Sustaining Kenya’s Economic Development by Deepening and Expanding Economic Integration in the Region

Popular Version

KENYA ECONOMIC REPORT 2017

To create a globally competitive and prosperous nation with a high quality of life by 2030
Sustaining Kenya’s Economic Development by Deepening and Expanding Economic Integration in the Region
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Background

The theme of the Kenya Economic Report (KER) 2017 is “Sustaining Kenya’s economic development through deepening and expanding economic integration in the region”. Regional economic integration is an essential ingredient of economic development strategy for Africa because it helps the countries achieve economies of scale and enhance competitiveness, which are necessary for structural transformation. In Africa, regional economic integration also enables countries to enhance domestic and foreign investments as well as promote peace and security.

EAC: Burundi; Kenya; Rwanda; South Sudan; Tanzania; Uganda

COMESA: Burundi; Comoros; Democratic Republic of Congo; Djibouti; Egypt; Eritrea; Ethiopia; Kenya; Libya; Madagascar; Malawi; Mauritius; Rwanda; Seychelles; South Sudan; Sudan; Swaziland; Uganda; Zambia; Zimbabwe

SADC: Angola; Botswana; DR Congo; Lesotho; Madagascar; Malawi; Mauritius; Mozambique; Namibia; Swaziland; Tanzania; Zambia; Zimbabwe; South Africa; Seychelles

*Tanzania is the only EAC country which is not in COMESA, but is in SADC
The Kenya Economic Report 2017 focuses on how to exploit available opportunities in economic integration to strengthen macroeconomic performance and secure a strong sustainable and inclusive growth. Regional economic integration is multifaceted, encompassing trade, money and finance, infrastructure development, management and exploitation of natural resources, increasing productivity, development of human resources and ensuring labour mobility across borders as well as maintenance of peace and security, among other things. Furthermore, economic integration initiatives provide an opportunity for Kenya to expand private investments in support of value addition and diversification of exports, thus placing the economy on a stable and sustainable growth path.

Towards Becoming an Upper Middle Income Country

Kenya aspires to transform from a lower middle income country to an upper middle income country by the year 2030. This aspiration is valid and attainable because most of the economic fundamentals are largely in place to enable the country take off. The country’s economy has remained resilient over time, with...
economic growth rate increasing from 5.7 per cent in 2015 to 5.8 per cent in 2016 largely due to a stable macroeconomic environment. The major sources of Gross Domestic Product (GDP) growth in 2016 were agriculture, forestry and fishing (15.2%), manufacturing (6.3%), transport and storage (9.7%), information and communication (6.1%), construction (8.2%), real estate (12.3%) and financial services (7.3%).

Despite this, the difference between Kenya’s total value of exports and total value of imports has been negative for some time and this is constraining growth of aggregate demand (the total demand for goods and services). Further, due to the recent increase in government investments in infrastructure, Kenya’s public debt has increased to 52 percent of GDP, surpassing the East African Community (EAC) convergence criteria of 50 per cent of GDP. However, government borrowing plans remain anchored in the medium term debt management strategy which aims to ensure public debt sustainability.

The gap between savings and investment (deficit between current aggregate savings and the level of savings required to provide funds for business investment) has remained high over time. This means that there is need to boost the mobilization of domestic resources to enable access
to adequate and appropriate financing of the required investment. Interest rates in Kenya are stabilizing following the capping of interest rates in 2016 and continued tight monetary policy stance adopted to maintain stability. However, the capping of interest rate has partly resulted into decline in credit to the private sector as banks tighten lending requirements.

To attain the upper middle income category and sustain growth that creates employment opportunities, reduces poverty, and provides access to essential services by the poor, the economy needs to grow at an annual rate of 10 per cent. This requires accelerated growth in private investments to reach investment/GDP ratio of 30 per cent and over 9.0 per cent growth in exports.

Allowing for exogenous shocks, including persistent drought, possible negative impacts of the August 2017 General Elections and volatility of global commodity prices, a more conservative economic growth of 6.1 per cent is projected for 2017. There is also need to remain vigilant on the possible loss of duty-free EU market; reduced trade with Britain following Brexit; and isolation from global markets with the emerging mega-regional trade agreements. Should these risks materialize, growth will stagnate and Vision 2030 targets will not be met.

Boosting Domestic and Foreign Trade

Domestic trade in Kenya largely comprises wholesale and retail trade which accounted for 7.3 per cent of GDP in 2016. The sector growth declined to 3.8 per cent in 2016 from 5.9 per cent in 2015. This is partly attributed to increased competition in the sector, and the effects of e-commerce and online shopping.

Micro, Small and Medium Enterprises (MSMEs) dominate the domestic trade sector and also play a critical role in cross border trade. While the government has initiated various reforms to enhance information sharing, reduce operational costs,
promote integration among producers and entrepreneurs, and improve product competitiveness, the domestic trade licensing regime is still characterized by multiple charges at the national and county government levels, which are leading to high cost of doing business. MSMEs also face the challenge of inadequate business premises and lack of basic facilities to handle perishable agricultural products for wholesale traders. Besides, informal sector traders are yet to fully benefit from the EAC and COMESA simplified trade regimes which aim at simplifying cross border trade.

"Kenya’s trade surplus in the EAC has been gradually declining since 2011 due to strengthening of the manufacturing sector in partner states and increased competition from imports from India and China into the region."

![Exports and Imports Map]
The enactment of the Special Economic Zone Act 2015 has facilitated establishment of Special Economic Zones with the purpose of reducing the operational cost for potential investors in production of goods and services. In addition, Huduma Centres have been established in various counties, as well as the National Electronic Single Window System to enhance efficiency in registration and simplify e-commerce transactions. While significant progress has been made to improve the business environment for domestic trade, a lot more is required to address fragmentation in the supply chain and to further reduce the cost of doing business.

At regional level, Kenya has remained an active player in regional and international trade matters. The country is a founder member of the EAC, COMESA, Inter-governmental Authority for Development (IGAD), African Union (AU), the African, Caribbean and Pacific (ACP) group of states and the World Trade Organization (WTO).

Kenya’s total trade is about 40 per cent of GDP but the global share is very small. The bulk of exports are raw materials and primary products while imports are high value capital and finished products and this sustains the persistent trade deficit. The EAC is a major export destination for Kenya and accounted for 21.0 per cent
of total exports in 2016, while those to COMESA accounted for 14.4 percent and the rest of Africa 5.3 percent. This small share of exports exemplifies the potential for increasing Kenya’s export market to the African markets. Kenya’s trade surplus in the EAC has been gradually declining since 2011 due to strengthening of the manufacturing sector in partner states and increased competition from imports from India and China into the region.

Despite the opportunities arising from tariff preferences provided under the various regional integration initiatives, Kenya is yet to fully exploit the regional markets. Increased regional market access by Kenya is partly hampered by persistent non-tariff barriers (NTBs) within EAC and COMESA. Eliminating such barriers and sensitizing on the EAC rules of origin to enhance cross border trade is therefore a priority.

Further, the initiative to establish the African Continental Free Trade Area (ACFTA) provides an opportunity for Kenya to penetrate markets outside the EAC and COMESA regions. However, Kenya has to strategically position herself by improving the business environment, promoting value addition and diversifying production.
Promoting Tourism

Tourism continues to play a key role in the economy but its full potential is yet to be exploited. There are significant gaps between arrivals and receipts that seem to reflect on the packaging of tourism products. The sector shows signs of recovery with the reduced issuance of travel advisories. However, downside risks at global and regional level still persist. The ranking of JKIA as a Category One airport provides an opportunity that needs to be fully exploited.

The tourism sector contributes about 10 per cent to GDP and 9 per cent of total formal wage employment. The sector’s performance is below the MTP II annual targets but on a recovery path. The slow growth of the sector is mainly due to terrorism-related insecurity that has led to travel advisories issued by major tourist source markets in North America and Europe. Furthermore, the sector has been susceptible to market price fluctuations, increasing competition in the region, political instability and the recent global recession.

TICAD VI Summit, 27-28 August 2016, Nairobi
Although Kenya receives a high volume of tourists compared to other EAC countries, the revenues received are comparatively low. To address the mismatch between arrivals and revenues there is need to re-look at the packaging of tourism products with a view to exploring the untapped product diversity. In addition, there is need to provide investment incentives for expansion of accommodation facilities and Meetings, Incentive travel, Conventions and Exhibitions (M.I.C.E.) sub-sector infrastructure.

Kenya has put in place initiatives to boost tourism marketing but it is lagging behind in implementing flagship projects targeted to boost tourism. Maximizing on the complementarities of the two aspects will support a strong recovery in the tourism sector.

The EAC seeks to market the region as a single tourism destination. So far, Kenya, Rwanda and Uganda have adopted the EAC common visa to avoid multiple applications and issuance of Visas to visitors. The three countries have also launched a portal to jointly market their tourism products online. The proposed Open Sky policy is expected to boost tourism in the region. Further diversification of tourism products and joint efforts in tourism promotion are needed to sustain development of the sector in Kenya.
Attaining Food Security through Enhanced Regional Trade

Kenya’s food security is dependent on imports. While self-sufficiency has improved, post-harvest losses, low agricultural productivity and frequent weather shocks remain constraints to achieving food security. Cross-border trading provides an opportunity to enhance food security in the region. While the Common External Tariff (CET) accord food products protection, and the simplified rules of origin have been adopted to facilitate cross-border trading in agricultural products, non-tariff barriers such as arbitrary bans, and poor infrastructure, continue to hamper agriculture trade in the region.

Kenya’s agriculture sector is dominated by smallholder farmers in rural areas, making it an important sector in food security and poverty reduction. In 2016, the sector’s share of GDP increased to 32.6 per cent from 30.4 per cent in 2015. In addition, the sector indirectly contributes about 27.0 per cent to GDP through linkages with manufacturing, distribution and other service-related sectors.

The country has been experiencing food deficit in all food categories except for starch roots. Generally, the deficit is attributed to low production and post-harvest losses. Post-harvest losses which account for about 15 per cent of food production are particularly in cereals and pulses. These losses occur mainly due to poor storage, and translate into loss of income to smallholder farmers and higher prices for consumers.

Over-reliance on rain-fed agriculture has increased the vulnerability of agriculture to weather shocks, with extreme events such as drought becoming more frequent. This has greatly constrained the sector performance by disrupting production of food crops and livestock both in Kenya as well as in the EAC region.
The government has taken a number of measures to boost the country’s food security. The MTP II aimed to reduce agriculture dependence on rainfall by increasing irrigated land by 404,800 hectares. By 2016, 26,101 hectares had been irrigated, 2,500 hectares of which were in Galana Kulalu project where maize was planted. The first production from the project was, however, below expectation. Achieving the irrigation target was constrained by funding levels.

The EAC integration aims at achieving food security among other goals. This can be achieved through facilitation of cross border trade in agricultural products and removal of non-tariff barriers that hamper agriculture trade in the region. Moreover, the potential for food security can be exploited by diversifying food products, increasing productivity in agriculture, minimizing post-harvest losses and investing in value addition.
Deepening Industrialization through Integration

Industrial development is crucial in achieving structural transformation. However, growth in manufacturing sector is slowing while the extractive sector is yet to be fully exploited. Kenya’s share of manufactured exports to the region has narrowed with the strengthening of manufacturing sector in partner states. In addition, counterfeit products threaten growth of the manufacturing sector. The structure of Kenya’s manufacturing sector comprises mainly of micro, small, medium and large firms. The share of medium and large firms is less than 5 per cent but their contribution to sector’s GDP is above 60 per cent. About 95 per cent of manufacturing firms are micro and small, contributing only about 20 per cent of the sector’s GDP.

There have been mixed results in industrial investments in Kenya in the recent past, with new companies entering the Kenyan market and others relocating to other regional markets. This is mainly due to the competitive environment created domestically and complemented by regional integration initiatives to make EAC a common investment area; as well as investment promotion, and liberalization.

The agro-processing, textiles, leather and construction materials sub-sectors have been earmarked as priority sectors in Kenya’s industrial transformation programme. These sub-sectors are generally labour-intensive and have potential for value addition to spur growth. However, the manufacturing sector is largely dominated by Micro and Small Enterprises (MSEs) that are characterized by low quality jobs, coupled with under-employment that increases vulnerability to poverty. Competitiveness is further hampered by relatively high cost of production, including power outages and high electricity tariffs compared to regional markets.

The EAC market is an important destination for Kenya’s manufactured exports although they comprise only 6 per cent of total manufactured goods. Increased competition from cheap imports into the local and EAC markets, especially from China and India, and the strengthening of the manufacturing sector in the EAC countries pose a major threat to
Kenya’s share of manufactured exports to the region has narrowed with the strengthening of manufacturing sector in partner states. In addition, counterfeit products threaten growth of the manufacturing sector.

growth of Kenya’s manufacturing sector. In addition are challenges of increased incidences of illicit trade, including counterfeits and dumping. Kenya needs to diversify to medium and high technology products to secure and expand its market share.

In addition, Kenya has to focus on reducing the cost of doing business to secure and attract Foreign Direct Investments (FDIs). For example, reduction of energy cost and supply of stable and quality power are important in enhancing efficiency and productivity in the industrial sector.

“A textile factory in the Special Economic Zone in Kenya”
Infrastructure Development and Regional Economic Integration

Infrastructure development has significant multiplier effects through linkages with other sectors of the economy. Significant efforts have been made in development of Kenya’s infrastructure–transport, energy and information technology–with a view to enhancing efficiency in production, trade and investments. In 2016, the transport, energy and communications sectors contributed 8.4 per cent, 9.1 per cent and 9.7 per cent to GDP, respectively. So far electricity installed capacity has expanded, access to electricity increased, and electricity tariffs reduced. Despite the significant reduction in electricity tariffs, they remain relatively high at regional level and this could undermine the country’s industrial competitiveness.

In the transport sector, there is increased kilometres of paved roads, air passenger traffic, and improved port performance in cargo tonnage and reduced dwell time. Similarly, the Information and Communication Technology (ICT) sector shows growth in cellular mobile services, data and internet usage as well as acquisition of television and radio frequencies and transceivers. However, to be a regional hub, Kenya needs to market a package of infrastructure services.

Regional infrastructure development has been critical in facilitating regional trade. In this respect, Kenya hosts the Northern Corridor Infrastructure Project (NCIP), which

![Expansion of Jomo Kenyatta International Airport, Nairobi](image_url)
constitutes a multimodal transport corridor consisting of surface transport modes that include the Port of Mombasa, road, rail, inland waterways and oil pipeline networks. A modernization programme has improved productivity and efficiency of the Port of Mombasa. For instance, container traffic has increased from 903,463 twenty-foot-equivalent-unit (TEU) in 2012 to 1,091,371 TEU in 2016 over the same period, while dwell time has reduced from 10 to 4 days.

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Kenya is well positioned to become the hub of technology services in the region, given its deep telecom penetration, strong private sector, skilled workforce and critical mass of technology companies. ICT-intensive service sectors such as telecommunications, finance, transport, tourism and business services have prospered over the past decade. Overall, the growth and expansion in modern services has lowered transaction costs and created spillover of knowledge to other sectors, while stimulating demand for traditional services such as trade and distribution.
Enhancing Labour Mobility through Economic Integration

Like other partner states in the EAC, Kenya has a youthful population that requires to be engaged productively to reap the dividends. To improve labour mobility, the EAC Common Market Protocol has provisions that allow for free movement of labour. Kenya has signed Mutual Recognition Agreements (MRAs) with partner states in various categories of professionals. However, none of the partner states have aligned their laws to the provisions of the MRAs so far, and the existence of shortages and mismatches in professional skills in the region has limited the mobility of such skills.

Kenya’s population is estimated at 45.4 million in 2016 with a growth rate of 2.9 per annum. The population is projected to increase to 59.0 million in 2030 and 75.0 million in 2050. The population-age structure is youthful, with the population of children below age of 15 years constituting 43 per cent of the total population. The employment to population ratio increased from 0.28 in 2009 to 0.32 in 2014, implying that growth in employment increased faster than growth in population. The per capita income was US$ 1,361 in 2015 and is projected to grow to US$ 2,139 in 2020.

Total employment increased by 5.9 per cent annually between 2013 and 2015 while growth in 2016 was 5.5 per cent. This increase was largely driven by the rise in informal component which grew by 6.0 per cent while wage employment grew by 4.5 per cent from a lower base. Informal sector employment accounted for 85 per cent of all new employment and created
747,300 new jobs in 2016 compared to 716,400 new jobs in 2015. Although Kenya’s economic growth is relatively strong and above the Sub-Saharan Africa (SSA) average, growth in wage employment in the modern sector has been slow over the last three years.

At regional level, the EAC (excluding South Sudan) has a population of 145.5 million with an average annual growth rate of 2.7 per cent. The labour force in the EAC is projected to more than double from 77 million in 2010 to 169 million by 2050. However, the challenge that the region faces is how to match the growth of economically active population with creation of quality jobs. The East African region can enhance the demographic dividends of a youthful population by providing opportunities for the youth to engage in productive economic activity. Whereas the EAC Common Market Protocol (CMP) promotes free movement of labour, it only permits free movement of highly skilled workers yet the informal sector is the main employer in the region. There are disparities on availability of professional skills and Kenya needs to take advantage of the CMP provisions to promote exports of her significant number of professionals. In addition, a labour portal to facilitate information sharing will enhance labour mobility in the region.

Notwithstanding the huge youth population and relatively high levels of unemployment, the EAC region has shortages of professionals and mismatch of skills. As a result, many professionals are left without jobs. Kenya, however, has a relatively developed market for accounting services compared to the other EAC partner states, which exemplifies the potential to export professional skills to the region.
The EAC has adopted measures to facilitate free movement of persons through the use of EAC passports, national identity cards, and establishment of EAC citizens’ desk at points of entry. However, movement of workers and service providers face restrictions such as work permits and the six (6) months maximum length of stay requirement as contained in national migration laws and regulations. In addition, the CMP does not make a distinction between entry, stay, and exit of service suppliers and workers in another EAC partner state, which somehow restricts the movement of service suppliers. EAC partner states through the EAC Common Market Protocol have in principle agreed that free movement of service suppliers should be seen as separate from free movement of workers.

Governance, Peace and Security

Kenya continues to play a critical role in the regional efforts to enhance peace and security. Maintenance of peace and security are important for safeguarding development gains. However, there are challenges that could threaten deepening regional integration, including border disputes, influx of refugees, and terrorism. Establishment of strong governance structures to facilitate peaceful settlement of disputes, as well as harmonized laws among partner states, are necessary to enhance peace and security in the region.

Kenya’s participation in peace and security missions have been in Somalia and Democratic Republic of Congo; the Sudanese Comprehensive Peace Agreement (CPA); the Great Lakes region; and the IGAD initiatives, among others.

The EAC provides mechanisms for promoting good governance, democracy and political stability. This has worked well to enhance mutual trust, political goodwill, peaceful coexistence and good neighbourliness. It provides a platform for coordination of defence, peace and security matters. These include sharing criminal intelligence, surveillance to combat cross-border crime and holding of joint patrols. However, the existing institutions, including the EAC Secretariat, the East Africa Court of Justice and the East African Legislative Assembly (EALA) need to be empowered to deal with non-conformity to the EAC Treaty provisions by partner states.

The EAC region also faces several challenges that could threaten the integration process. These include cross border cattle rustling, border disputes, influx of
refugees, and terrorism. Lack of a strong institutional structure to facilitate peaceful settlement of disputes and harmonization of laws among partner states could undermine peace and security in the region.

Dynamics of other Partnerships and Emerging Global Issues

Recent developments in the global economy are creating new rules and orders. The emerging issues are likely to affect foreign trade, investments, engagements, and relationships.

Kenya risks losing duty-free quota-free market access to the EU market due to delays in signing and ratifying the EU-EAC EPA agreement by all EAC partner states. Further, the unfolding dynamics of Brexit are a source of concern given that Britain is a key trading partner for Kenya. The region also stands to be isolated from international trade systems by the mega regional trade agreements that have the potential to reshape the global trade landscape.

The mega regional trade agreements (RTAs), i.e. Trans-Pacific Partnership (TPP) and the Trans-Atlantic Trade and Investment Partnership (TTIP), are likely to re-shape the multilateral trading system to the disadvantage of Africa countries who are not members. In addition, they are likely to increase global protection of markets and this could undermine Africa's participation in global markets. It is envisaged that negotiations of the Tripartite Free Trade Area (Tripartite FTA) as well as the Continental Free Trade Area (CFTA) would not only help harmonize trade policies among member states in various regional economic blocs but also establish industrial linkages. The CFTA opens the way to develop integrated regional value chains in agriculture, manufacturing and services.
Sustaining Kenya’s Economic Development by Deepening and Expanding Economic Integration in the Region

Recommendations

For Kenya to enhance growth and development through deepening of economic regional integration, the following policy recommendations are proposed:

1. Increase productivity of the economy by promoting agro-processing and developing value chains even at regional level, and exploit extractive resources to diversify sources of growth. Boosting private investment is also a priority.

2. Expand export market through diversification of export products and destinations. This will in turn boost the development of industries in the priority sectors in the country.

3. Expand business development programmes to strengthen and integrate the wholesale and retail supply chains. Also, rationalize and harmonize business regulations across national and county governments to improve the business environment for wholesalers and retailers.

4. Establish a National Trade Commission to implement the National Trade Policy and coordinate bilateral, regional and multilateral trade issues.

5. Develop a tourism master plan to enhance sustainable development of the tourism sector. In addition, promote joint security surveillance in the region.

6. Train farmers on appropriate farming methods and management of post-harvest losses and improve food distribution to address food deficit. Promote commercialization and value addition to boost productivity and develop the sector.

7. Eliminate non-tariff barriers and sensitize cross-border traders on the EAC simplified rules of origin to enhance cross-border-trade and minimize food insecurity in the region.

8. Progressively diversify manufacturing to medium and high technology products and establish incubation centres to nurture innovation. This will help in diversifying manufactured exports.

9. Invest in domestic infrastructure targeting to feed into the regional connectivity and support Trans-African infrastructure development. Scale up measures towards least cost energy technologies to support large scale industries, and
design a package for infrastructure services hub.

10. Establish a joint labour portal to create awareness and enhance information sharing to facilitate wider labour mobility in the EAC region. In addition, harmonize the certification and accreditation of professionals.

11. Continue promoting peace and security in the region to reduce conflicts, displacement of persons.

12. Enhance citizen participation and representation at national and regional level to strengthen governance institutions.

13. Develop a comprehensive framework for implementation of EPA, including identifying specific roles of various agencies, documentation of violations and domestication of various provisions.

14. Remain alert to any changes in global strategy on foreign policy and security particularly by Europe and the United States.
The Kenya Institute for Public Policy Research and Analysis (KIPPRA) is an autonomous institute whose primary mission is to conduct public policy research leading to policy advice. KIPPRA’s mission is to produce consistently high-quality analysis of key issues of public policy and to contribute to the achievement of national long-term development objectives by positively influencing the decision-making process. These goals are met through effective dissemination of recommendations resulting from analysis and by training policy analysts in the public sector. KIPPRA therefore produces a body of well-researched and documented information on public policy, and in the process assists in formulating long-term strategic perspectives. KIPPRA serves as a centralized source from which the Government and the private sector may obtain information and advice on public policy issues.

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Our Vision
An international centre of excellence in public policy research and analysis; an international centre of excellence

Our Mission
To provide quality public policy advice to the Government of Kenya and other stakeholders by conducting objective research and through capacity building in order to contribute to the achievement of national development goals