports (about 18.6 percent of GDP). Ethiopia's debt stress could be even larger if parastatals' indebtedness

**TABLE 4** Current account balance, including grants (percent of GDP)

	2016	2017 (estimated)	2018 (projected)	2019 (projected)
East Africa	-6.7	-5.4	-5.5	-5.3
Burundi	-12.3	-11.6	-10.4	-9.3
Comoros	-9.3	-9.1	-10.5	-11.1
Djibouti	-30.4	-26.8	-21.8	-18.9
Eritrea	-0.1	0.7	0.3	-1.1
Ethiopia	-10.6	-8.4	-7.4	-7.0
Kenya	-5.5	-5.9	-6.8	-6.6
Rwanda	-14.4	-10.3	-11.1	-9.8
Seychelles	-20.0	-15.4	-14.4	-14.6
Somalia	-10.1	-11.1	-10.7	-10.0
South Sudan	4.7	1.7	-12.7	-10.1
Sudan	-5.2	-3.5	-2.7	-2.9
Tanzania	-4.6	-1.9	-4.1	-3.3
Uganda	-4.1	-5.4	-6.5	-7.7

Source: AfDB statistics.

**TABLE 5 External debt**

	External debt, 2016			Debt service
	\$ billion	% of GDP	% of exports	% of exports
Burundi	0.2	21.2	327.4	31.7
Comoros	0.2	25.9		
Ethiopia	23.1	32.0	389.6	21.0
Kenya	22.3	32.0	212.2	10.6
Rwanda	2.8	34.1	173.4	8.3
Sudan	21.1	24.3	454.4	6.4
Tanzania	16.5	35.3	175.6	5.4
Uganda	9.9	39.6	220.0	18.8

Source: AfDB statistics.

to nontraditional partners, particularly China, were counted. In Kenya, the debt-to-GDP ratio has increased for the past three years. Currently it stands at about 56 percent, higher than the 2010–14 average of 45 percent and the 2015–16 average of 52 percent. Similarly, in Seychelles, debt currently stands at around 64 percent of GDP. Fiscal discipline coupled with effective debt restructuring supported the government's debt reduction strategy, according to the central bank. But Seychelles' initial target of reducing public debt to 50 percent of GDP by 2018 was extended to 2020—the government hopes that the increased debt service will not reduce planned expenditure too much in years to come.

Debt stress is extremely high in post-conflict and conflict-ridden countries. In Eritrea, public debt was 105.8 percent of GDP in 2015–17, according to available data. Similarly, in Somalia, an estimated \$5 billion in external debt (about 79 percent of the country's estimated GDP), continued to accumulate arrears in 2017, precluding further external borrowing. In both South Sudan and Sudan, debt increased substantially in 2017. In Sudan, public external debt is unsustainable, most is in arrears, and an attempt to lower external borrowing is causing a sharp increase in monetizing financing needs and hence high inflation.

In general, the negative external trade and current account balances in East Africa, arising from a domestic resource gap, are increasing

debt. Shifting external financing toward nontraditional partners, particularly China, could aggravate indebtedness, because the cost is high.<sup>3</sup> Also, some countries have begun borrowing through the international bond market, also an expensive course that could raise debt stress further. The only exceptions to the regional trend are Tanzania and Uganda. Tanzania's debt is sustainable in both the short and medium term, and the risk of debt distress remains low. Similarly, Uganda's current debt is well below the sustainability threshold, and debt remains sustainable in the medium and long term.

## POVERTY, INEQUALITY, AND EMPLOYMENT

### Trends in poverty and inequality

Poverty pervades Africa despite excellent economic growth since 2003. Nearly half the population lives below the international poverty line of \$1.25 a day.<sup>4</sup> This Africa-wide challenge also holds for East Africa, where poverty reduction remains limited except in the small island economies (table 6).

Inequality, too, is a regional problem (see table 6). Across many countries in East Africa the top 20 percent of the population controls about 50 percent of the income while the bottom 20 percent of the population earns only about 5 percent. Inequality arising from growth is offsetting

Across many countries in East Africa the top 20 percent of the population controls about 50 percent of the income

Structural transformation is more vital for reducing poverty than per capita economic growth

**TABLE 6** Poverty and inequality, 2013

	Poverty— percent of population		Inequality— percent of income going to the	
	At \$1.90 a day PPP	At \$3.20 a day PPP	Top 20% of the income distribution	Lowest 20% of the income distribution
Burundi	32.4 <sup>a</sup>	53.2 <sup>a</sup>	46.7	6.6
Comoros	17.7 <sup>a</sup>	36.9 <sup>a</sup>	50.1	4.5
Djibouti	22.5	44.6	50	4.9
Ethiopia	29.6 <sup>b</sup>		29.8 <sup>b</sup>	
Kenya				
Rwanda	60.4 <sup>a</sup>	81.5 <sup>a</sup>	57.1	5.2
Seychelles	1.1 <sup>a</sup>	2.5 <sup>a</sup>	53	5.4
Tanzania <sup>c</sup>	48.8	28.2		
Uganda	34.6	66.6	48.3	6.4

Source: AfDB statistics.

a. World Bank, WDI, 2017 poverty headcount ratio (% of population at \$1.90 a day, 2011 PPP).

b. National poverty line; inequality is Gini coefficient using data from Ethiopian Ministry of Finance and Economic Development 2013.

c. Authorized Economic Operator (2017) using \$1.90 (48.8%) and national data (28.2%).

poverty reduction that might come from that same growth.<sup>5</sup> Micro-level evidence in Djibouti, for instance, shows that although overall poverty declined in the past decade, inequality has not shown clear signs of improvement, and growth has mainly benefited those in the upper part of the income distribution.<sup>6</sup> The Djibouti study noted that progress in poverty reduction and inclusiveness would require not only sustained high growth but also better-targeted social policies, more attention to the regional spending distribution, and new opportunities in sectors with high earning potential for the poor.<sup>7</sup> Ethiopia has similar patterns of growth, poverty, and inequality.<sup>8</sup>

Because positive growth has made little dent in inequality, policy makers should make a concerted effort at inclusive growth and poverty reduction. For Africa, the AfDB outlines these key pillars of inclusive growth: (1) improved agricultural productivity, (2) enhanced regional integration, (3) job creation, including improved skills, (4) raised productivity and competitiveness, (5) wider access to basic infrastructure and basic social services, (6) improved access to business opportunities, social protection, and inclusion, and (7) wider access to

productive knowledge.<sup>9</sup> These pillars are very relevant to East Africa.

Conflict in Africa has been associated with lack of inclusive growth and inequality. Addressing inequality through inclusive growth would reduce the risk of conflict in a region dominated by conflict-prone countries.<sup>10</sup>

## Employment, structural change, and poverty reduction

### *Employment dynamics and employment response to growth*

Gainful employment is crucial for poverty reduction. But East Africa saw unemployment averaging 36 percent in 2016 and ranging as high as 75 percent in Djibouti (table 7). It was not expected to fall much in 2017.

### *Structural change, productivity, and employment and poverty implications*

Structural transformation is more vital for reducing poverty than per capita economic growth. Between 1981 and 2008 in Sub-Saharan Africa, poverty declined only by 4 percentage points



**TABLE 7** Structural change, growth, and employment

	Structural change (value added)				Growth and employment dynamics		
	Agriculture (% of GDP)	Industry (% of GDP)	Services (% of GDP)	Manufacturing export (% of total trade)	GDP per person employed (2011 PPP \$)		Unemployment (ages 15 and up, % of population)
					2015	2016	2016
Burundi	39.5	15.1	45.3	22.2	1,502.2	1,451.4	17.7
Comoros	33.6	10.8	55.7	21.7	4,897.4	4,867.8	53.7
Djibouti	3.6	19.5	76.8		9,975.7	10,426.0	75.1
Ethiopia	41.0	16.3	42.8	7.3	3,342.4	3,455.8	21.6
Kenya	24.0	22.0	54.0	36.9	8,390.0	8,583.1	38.8
Rwanda	34.6	15.1	50.3	15.4	3,400.8	3,485.6	17.0
Seychelles	2.5	16.2	81.4	5.2	na	na	58.5
Sudan	32.0	20.6	47.3	na	16,022.0	16,055.4	24.1
Tanzania	31.5	25.0	43.5	26.1	5,799.5	6,034.5	17.9
Uganda	27.0	21.9	51.1	24.6	3,971.5	4,020.1	17.0
East Africa (average)	27.6	18.0	54.5	19.9	6,082.2	6,193.1	36.1

Source: Value added and unemployment are computed based on AfDB, statistics department, The rest from WB, WDI, 2017.

Growth, propelled by both domestic and foreign investment, is crucial for employment creation and poverty reduction

(since 2002, during robust growth, by only 5 percentage points).<sup>11</sup> But between 1981 and 2008 in East Asia, where growth was accompanied by structural transformation and inclusiveness, poverty declined by 63 percentage points—from 77 percent to 14 percent.<sup>12</sup> The contrast shows how important the kind of growth is for poverty reduction—whether it is inclusive and whether it entails structural transformation and job creation.

Despite more than a decade’s robust growth, the lack of structural transformation is shown by the industrial sector’s small contribution to GDP of about 18 percent (see table 7). The smaller share of the manufacturing sector, an industrial sector subset, shows the deficiency to be even more. For instance, in Ethiopia the industrial sector’s share in GDP was estimated at about 16.3 percent, but the manufacturing subsector’s share is below 10 percent. And the manufacturing sector’s share in GDP has remained constant for more than two decades, even during double-digit GDP growth. Most countries in the region have a similar pattern, showing the lack of structural transformation. The Economic Commission for Africa’s decomposition

of GDP into agriculture, industry, and services across successive five-year periods and analysis of related sectoral productivity and investment also underscores Africa’s limited structural transformation. This lack of structural transformation and productivity growth is a main contributor to the failure of the region’s buoyant growth to bring about meaningful employment growth or poverty reduction.

The lessons from this general picture of growth, structural change, productivity growth, inequality, and poverty are manifold. First, growth, propelled by both domestic and foreign investment, is crucial for employment creation and poverty reduction. However, the nature of growth matters a lot: whether it is inclusive and accompanied by structural transformation and rising productivity. Second, sustainable employment creation takes place when investment goes to manufacturing (this generally seems not to happen in East Africa). Though further study is required, the region’s failure to shift employment toward the service sector shows the importance of emphasizing labor-intensive manufacturing and human capital

Improving industrial sector productivity for light industrial goods that will boost agricultural sector productivity should be a policy goal

formation. Third, to shape growth and enhance investment’s effect on poverty reduction, policies should seek investment and financing for projects that create more jobs and bring about structural transformation. Typical projects would improve manufacturing or raise productivity in agriculture, though choosing projects will reflect distinct country-level circumstances.

### Growth decomposition

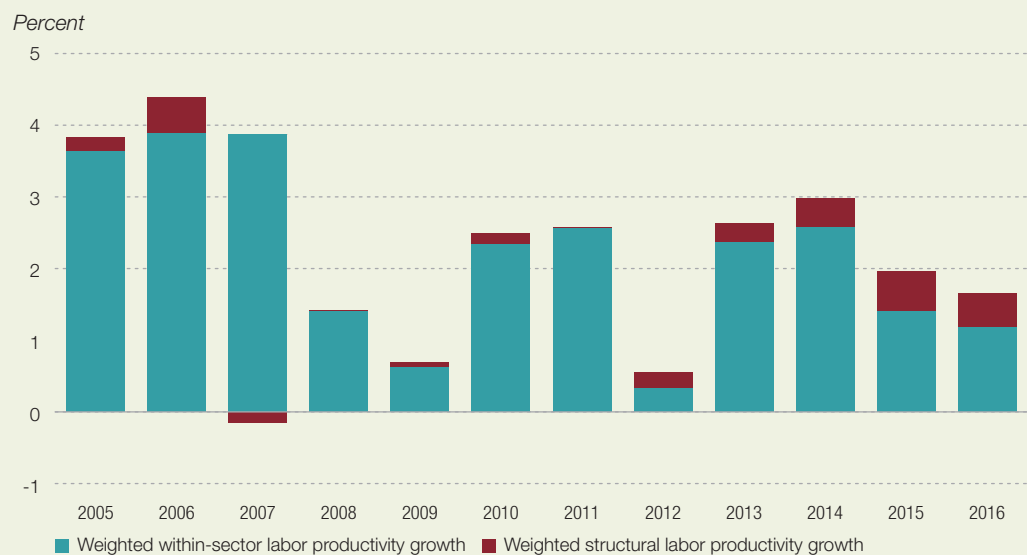
What kind of growth has the region experienced, and have changes in economic structures been transformational? To examine this question, labor productivity is decomposed in two components.<sup>13</sup> The first measures “within-sector” productivity growth and its contribution to aggregate labor productivity growth. Within-sector productivity growth may reflect occasional shocks, such as severe weather or volatile commodity prices. The second component measures “between-sector” productivity growth—the contribution to aggregate productivity growth of reallocating labor from low-productivity sectors to high-productivity sectors. Changes in sectoral employment shares that are positively correlated with productivity contribute positively to economywide productivity growth. Between-sector productivity growth

captures long-term economic transformation that determines countries’ performance, including their capacity to reduce poverty and create enough decent-paying jobs.

East Africa’s labor productivity growth was positive between 2005 and 2016 at an average annual rate of 2.4 percent, with a peak of 4.4 percent in 2006 (figure 4). From 2005 to 2011, that growth represented mainly within-sector productivity growth in services. From 2013 to 2016, all three sectors recorded productivity growth, with agriculture and services leading. Productivity growth in agriculture may have resulted from technological change: increased farm inputs, a shift from subsistence to cash crop agriculture, and a shift from high-risk to low-risk improved seed varieties. Improving industrial sector productivity for light industrial goods that will boost agricultural sector productivity should be a policy goal.

The structural component of labor productivity growth was positive between 2005 and 2016 except for 2007. Stated differently, employment in East Africa has been moving from lower-productivity agriculture to higher-productivity services and industry, particularly in 2012–16. The services sector has been the most dynamic in absorbing labor, but low-skill services in urban

**FIGURE 4** Decomposition of labor productivity growth



Source: AfDB statistics.

areas may be prevalent, such as self-employment in transportation, wholesale, and retail. Industry's contribution to structural change has been rising since 2012. Investments in infrastructure and institutions could increase that contribution by creating an environment conducive to investment in manufacturing, particularly light manufacturing.

## EMERGING POLICY ISSUES

### Policy priorities for sustaining rapid and inclusive growth

East Africa, with GDP growth of 5.9 percent in 2017, continued to be an important driver of growth on the continent. The region is a home to many fast-growing economies, such as Ethiopia, Kenya, Rwanda, and Tanzania. Ethiopia alone accounted for 23 percent of East Africa's real output and 38 percent of output growth in 2017. The region is also home to politically unstable fragile states, such as Burundi, Somalia, and South Sudan.

Much of the growth in the region is coming from low-income non-resource rich economies. Growth was made possible by better macroeconomic management (not by the resource sectors), improved public sector investment, and increased household consumption thanks to the growing middle class. Even so, growth has not been inclusive. The region continues to have high poverty, rising inequality, and increasing unemployment, with youth accounting for the lion's share.

To sustain regional GDP growth and move to a higher growth trajectory, countries need to strengthen their macroeconomic stability. How? Through prudent macroeconomic policies that take into account individual countries' circumstances. Through vigorous efforts to improve domestic resource mobilization and expand the fiscal space to support public investment. And through structural transformations to broaden the growth base, create more jobs, and reduce the vulnerability to external shocks by diversifying the sources of government revenue and foreign exchange earnings.

### Macroeconomic stability to sustain growth and generate employment

Despite solid economic growth in the last couple of decades, some countries in the region have

experienced instability in their macro economy, which if not addressed and corrected could lead to a growth crisis. Ethiopia, Djibouti, and Sudan have recently been running double-digit inflation rates caused by external shocks, internal strife, and overheating economies. Whatever the cause, central banks have to put a tab on inflation and contain its impact on the poor. In addition, large budget deficits (Burundi, Djibouti, Eritrea, and Kenya) and severe current account deficits (Burundi, Comoros, Djibouti, Eritrea, Ethiopia, Kenya, Rwanda, and Seychelles) threaten future growth prospects, possibly leading to debt distress and investment slowdowns just when they need to accelerate growth.

### Domestic resource mobilization

Countries cannot keep relying only on public investment as major driver of growth. And as they seek a viable alternative in private sector led growth, they need to expand their fiscal space to step up infrastructure investments while reducing public debt.

Increases in public investment supported GDP growth in Kenya and Ethiopia. However, Kenya's large borrowings to finance its infrastructure spending also elevated its risk of debt distress. And Ethiopia's higher debt has worsened its credit risk profile, recently downgraded from medium to high and making borrowing from external financial markets more costly.

So, enhancing infrastructure investment has to be within each country's means, leveraging private investment where possible. This requires policies to expand the fiscal space by raising revenue (tax revenue as percent of GDP is low in the region) and by rationalizing and raising the efficiency of public spending through stricter public financial management.

Improving tax administration can bring more taxpayers into the tax net (formalizing the informal sector through incentives and financial inclusion).

Increasing the efficiency of tax collection efficiency (e.g. integrated tax administration systems). A good example is the impact the introduction of ICT (electronic cash register system) had on tax collection in Ethiopia; it resulted in an increase in VAT collection by 19 percent (box 1).

Enforcing tax laws to increase compliance of those already in the tax net is yet another

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Enhancing infrastructure investment has to be within each country's means, leveraging private investment where possible

### BOX 1 Increasing tax compliance in Ethiopia

There is a common perception that tax evasion in most African countries tends to be very high because of the large informal sector, narrow tax base, weak revenue and custom authorities, and insidious corruption.

Taxpayers comply voluntarily if they have strong trust in tax authorities and the ability to detect evasion. They also comply if they fear severe penalties. But when trust in authorities is weak, and tax authorities are also weak, tax evasion becomes the norm, and most African countries seem to be on the slippery slope of the figure below.

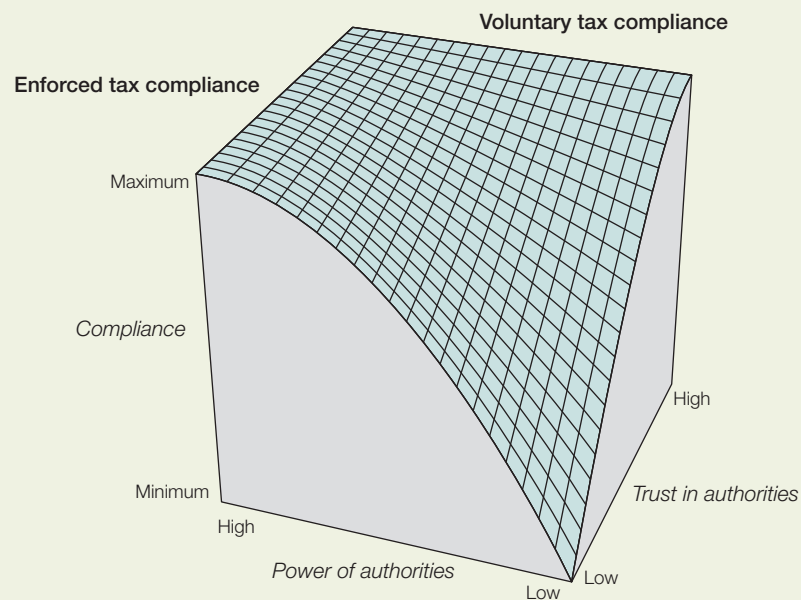
Ethiopia is one of few African countries to increase both trust and power of revenue authority to increase compliance. Its revenue authority introduced various schemes to incentivize taxpaying businesses proportional to their compliance. It also strengthened its detection capabilities through a new electronic cash register system to monitor the daily sales transactions of all businesses. Applying ICTs increased VAT collections 19 percent. It also increased employment among businesses that adopted the electronic cash register, compared with nonadopters.

On questions of trust in the authorities and their power to coerce compliance, an experiment covering 5,000 businesses in Addis Ababa found that close to 40 percent were evading taxes. Trust in authorities could increase tax compliance by 32 percent, and a carrot and stick approach could sustain increases in tax collections. For example, better communications about the economic and social benefits of paying taxes through media and credible evidence could increase tax compliance. And improving the ability of revenue authorities to detect evasion could also increase compliance.

As revenue authorities digitize information, and apply uniform accounting principles, they tend to benefit from third-party information in identifying businesses chronically evading taxes. Indeed, tax evasion in Ethiopia could have been close to 70 percent if not for the ICT applications.

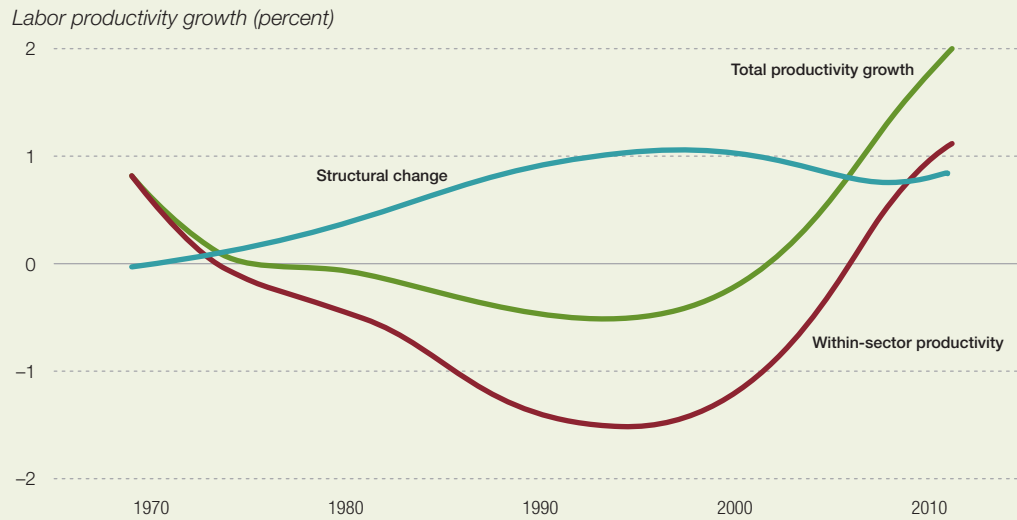
When trust in authorities is weak, and tax authorities are also weak, tax evasion becomes the norm

#### The slippery slope of tax (non)compliance



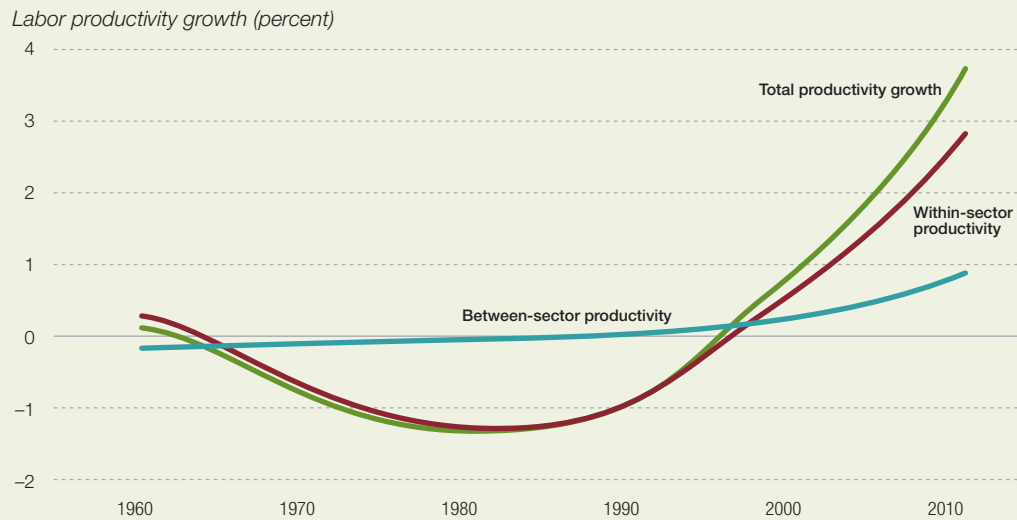
Source: Merima, Shifa, Shimeles, and Firew 2017; Shimeles, Gurara, and Woldeyes 2017.

**FIGURE 5** Labor productivity growth in Kenya, 1960–2010



Source: Based on data from the Groningen Growth and Development Center.

**FIGURE 6** Labor productivity growth in Ethiopia, 1960–2014



Source: Based on data from the Groningen Growth and Development Center.

important measure that countries should consider for great domestic resource mobilization. Tax compliance is very low in East Africa, evidenced by the low C-efficiency for Kenya (a country with its fairly well-developed ICT infrastructure) which is low at 25 percent. This suggests huge potential

available to increase revenue collect via VAT compliance alone.

A recent study investigating Ethiopia’s low compliance highlighted public “trust” in tax authorities and the power to enforce compliance. With previous tax evasion rates at 40 percent, the



All countries in the East Africa region need to increasingly rely on structural change to accelerate and sustain growth

country reversed the situation by combining the carrot and stick approach carefully and smartly. The approach helped the country increase tax compliance by 32 percent (see box 1).

### Structural transformation

Countries in the region have not transformed their economic structures very much: manufacturing's share in GDP and employment remains low, agriculture's remains high, and services' is growing, much of it informal—with some exceptions. In Kenya and more recently in Ethiopia, the movements of labor from low to high productivity activities helped accelerate labor productivity growth (figures 5 and 6). Structural changes moving people to high-productivity activities expanded in Kenya particularly during 1990–2000, when manufacturing, tourism, and formal services boomed and about 10 percent of productivity growth was thanks to structural change. Similarly, structural change started to pick up in Ethiopia during 2005–14, contributing 10 percent to overall productivity growth.

While these are just two examples, all countries in the East Africa region need to increasingly rely on structural change to accelerate and sustain growth. They thus require well planned and executed structural transformation initiatives supported by redistributive public policies tailored to their socioeconomic circumstances.

Structural transformation would broaden the sources of GDP growth (by diversifying growth away from the traditional sectors). It would create more jobs for the growing number of less skilled and unemployed youth (through labor-intensive sector growth). And it would fight poverty and inequality (through appropriate redistributive public policies). But it would also demand greater private involvement in the economy, which requires addressing the constraints on private sector development.

To foster structural transformation in East Africa, policymakers should consider the following priorities:

**Addressing the huge infrastructure gap.** The stock of infrastructure in relation to GDP is lower in the region than the 70 percent international benchmark. Innovative infrastructure financing

mechanisms and increased involvement of the private sector in infrastructure development through public–private partnerships are keys to addressing the infrastructure financing gaps.

**Improving access to finance.** In East Africa as elsewhere on the continent, micro, small, and medium enterprises account for more than 90 percent of the private sector GDP. But they are constrained by limited capacity and access to finance. Kenya's fairly well developed financial sector made notable inroads in financial inclusion. But the interest rate cap introduced in September 2016 hurts not only the MSMEs but the large formal firms. It also impairs the effectiveness of monetary policy.

**Creating conducive policies, institutions, and financial support mechanisms.** To support country ambitions to industrialize by developing global and domestic value chains requires attracting foreign and domestic. Kenya and Ethiopia are the region's leading destinations for FDI, and both have success stories to share. For example, FDI is helping Ethiopia to transition from agriculture-led to industry-led growth and to achieve its plan of soon becoming a lower middle-income economy.

**Addressing skills gap through technical and vocational education and training.** Private sector growth is increasingly constrained by a lack of skilled labor in the right quantities, with universities producing graduates who remain unemployed or underemployed. For example, Kenya has a growing skill mismatch in its labor market, especially in such booming sectors as construction and mining. As countries address these issues by opening and expanding TVET centers, they have to focus on sectors with clear comparative advantages.

**Capitalizing on the growing domestic and regional markets.** Thanks to its growing middle class, the East African Community is doing better than many other regional economic communities on the continent. But lingering challenges require attention, with political instability the most visible.

Restrictions on the cross-border movement of goods, services, and labor continue despite

the common market protocol signed in 2010. Consider the trade disputes and mistrust leading to nontrade barriers (Kenya and Tanzania) and the enforcement of work permits (Tanzania and Burundi). Nor have members countries stood as one strong entity on issues of interest to the East African Community—they are in disarray over the negotiations for an economic partnership agreement with the European Union.

Also needed are stronger commitments to regional projects. Consider the breakdown in progress on the standard gauge railway and the oil pipeline between Kenya and Uganda—and Kenya recently pulling out of the East African Community's infrastructure to connect all EAC stock markets electronically. Such reversals and backtracking have to be avoided to earn the confidence of investors and country partners.



# THE MANUFACTURING SECTOR IN EAST AFRICA: A QUICK ASSESSMENT

**A** competitive manufacturing sector is important for economic transformation, but in East Africa, it plays a limited role in the region's economic transformation because the sector's contribution to GDP and employment as well as productivity are all low.

Manufacturing value added averaged only 7.5 percent of GDP for the seven countries examined in this part of the East Africa economic outlook: Burundi, Ethiopia, Kenya, Rwanda, Seychelles, Tanzania, and Uganda. Manufacturing value added per capita in these countries was lower than the African average. In general, East Africa still depends heavily on minimally processed resources and resource-based manufactures. Economic diversification toward manufactured products remains limited. While resource-based exports can contribute to high growth rates, they involve relatively low value addition and make exporting countries highly vulnerable to external price shocks.

This part of the outlook analyzes the manufacturing sector in those seven countries. Each country is unique in many respects. The differences among them range from geography and population size to economic structure, political orientation, and institutional quality and effectiveness. These differences present equally diverse opportunities and challenges.

Changes in global manufacturing will affect East Africa. The region's push to industrialize and to carve out a growing share of global manufacturing will take place in very different global macro- and microeconomic contexts than previous industrializations in other parts of the world. Two particularly important proliferating trends are global value chains and the renewed global interest in industrial policy. This part of the outlook evaluates the manufacturing sector's status and performance in East Africa in light of these trends.

## OVERVIEW

Manufacturing is a key driver of productivity growth, formal employment growth, innovation and technological advance, and export performance. Further, exporting manufacturers tend to be large and highly productive enterprises. Participation in foreign export markets stimulates "learning by exporting" and "learning to compete," driving up firm productivity.

Despite manufacturing's importance to economic growth and employment, the sector's share in overall GDP in East Africa is very small. It ranges from a low of 4 percent in Ethiopia to about 12 percent in Kenya. In contrast, agriculture accounts for about 45 percent in Ethiopia and services contribute more than 80 percent in Seychelles (table 8).

The pattern for manufacturing value added per capita has been equally mixed. Rwanda, Tanzania, and Uganda have performed relatively strongly. However, Burundi and Ethiopia

Manufacturing's low value added and small share in GDP are symptomatic of the deindustrialization of many countries

have performed poorly—as low as \$20 in value added per capita in Ethiopia. In Kenya, after strong performance up to the 2008 global financial crisis, manufacturing value added dipped and has not recovered. Similarly, Seychelles, which had the biggest manufacturing sector in relative terms in 2000, has seen manufacturing value added per capita decline by almost half since the crisis—from over \$1,500 in 2002 to an average of only \$831. The regional weighted average of about \$36 of value added per capita is a fraction of Vietnam's \$301 and very far behind that of BRICS countries, such as South Africa's \$835 and China's \$1,300.

Manufacturing's low value added and small share in GDP are symptomatic of the deindustrialization of many countries in Africa. Given the room for very strong catch-up growth in manufacturing, the inconsistent and overall weak dynamic indicates that economic conditions and policies are not conducive to rapid industrialization. Manufacturing's share in merchandise exports varies widely across the region and lags behind Cambodia, China, and South Korea (figure 7). Among East African countries, Ethiopia has the lowest share of manufactured exports—only 6.2 percent, less than a tenth of China's 87.5 percent. Recent development in Ethiopia of industrial clusters and parks (mainly receiving investments from China) are likely to raise this proportion.

In general, manufacturing in East Africa is dominated by food and beverages, but the share varies by country (table 9), as does the main input (in the Seychelles, for example, the main input is fish for processing). For the mainland economies,

cotton-based textiles and clothing, leather production, and wood-based products (including furniture, paper, and printing) also figure prominently. The region also produces more refined consumer products, including soaps, perfumes, and cosmetics. Nascent industrial developments produce advanced products for local or regional consumption. Ethiopia, Kenya, and Tanzania have small industries producing vehicles, electronic equipment (such as cell phones), and machinery and equipment. For Ethiopia (for which statistics are available), imported components constitute about 90 percent of the value of goods in these categories.

Imported inputs are also mainly used for industrial products (chemicals, rubber and plastics, and basic metal products), highlighting the absence of well-developed local basic industries. Manufacturing based on local agricultural inputs (food and beverages or pharmaceuticals and cosmetics) or on local mining products (ceramics, cement, and other nonmetallic mineral products) has a much stronger effect on competitiveness, employment and value addition.

The reliance on imported inputs is most pronounced in Seychelles, which has the narrowest resource base. Seychelles' burgeoning beverage industry, a good example of value chain participation, relies on inputs imported from geographically dispersed locations for everything from basic sugars and other ingredients to bottles, labels, and shipping cartons. Kenya's manufacturing sector also depends on imported inputs and participates in value chains. Kenya's vehicle assembly and manufacture of soap, perfumes, cosmetics, and toiletry

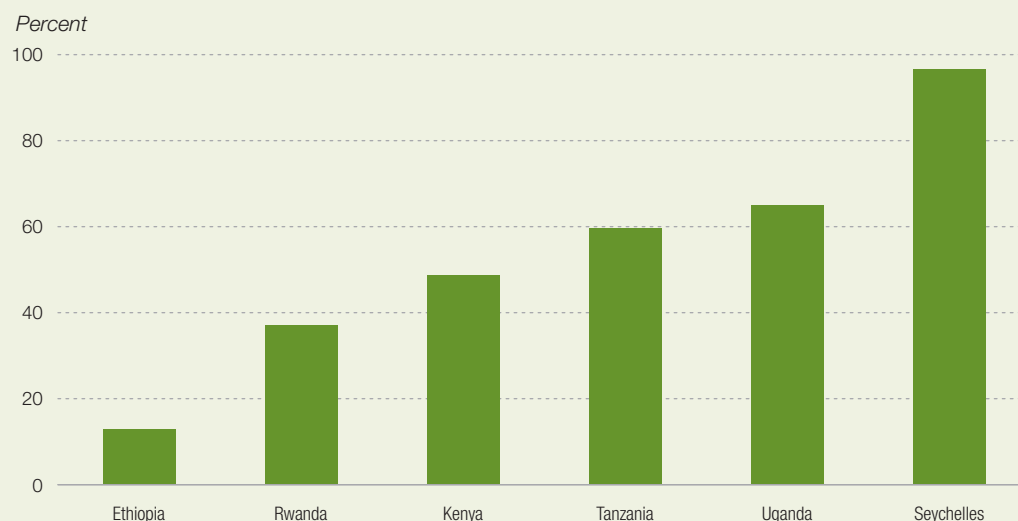
**TABLE 8** Sectoral share of GDP, 2015 (percent)

	Agriculture	Manufacturing	Other industry	Services
Burundi	42.9	10.9	5.7	40.5
Ethiopia	45.0	4.0	8.0	43.0
Kenya	30.0	11.9	8.2	49.9
Rwanda	35.1	5.5	10.2	49.2
Seychelles	2.5	10.1	6.1	81.4
Tanzania	31.5	6.1	18.9	43.5
Uganda	27.0	10.0	11.9	51.1

Source: AfDB statistics.



**FIGURE 7** Share of manufacturing exports in total exports, 2012



Source: AfDB statistics.

Imported inputs are also mainly used for industrial products, highlighting the absence of well-developed local basic industries

**TABLE 9** Composition of manufacturing by main sector, selected East African economies (percent)

Industrial group	Ethiopia (2009/10)	Kenya (2011)	Rwanda (2012)	Seychelles (2011)	Tanzania (no date)	Uganda (2011) <sup>a</sup>
Food, beverages, and tobacco	32.5	39.7	72.4	73.9	57.0	52.0
Textiles and apparel	16.6	13.6	4.9	na	5.0	5.0
Tanning and leather	5.8	1.6	na	na	na	na
Wood, furniture, paper, and printing	11.7	5.7	8.3	na	na	8.0
Vehicles and manufacturing and equipment	1.4	3.5	na	na	na	na
Other	32.0	35.9	14.4	26.1	38.0	35.0

Source: AfDB statistics.

Note: Data for Burundi are not available.

a. Shares based on employment.

products for the domestic market largely depend on imported inputs. But Kenya's pharmaceuticals industry has a strong regional supply chain and an export market share in both the East Africa Community and the Common Market for Eastern and Southern Africa (COMESA). Regional and global value chains expand the market, enhance productivity growth, and lead to knowledge spillovers.

## CONSTRAINTS TO THE COMPETITIVENESS OF EAST AFRICA'S MANUFACTURING SECTOR

East Africa's economic infrastructure is weak by global standards and even by African standards. This costs businesses. In a highly competitive

Governments in East Africa have developed many schemes and policies to promote industrialization

world, constraints to participating in the value chain undercut local firms' competitiveness in export markets.

Over the past decades, governments in East Africa have developed many schemes and policies to promote industrialization, including privatization, incentive schemes for private businesses, special programs for priority sectors, and horizontal initiatives, all aimed at creating an enabling business environment. But they face major constraints in transport and logistics, energy supply, telecommunications, and policy and institutional support.

### Transport and logistics

In surface transport, East Africa has serviceable regional trunk road networks, but conditions are mostly poor, and the combination of low speeds and long distances causes high transportation costs. A study of the two main road corridors showed that the Northern Corridor (anchored by the port of Mombasa and running north of Lake Victoria through Kampala and south through Kigali to Bujumbura) was almost entirely paved, but only 13 percent of roads were in good condition, 44 percent in fair condition, and 43 percent in bad condition.<sup>14</sup> The Central Corridor (anchored by the port of Dar es Salaam and running to the Tanzanian hinterland as well as to Burundi, Rwanda, and Uganda) was in especially poor condition. Many road projects are under way, and the situation is evolving rapidly.

Rail transport's limitations push goods transport onto roads. This compounds the problems of roads, creating congestion and raising the unit cost of transport over longer distances, particularly for landlocked countries. And the goods traffic damages roads. A rail route from Addis Ababa to Djibouti is under construction, and a standard gauge rail link is planned from Mombasa to Malaba with a branch line to Kisumu, financed by China.

Port inefficiency results in container underutilization (table 10). East African ports generally underperform global competitors across a range of indicators. Two-thirds of the containers shipped from East African ports are empty (table 11).

Mombasa and Dar es Salaam, the two main ports in the region, have very little capacity. Mombasa's performance may improve following the commissioning of a new berth facility that aims at expanding handling capacity by 200,000 TEU (twenty-foot equivalent units). Surface transport compounds port problems: transport to ports suffers from holdups at national borders and checkpoints along road networks.<sup>15</sup> Improving export capabilities could greatly reduce trade costs and increase the region's participation in global value chains.

### Energy supply

Inadequate energy supply is the biggest infrastructure problem. East Africa has the lowest

**TABLE 10** Port performance: East Africa and comparators

	Djibouti	Mombasa	Dar es Salaam	East Africa	Southern Africa	West Africa	Global best practice
Container dwell time (days)	8	5	7	5 to 28	4 to 8	11 to 30	<7
Truck processing time (hours)	12	5	5	4 to 24	2 to 12	6 to 24	1
Containers per crane per hour	17	10	20	8 to 20	8 to 22	7 to 20	20 to 30
Container handling charge (\$/TEU)	135	68	275	135 to 275	110 to 243	100 to 320	80 to 150
General cargo handling charge (\$/tonne)	8	7	14	6 to 15	11 to 15	8 to 15	7 to 9

Source: AfDB 2013.

Note: TEU is twenty-foot equivalent unit.

**TABLE 11** Container utilization, Mombasa and Dar es Salaam (shipped out containers, 1,000 TEUs)

		2003	2004	2005	2006	2007	2008	2009
Mombasa	Full	78.0	91.0	94.1	86.3	101.3	102.9	95.8
	Empty	79.0	110.0	107.5	132.2	165.5	181.0	205.6
Dar es Salaam	Full	39.2	43.9	53.3	49.1	54.3	58.7	63.7
	Empty	38.4	49.8	59.8	68.8	81.0	95.7	106.0

Source: Nathan Associates 2011.

energy generating capacity per capita on the continent, and stakeholders identify inconsistent supply as a major cost. Poor energy supply causes blackouts and demands expensive supplementary generators. For energy-intensive production, inconsistent power supply is a major competitive disadvantage. In addition, developing the power grid and ways to manage and trade new energy remain challenging. The region has untapped hydro, wind, and fossil fuel resources that could increase energy supply. New fossil fuel revenues that are expected to be realized in some countries in the region in the near future such as Kenya, Tanzania, and Uganda need proper management to avoid the macroeconomic imbalances that can arise from foreign currency inflows, as well as the damage to development that often accompanies natural resource wealth.

The problem of electricity supply is acute for small firms and households. For cooking, for

example, the vast majority of households in the region still rely on wood and charcoal, which is one of the most environmentally inefficient energy sources. The planned expansion in electrification from 35 percent to 60 percent of households in East Africa could create greatly expanded demand for durable goods, a class of manufacturing well-suited to the region.

### Telecommunications

East Africa has experienced a technological revolution, but this has not reduced costs. The region has the lowest penetration rates in Africa for fixed telephone lines, mobile phones, and especially internet services, though rates vary widely across countries (table 12).<sup>16</sup> Even in the relatively advanced Seychelles, internet penetration is half the rate in advanced countries. However, the situation has improved markedly. Tanzania's economic reforms have remarkably improved telephone service quantity and

**TABLE 12** Internet and cell phone users and penetration rates, East Africa, 2012

	Internet users	% penetration	Rank	Cell phone users	% penetration
Seychelles	42,380	47.1	92	138,272	153.6
Kenya	13,805,311	32.1	129	30,731,754	71.5
Uganda	4,941,704	14.7	156	16,356,387	48.6
Tanzania	6,136,331	13.1	161	27,219,283	58.0
Rwanda	937,964	8.0	177	5,690,751	48.7
Ethiopia	1,352,259	1.5	204	20,523,889	22.5
Burundi	128,799	1.2	208	2,247,126	21.3

Source: International Telecommunications Union: percentage of persons using the internet.

quality, although access to the internet remains a challenge.

The Ethiopian Commodity Exchange, the first such initiative in Africa, empowered 2.4 million mobile phone users in its first four years. The exchange now fields 1.2 million calls per month for price information.

### Policy and institutional support

Although soft infrastructure—the regulatory and business environment—has made progress in some East African countries, it continues to constrain manufacturing. In the World Bank’s *Doing Business 2018* survey, only Kenya, Rwanda and Seychelles rank higher than 100 of 185 countries in the overall ranking as well as across a number of indices except obtaining a construction permits (table 13). Rwanda ranks second in ease of registering property, and its overall ranking is 41. Kenya has also made some progress, notably in ease of obtaining credit, investor protection, and getting electricity. Kenya’s overall ranking is 80.

East African manufacturing’s failure to take off does not necessarily impugn any single policy. Rather, combined policies and institutional mechanisms have failed. Identifying these constraints on industrialization is inevitably a country-by-country, sector-by-sector exercise.

## COMPETITIVENESS AND COMPARATIVE ADVANTAGE IN EAST AFRICA

East African countries have made strides toward economic competitiveness, underscoring the benefits that could accrue if progressive reforms eased the constraints to doing business. The progress also shows the countries’ ability to undertake complex and bold reforms to accelerate industrialization.

East Africa—with the exception of the Seychelles, which is a special case—has a revealed comparative disadvantage in manufacturing sector activities overall (figure 8), although most countries have particular subsectors in which they do have some degree of comparative advantage—for example, Kenya in food and beverages, leather products, textiles, and clothing. Rwanda’s comparative advantage is in processed tea, Tanzania’s in textiles, and Uganda’s in cement, clay, and ceramics. Seychelles’ main source of comparative advantage in manufacturing is processed fish products.

The Competitive Industrial Performance (CIP) index produced by the United Nations Industrial Development Organization offers an alternative assessment of East African countries’ potential

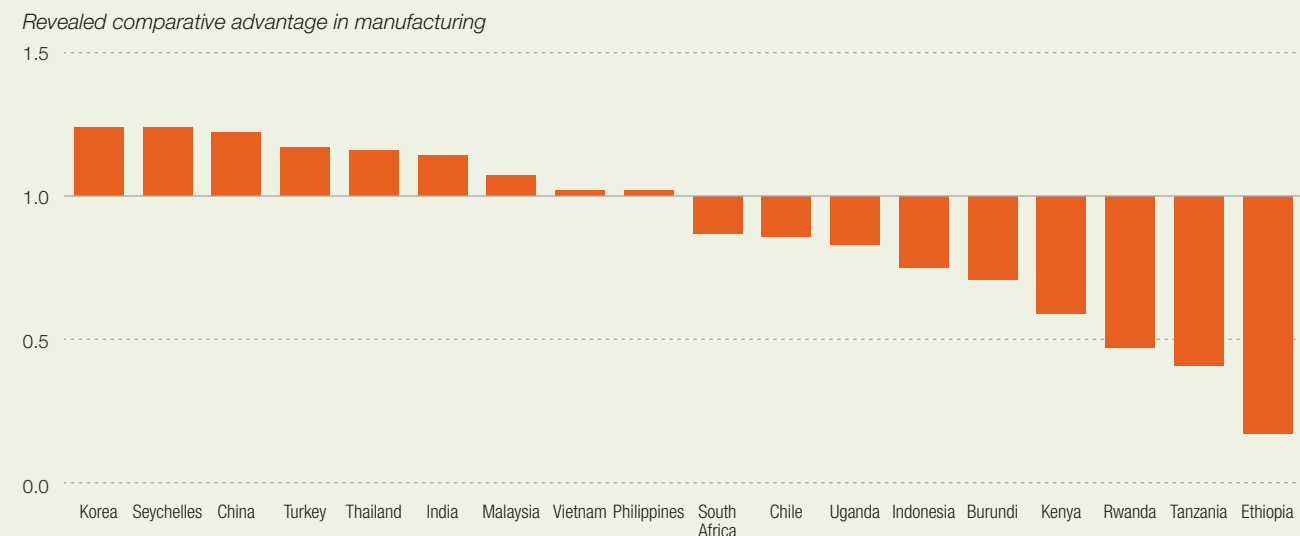
Tanzania’s economic reforms have remarkably improved telephone service quantity and quality

**TABLE 13** Legal and regulatory environment in East Africa, 2016 (ranking among 185 economies)

	Burundi	Ethiopia	Kenya	Rwanda	Seychelles	Tanzania	Uganda	Average	Rwanda and Seychelles average	Other five average
Doing Business rank	164	161	80	41	95	137	122	114	68	136
Protecting investors	132	176	62	16	108	129	108	104	62	131
Getting credit	177	173	29	6	133	55	55	90	70	119
Enforcing contracts	150	68	90	85	130	58	64	92	108	94
Paying taxes	138	133	92	31	29	154	84	94	30	108
Construction permits	168	169	124	112	131	156	148	144	122	154
Starting a business	42	174	117	78	141	162	165	126	110	137
Registering property	95	139	125	2	62	142	124	98	32	112
Resolving insolvency	144	122	95	78	67	108	113	104	73	111
Getting electricity	182	125	71	119	134	82	173	127	127	139
Trading across borders	164	167	106	87	88	182	127	132	88	146

Source: World Bank, *Doing Business 2017*.

**FIGURE 8 Comparative advantage in manufacturing—East African and comparator countries**



Source: AfDB statistics.

for growing their manufacturing. The CIP index assesses an economy’s ability to produce and export manufactured goods competitively and distinguishes between medium- and high-technology products. On the CIP index for 2015, Kenya ranked 102nd and Tanzania 106th out of 135 countries, trailed by Uganda (120th), Rwanda (129th), Ethiopia

(130th), and Burundi (132nd) (table 14). Progress has been slow. For example, Vietnam improved its CIP index score between 2009 and 2010 by 0.003; East Africa took 10 years to improve its score by the same amount.

Seven manufacturing subsectors are more or less common across East Africa (table 15). They

**TABLE 14 Competitive industrial performance index, East African region and comparator economies, 2008–15**

	2008	2009	2010	2011	2012	2013	2014	2015
Burundi	0.001	0.001	0.001	0.001	0.001	0.001	0.001	0.001
Ethiopia	0.002	0.002	0.002	0.000	0.000	0.000	0.000	0.000
Kenya	0.009	0.011	0.010	0.012	0.011	0.011	0.011	0.011
Rwanda	0.002	0.003	0.002	0.003	0.003	0.003	0.003	0.002
Seychelles	na	na	na	na	na	na	na	na
Tanzania	0.007	0.008	0.009	0.007	0.007	0.006	0.007	0.008
Uganda	0.004	0.004	0.004	0.007	0.007	0.005	0.005	0.005
Average East Africa	0.004	0.005	0.005	0.005	0.004	0.005	0.005	0.005
Korea	0.373	0.399	0.404		0.393	0.388	0.388	0.393
China	0.291	0.318	0.329	0.358	0.371	0.376	0.385	0.401
South Africa	0.080	0.077	0.077	0.084	0.082	0.078	0.077	0.072
Vietnam	0.045	0.051	0.054	0.055	0.061	0.066	0.072	0.080

Source: AfDB computations from United Nations Industrial Development Organization statistics.



Focused and determined policy interventions can win a considerable share of global manufacturing for East Africa

**TABLE 15 Key manufacturing subsectors**

Sector	Category
Agro-processing	Regional processing
Textiles and clothing	Labor-intensive tradable goods
Leather and leather products	Labor-intensive tradable goods
Wood products	Resource-based commodities
Niche pharmaceuticals	Local processing of unique local resources for global markets
Industrial materials	Resource-based commodities
Assembly of advanced products	Global innovation for local markets

Source: AfDB statistics.

have foundations in local demand or in local resource inputs. In general, Africa has a competitive advantage in many of these subsectors already.<sup>17</sup>

**Agro-processing:** Agro-processing is essential in expanding manufacturing capability given raw material availability and semiskilled labor requirements. It has scope for increased value addition in higher-quality food preparation and branding.

**Textiles and clothing:** This was a “starter” sector for industrializing in East Asia. As East Asia sheds some of this activity and moves up the value chain, it can serve the same role in East Africa. The sector is labor-intensive and so can provide strong job creation; moreover, it has scope for innovation in both fashion and industrial textiles.

**Leather and leather products:** The mainland economies (for example, Ethiopia) have the requirements for a thriving leather goods industry. The livestock sector’s rapid expansion provides a large supply of hides and skins highly regarded for their quality.

**Wood products:** East Africa has adequate resources for a vigorous furniture and building products industry targeted mainly at the regional market due to the high transportation costs of

wood products. A high proportion of the region’s wood products are currently imported.

**Niche pharmaceuticals:** Africa has the highest disease burden in the developing world but by far the lowest availability of medicines. And the continent has a rich biological basis, while over 80 percent of its territory has not received standard scientific evaluation.<sup>18</sup> Given that 67 percent of new medicines introduced worldwide from 1981 to 2002 came from natural sources, East Africa has resources, largely unexplored, both to develop manufacturing and to generate major positive externalities for the region’s health care systems. The region has started to exercise this potential.

**Industrial materials:** The construction sector has been growing rapidly due to infrastructure development and rapid urbanization. Construction needs ceramics (bricks, tiles, and blocks), cement, structural steel products, basic hardware (wire, nails, and so on), and various chemical-based industrial products. Except for cement and clay products, East Africa largely relies on imported industrial inputs that are expensive due to transportation costs. With expanded mining, the region’s mineral wealth is being brought to light, but its capabilities for manufacturing industrial materials are weak.

**Assembly of advanced products for regional markets:** One cause of Africa’s new attractiveness to multinational firms is the emergence of a middle-class consumer base. The demand for high-end consumer goods enables plants to locate within the region to serve the regional market. This activity is in its early days, but both automobile and cell phone assembly based on imported parts have been established. The scope for building supply chain linkages is thus emerging.

## CONCLUSIONS AND POLICY RECOMMENDATIONS

Manufacturing’s contribution to GDP and employment is small in East Africa, diversification is limited, and technological development is low. Much activity still consists of minimal processing

of agricultural and mineral resources. However, countries in the region have a competitive advantage in several manufacturing subsectors, which if nurtured can accelerate industrialization. To capitalize on this potential, the seven countries studied here need to address multiple legal and regulatory constraints and infrastructure and logistics weaknesses.<sup>19</sup>

Focused and determined policy interventions can win a considerable share of global manufacturing for East Africa. The results would boost the region's development. However, policies have to take into account each country's unique resource endowment, economic sophistication, and state capacity to undertake bold reforms.

Countries should prioritize loosening immediate constraints on the development of manufacturing. Although individual country-specific characteristics will determine relevant policies, some fundamentals are common throughout East Africa. The three main horizontal agendas—macroeconomic framework, economic infrastructure, and business operating conditions—should include three specific areas of horizontal reform that bear the greatest promise—trade logistics, finance infrastructure, and special economic zones and industry–university clusters.

***The macroeconomic framework should support manufacturing.*** As a primary pillar of manufacturing policy in East Africa, maintaining a competitive exchange rate and positive real interest rates can induce the saving required to finance growth. East African countries should lean hard against the tendency for letting the resource sector crowd out manufacturing.

Given the East African Community's plans to move toward currency union, aligning exchange rates within the region with costs and guiding the regional exchange rate toward a competitive level for the entire region should be a first priority.

***The economic infrastructure should foster a competitive business environment for manufacturing.*** To establish scalable formal enterprises, East African countries should prioritize reforms that remove barriers to formal startups. Following success in relaxing constraints in the cut flower sector, East African countries should

systematically troubleshoot inhibiting factors in other priority sectors.

Technological advances can be gained through leveraging FDI. Imitating China's approach to capitalizing on FDI inflows, which translated FDI into domestic technological advance more successfully than, for example, Southeast Asia's approach, would seem appropriate.

***Business operations require sustained investment in physical infrastructure.***

Specifically:

- World-class telecommunications facilities should be installed in the main industrial centers as a leading priority.
- A regional energy trade agreement should minimize inefficiencies in the existing electricity grid.
- The Addis Ababa–Djibouti Corridor improvement and the Kenya–China deal to construct a modern standard gauge rail link in the Northern Corridor to Uganda should be complemented by a heavy-duty rail link in the Central Corridor. The still more ambitious plans for an East Africa rail network should move forward.

***Trade logistics need improvement.*** Regional transit agreements and modern risk-based customs procedures are needed to eliminate delays and logistics chain costs.

***The finance infrastructure for the manufacturing sector needs improvement.*** East Africa should troubleshoot financial factors that inhibit capital supply for operations and expansion. Problems will tend to be country-specific. Converting informal companies into scalable formal ones can advance through reforming policy, mobilizing saving from the poor, increasing the role of development finance institutions, and making informal “un-bankable” companies bankable through more flexible collateralization. Credit mechanisms based on varied types of collateral and an effective export credit financing system need development.

***Special economic zones and industrial clusters can promote innovative industry.*** Fully removing the region's development constraints will take a decade or more. But oases of suitable conditions

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East Africa should troubleshoot financial factors that inhibit capital for operations and expansion

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Public support for industry should focus on “in-kind” support rather than financial incentives

can be established by creating industrial parks as special economic zones with appropriate services, streamlined rules, and experimentation to discover what actually works in East Africa. Ethiopia’s industrial parks provide valuable lessons. Such zones can designate resident firms as authorized economic operators. This would give them special customs status with streamlined procedures for both imports and exports.

Attracting multinational firms to these parks and clustering university-linked research institutes (supported by public funding), branches of engineering schools, and vocational training facilities around them would stimulate the region’s knowledge base by encouraging knowledge spillovers and technology adoption. Proximity of learning institutions to industrial activity would shape educational curricula to industrial requirements.

Public support for industry should focus on “in-kind” support rather than financial incentives, which have generally failed to achieve objectives, created tax leakage, led to corruption, and generated the large deadweight administrative cost of monitoring private corporations’ use of public funds. An example of in-kind support would be research by publicly funded institutes addressing specific problems encountered by firms.

*For specific manufacturing subsectors, a pragmatic approach is needed to eliminate binding constraints along the production chain.* A small troubleshooting office with a multidisciplinary staff could work on the problems of specific sectors, starting with general roadmaps such as those this outlook presents. The proposed office would engineer processes to resolve problems and pilot solutions.

*Manufacturing policies should mix private sector and state involvement.* Successful manufacturing development mixes private sector and state involvement. The division of labor, based

on the characteristics of goods and activities, is complementary, with the state providing public goods, promoting activities with positive externalities, and making investments too risky for private capital. The government should promote “orderly” competition—consolidation but not monopoly.

*Manufacturing should receive public procurement support.* To promote specific activities, governments should serve as a “launch customer,” using procurement to provide assured demand to competing private sector suppliers. Governments should also enter niches the private sector is not serving through state-owned corporations. These steps avoid subsidizing firms while stimulating competitive private sector activity.

*Acquiring and relocating firms can boost manufacturing.* Acquiring selected manufacturing firms and relocating them in industrial parks would introduce advanced techniques, machinery, and to some extent connections with suppliers and customers. The process could include assigning a mentoring role to the firms’ managerial and senior technical staff and creating partnerships with local firms in the same industry. Firms suitable for acquisition would:

- Have failed largely for macroeconomic reasons such as labor costs or currency overvaluation.
- Embody relatively high technology, possibly proprietary technology.
- Operate in sectors with backward and forward linkages to East African supply chains.
- Manufacture goods in growing demand in East Africa, so the firm can profit from its geographic transplant.

Such an approach could generate quantum leaps in technological capability—including in basic industries such as dairy and other agricultural processing where East African technology lags behind well-established global standards.

## NOTES


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6. Kireyev 2017.
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11. McKay 2004, 2013; Shimeles 2014.

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The *East Africa Economic Outlook* reviews economic performance in 2017 and forecasts the next two years by highlighting the region's key drivers of growth, opportunities, and challenges. It covers major macroeconomic developments in the region's 13 countries and discusses structural issues affecting future growth, poverty, and inequality. It also presents in part II a synopsis of manufacturing activity in the region, drawing on a previous study of seven of the region's countries. The outlook selects manufacturing as the sector to cover due to its potential to drive future growth and employment in the subregion.

Economic growth in East Africa was a robust 5.9 percent in 2017 and is forecast to persist in 2018 and 2019. It would have been even higher, had it not been for political instability in the region's fragile states.

The service sector is generally the main driver of East Africa's growth as agriculture, which has for a longtime played a leading role, is receding. Services grew 12.4 percent in 2017, compared with 12.0 percent for industry and 7.1 percent for agriculture. The mineral and industrial sectors' role in driving growth is also increasing. On the demand side, household consumption is the main driver of growth, followed by public investment in infrastructure, mineral exploration, and construction.