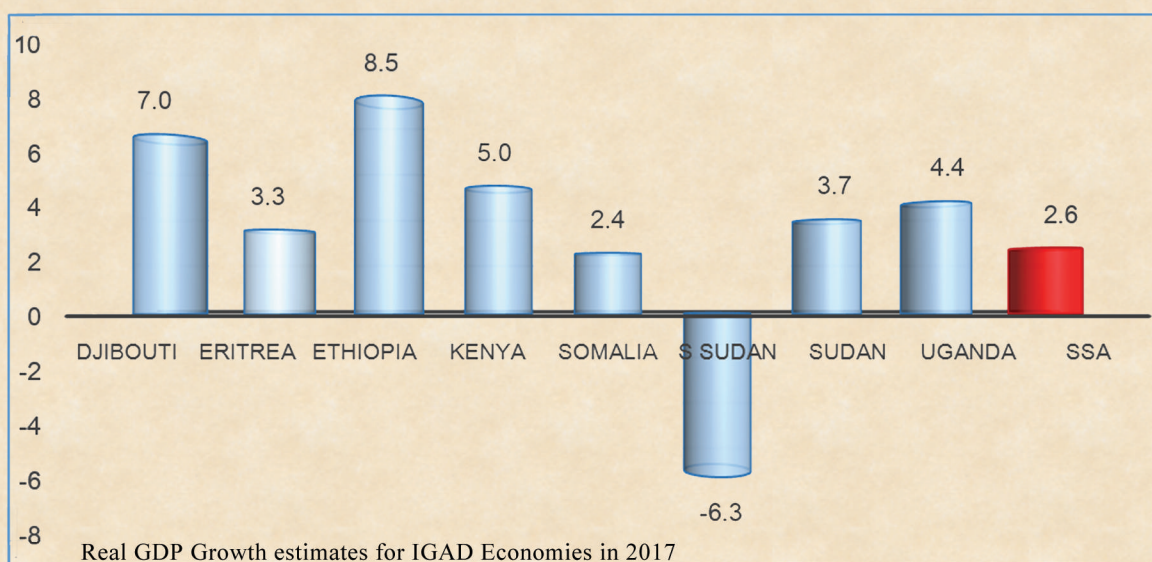




The Horn Economic and Social Policy Institute

The Annual HESPI Report on IGAD Economies

Macroeconomic Performance and State of Industrialisation in IGAD 2017



February 2018

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1st Floor, Teklu Desta Building, Addis Ababa, Ethiopia

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MACROECONOMIC PERFORMANCE AND STATUS OF INDUSTRIALISATION IN IGAD

Annual HESPI Economic Report on IGAD

February 2018

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Introduction

HESPI's 2017 flagship annual report constitutes two parts. The first part is an overview of the macroeconomic environment in the Inter-Governmental Authority on Development (IGAD) region and the second part presents the status of industrialization in the region.

Overview of the macroeconomic environment shows that most countries have registered moderate or high economic growth, except South Sudan, whose Gross Domestic Product (GDP) contracted due to the ongoing civil war in the country. Except in the Sudan and South Sudan, Consumer Price Index (CPI) has been in single digits in 2016 owing to tight monetary policy. Looking at the fiscal balance, Ethiopia and Sudan had a fiscal deficit less than the Sub-Saharan Africa (SSA) average in 2016, while Eritrea, Kenya, South Sudan and Uganda exceed the SSA average and Djibouti registered a fiscal surplus. All countries, except Uganda have seen a significant decline in their export earnings in 2016. With an increasing imports bill, the declining export earning has exacerbated the current account deficit in most IGAD member countries.

Investment as a share of GDP remained low by SSA standards, although growing in recent years. Foreign Direct Investment (FDI) inflows have been consistently increasing in Ethiopia, although declining in Kenya, Sudan and Uganda in the last couple of years. Remittances inflow have been large in absolute terms to the region; with Kenya (\$1,727 mn), Somalia (\$1,489 mn), and Uganda (\$1,078 mn) receiving in 2016 the largest amounts from their diasporas.

Assessment of the status of industrialization (manufacturing sector performance) in the region shows that the share of industry in GDP has been either stagnant or declining 2-3 decades after 1981, except in Ethiopia and Uganda. Likewise, manufacturing value added as a share of GDP has been stagnant or declining for all countries over the last 2-3 decades, except in Uganda. Moreover, manufacturing exports as a share of merchandise exports has been stagnant over the last decade in all countries. Among the major reasons for weak manufacturing sector in the region are little exports participation, weak organizational capacity, and weak supply chain linkages between high productive medium/large enterprises and low productive small enterprises. Other key factors have been passive government support limited to improving the investment climate, as well as failure of the Special Economic Zones (SEZs) in attracting FDI, job creation, export and productivity spillover.

Despite the challenges, there are prospects for the manufacturing sector in the region. First, various flagship infrastructure projects are taking place, which are hoped to enhance the competitiveness of the manufacturing sector. Second, shrinking surplus labor and rising wage in Asia, particularly in China creates huge vacuum in labor intensive industries, which IGAD countries can fill, with right industrial policies. This has enormous potential for job creation and manufacturing export. Third, there is growing international support for industrialization in developing countries including IGAD.

The report emphasizes that investment climate reforms are necessary but not sufficient condition. Hence, governments should make direct support in capacity building, finance and marketing to enhance competitiveness of the manufacturing sector in their respective countries. They need to push for export to develop firm capability; strengthen value chain relations between firms in SEZs and those outside the zones; and improve on trade logistics.

Part I: Recent Macroeconomic Performance

1.1. Economic Growth in IGAD

Most of the member countries of IGAD have experienced continuous output growth since the dawn of the new millennium. Like the rest of the region, several member states particularly Ethiopia and Uganda have been among the top growth performers in the world. In 2016, the highest GDP growth in the sub-region was registered by Ethiopia (8 percent) followed by Djibouti (6.5 percent) and Kenya (6 percent). Uganda on the other hand, has shown a slowdown in its economic growth over the last three years. Its economic growth has dropped from 5.2 percent in 2014 to 4.7 in 2016. The fragile economies in the region with low rank in institutional indices have performed relatively poorly in economic growth; the Fund for Peace's fragile states index rank show that South Sudan, Eritrea, Somalia and Sudan are among the lowest performers in different indices including the economy, security, human rights, and public service delivery¹. In 2016, Eritrea, Somalia and Sudan grew between 3.1 and 3.7 percent and South Sudan recorded output contraction for two consecutive years owing to the ongoing political unrest. In 2016 alone, the economy contracted by 13.8 percent.

Table 1: Real GDP growth (Percent)

	Actual			Estimates		
	2004-12	2013	2014	2015	2016	2017
Djibouti*	3.7	5.0	6.0	6.5	6.5	7.0
Eritrea	1.2	3.1	5.0	4.8	3.7	3.3
Ethiopia	11.1	9.9	10.3	10.4	8.0	8.5
Kenya	5.1	5.7	5.3	5.6	6.0	5.0
Somalia	...	2.8	3.6	3.6	3.2	2.4
South Sudan*	...	29.3	2.9	-0.2	-13.8	-6.3
Sudan	5.9	5.2	1.6	4.9	3.1	3.7
Uganda	7.4	4.0	5.2	5.0	4.7	4.4
SSA	4.4	5.3	5.1	3.4	1.4	2.6

Source: IMF Regional Economic Outlook for Sub-Saharan Africa & Middle East, North Africa, Afghanistan and Pakistan Region

*Average for 2002-12

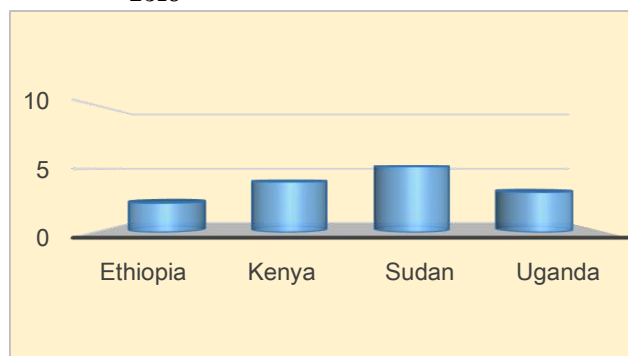
The growth performance especially of Ethiopia, Djibouti and Kenya was appreciable in spite of the fact that the region as a whole was hit hard by severe drought which caused humanitarian crisis. The drought affected more than 17 million people within the region², and significantly impacted the performance of the agriculture sector, which has been the main driver of economic growth in most parts of the region.

¹ The Fund for Peace, Fragile State Index. Accessed from <http://fundforpeace.org/fsi/excel/>

² <http://www.dw.com/en/drought-crisis-in-the-horn-of-africa/a-38950292>

The annual agricultural value added in the region was extremely impacted due to the drought in the region,

Figure 1: Agricultural value added annual growth in 2016



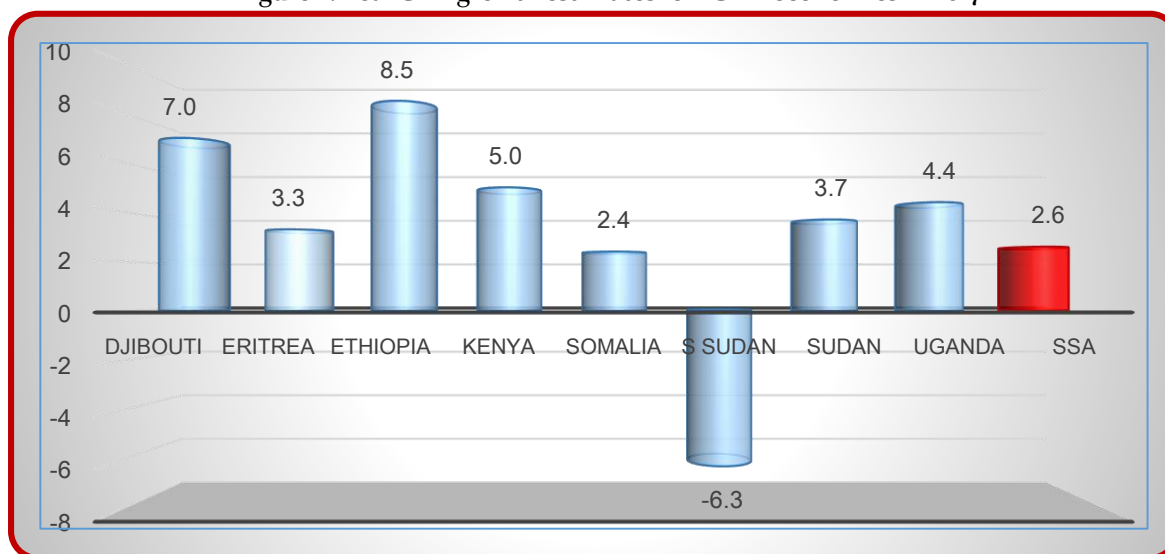
Source: World Bank Group (2017)

and the contribution of the agricultural sector to the overall countries' growth remained weak in 2016. The agricultural value added grew by 2.3, 3.2 and 4 percent in Ethiopia, Uganda and Kenya, respectively in 2016. Sudan recorded the highest growth in agricultural value added during the year, 5 percent.

The region's economic outlook seems commendable for the upcoming years. According to World Bank projections,

Ethiopia and Djibouti are expected to register a remarkable growth in 2017 with 8.3 and 7.0 percent, respectively, which puts them among the top ten fastest growing economies in the world. Kenya and Uganda will also grow by more than the Sub-Saharan average of 4.3 percent. Somalia, South Sudan and the Sudan, on the other hand, are projected to recover from recent economic woes with the annual economic growth at 2.5, -3.5, and 3.2 in 2017 respectively.

Figure 2: Real GDP growth estimates for IGAD economies in 2017



Source: IMF Regional Economic Outlook for Sub-Saharan Africa & Middle East, North Africa, Afghanistan and Pakistan Region

1.2. Inflation

Annual consumer price changes to a larger extent remained in single digits in 2016 in all IGAD member states with the exception of Sudan and South Sudan. In addition, the price volatility has also eased in some economies which faced considerable challenges for many years including Somalia, and also in Djibouti which registered very low consumer price changes in that particular year of 2.3 and 3 percent, respectively. In Ethiopia and Kenya, the annual consumer price changes in 2016 were at 7% and 6% respectively, but lower relative to 2015. Ethiopia's inflation dropped from 10.1 percent in 2015 to 7.3 percent in 2016, while that of

Kenya fell from 6.6 percent in 2015 to 6.3 percent in 2016. In Uganda, consumer prices barely rose in 2016 relative to 2015 from 5.4 to 5.5 percent.

In Sudan, the rise in consumer prices remained in double digits, but decreased from 37 percent in 2014 to 17 percent in 2015 and 13.5 percent in 2016. South Sudan, on the contrary, has been in a state of hyperinflation registering an annual inflation of 380 percent in 2016. The steady depreciation of the South Sudan Pound (SSP) in the parallel market (18.5 per \$ in December 2015 to SSP 80 per \$ in September 2016) contributed to the hyperinflation.

Table 2: Consumer prices for all items, percent change, previous period

	2004-12	2013	2014	2015	2016
Djibouti	3.6	2.4	2.9	2.1	3.0
Eritrea	15.1	6.5	10.0	9.0	9.0
Ethiopia	18.2	8.1	7.4	10.1	7.3
Kenya	8.9	5.7	6.9	6.6	6.3
Somalia	...	4.5	1.3	1.4	2.3
South Sudan	45.1	0.0	1.7	52.8	379.8
Sudan	11.8	36.5	36.9	16.9	13.5
Uganda	9.1	4.9	3.1	5.4	5.5

Source: IMF Regional Economic Outlook for Sub-Saharan Africa & Middle East, North Africa, Afghanistan and Pakistan Region.

*Average taken for 2002-12

All in all, stable domestic money supply together with the global fuel price drop played a role in stabilizing the consumer price changes in these economies. The tight monetary policy also significantly contributed to stabilize the consumer prices in the economies. As can be seen from table (3), in all economies except South Sudan and Sudan, for which data are available, percentage change in broad money changes has remained stable. Despite high broad money growth in Eritrea (close to 16 percent), inflation has remained in single digit over the last two years. In Kenya and Djibouti, money growth was recorded to be 3.6 and 8.7 percent respectively in 2016 which contributed to low level of inflation in these economies. On the other hand, money growth was significantly very high in South Sudan with more than 140 percent in 2016 followed by Sudan with 30 percent.

Changes in exchange rates and global shocks (oil and food price changes) remain important factors in shaping the consumer prices in IGAD economies.

Table 3: Broad money growth (annual percentage change)

	2012	2013	2014	2015	2016
Djibouti	...	...	6.5	19.0	8.7
Eritrea	17.9	17.5	17.2	13.9	15.7
Ethiopia	32.9	24.2	26.9	24.2	20.4
Kenya	14.1	15.6	16.7	14.1	3.6
Somalia	...	...	...	...	...
S. Sudan	33.9	-1.6	21.2	117.4	142.5
Sudan	...	...	17.0	19.8	30.0
Uganda	14.9	9.5	15.2	11.7	11.1

Source: IMF Regional Economic Outlook for Sub-Saharan Africa & Middle East, North Africa, Afghanistan and Pakistan Region

1.3. Government Fiscal Operations

(i) Government revenue and expenditure

Domestic resource mobilization in the IGAD member countries varied considerably. Government revenue constituted less than 16 percent of GDP, in several countries including: Eritrea at 14.2 percent, Ethiopia at 16 percent, Somalia at 2.7 percent, Sudan at 9.3 percent, and Uganda at 14.4 percent. However, the domestic revenue GDP ratio was considerably higher for Djibouti at 32.5 percent, South Sudan at 30.5 percent, and Kenya at 20.2 percent in 2016. Non-tax collections for port services receipts and port production accounted for the high domestic revenue in Djibouti and South Sudan respectively. On the other extreme, general government revenue for Somalia makes only less than three percent of its GDP manifesting the difficulty for the current government in collecting revenue despite the recent stability in the country. In 2016, government revenue was mostly from trade taxes and was a paltry of 2.7 percent of the country's GDP.

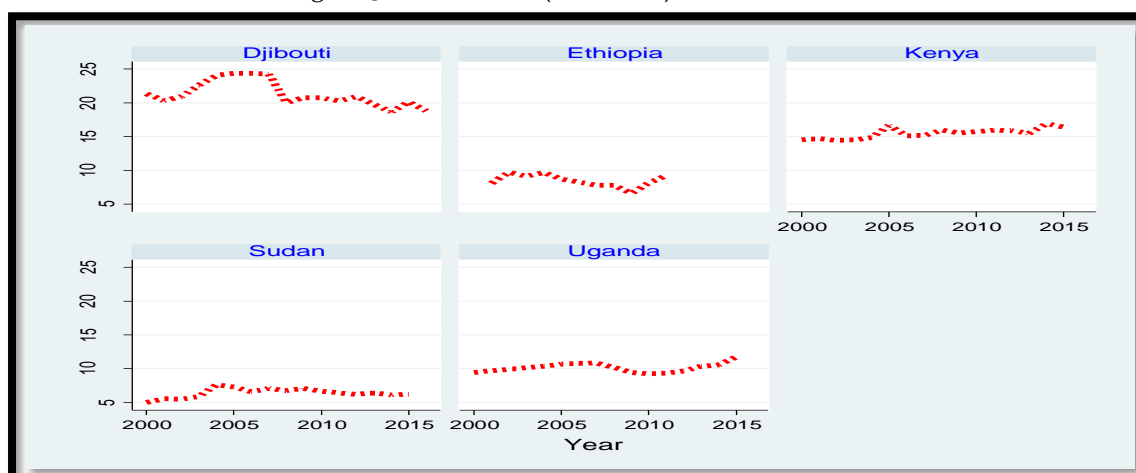
Table 4: General government revenue (% of GDP)

	Djibouti	Eritrea	Ethiopia	Kenya	Somalia	South Sudan	Sudan	Uganda
2012	34.5	15.3	15.5	19.1	...	16.8	9.9	13.4
2013	31.8	14.6	15.8	19.7	1.9	21.9	11.0	12.5
2014	30.9	14.5	14.9	19.8	2.4	27.2	12.0	13.2
2015	37.2	14.3	15.4	19.3	2.3	21.0	11.0	14.9
2016	32.5	14.2	16.0	20.2	2.7	30.5	9.3	14.4

Source: International Monetary Fund World Economic Outlook (2017)

As figure 3 shows, over the last decade or so, tax revenue (as percentage of GDP) has either stagnated or declined in IGAD economies. Djibouti which has relatively higher tax revenue among IGAD economies encountered declining tax revenue since 2005. In 2005, tax revenue constituted around 25 percent of GDP but by 2015 it became below 20 percent. In Kenya, Sudan and Uganda, tax revenue has remained stagnant over the last fifteen years. It hovered around 15 percent in Kenya, 10 percent in Uganda and 6-7 percent in Sudan. Ethiopia, on the other hand experienced declined tax revenue since early 2000s up until 2010 but since 2010 it seems that tax revenue has improved.

Figure 3: Tax revenue (% of GDP) for IGAD economies



Source: Prichard et al (2014)³

³ https://www.wider.unu.edu/sites/default/files/ICTD_WP19.pdf

Government expenditure as percentage of GDP in the IGAD sub-region like the rest of Sub-Saharan Africa (SSA) has shown an erratic pattern. General government expenditure as percent of GDP in 2016 was 50.3 percent in South Sudan, 48.3 percent in Djibouti, at about 28 percent in Eritrea and Kenya, at near 18 percent in Ethiopia and Uganda, and at only 11.1 percent in the Sudan. The variation in general government expenditure manifested the low level of revenue mobilized from domestic tax and non-tax revenue. It has also shown greater country variation ranging from 11 percent in the Sudan to 50 percent in South Sudan in 2016.

Table 5: General government total expenditure (% of GDP)

	Djibouti	Eritrea	Ethiopia	Kenya	South Sudan	Sudan	Uganda
2012	37.2	30.7	16.6	24.2	31.6	13.3	16.4
2013	37.7	29.7	17.8	25.4	24.8	13.3	16.5
2014	40.5	28.9	17.5	27.2	34.1	13.4	16.5
2015	58.9	28.5	17.3	27.5	39.4	12.9	17.6
2016	48.3	28.2	18.4	27.5	50.3	11.1	18.0

Source: International Monetary Fund World Economic Outlook (2017)

The average fiscal deficit in SSA was $-4\frac{1}{2}$ percent of GDP in 2016 following levels of -4.1 percent in 2015 and $-3\frac{1}{2}$ percent in 2014 (IMF, 2016). Over the years, government fiscal balance has consistently remained in deficit in all of the economies and their deficit has been more than the SSA average (particularly in Eritrea, Kenya, South Sudan, and Sudan). Ethiopia & Sudan have fiscal deficit less than SSA average. The growing public spending and the low tax base and collection has exasperated these countries' fiscal deficit. South Sudan and Eritrea run a huge fiscal deficit in 2016 with 20.4 and 14.3 percent respectively. On the other hand, Djibouti is the only country with fiscal surplus in the region. The fiscal adjustment has played much role in restraining the country's spending.

Table 6: General government fiscal balance (% of GDP)

	2004-12	2013	2014	2015	2016
Djibouti*	-1.9	-5.9	-12.2	-15.7	2.1
Eritrea	-22.1	-15.6	-14.8	-14.6	-14.3
Ethiopia	-6.1	-3.4	-3.7	-3.0	-3.2
Kenya	-3.8	-6.2	-7.9	-8.6	-7.8
South Sudan	-2.1	-9.4	-13.3	-24.8	-20.4
Sudan*	-1.2	-2.3	-1.4	-1.9	-2.0
Uganda	-5.7	-5.0	-4.5	-4.1	-4.6

Source: IMF Regional Economic Outlook for Sub-Saharan Africa & Middle East, North Africa, Afghanistan and Pakistan Region

*Average taken for 2002-12

(ii) *Government debt*

IMF's analysis on debt sustainability for IGAD economies confirms that some countries in the region face a high risk of debt distress. While others are less debt distressed and heavily sustainable levels of debt threshold indicators. Two of these economies (Ethiopia and Uganda) benefited from Multilateral Debt Relief Initiative (MDRI) under the joint IMF-World Bank enhanced Initiative for Heavily Indebted Poor Countries (HIPC Initiative). Yet these countries have now accumulated growing debt owing to their large-scale public investments in infrastructure financed through borrowing. Accordingly, Ethiopia's debt stress was raised

from low to moderate, while Uganda remains at low risk of debt distress. Similarly, the Debt Sustainability Analysis for Kenya shows that the country's debt stress is low, indicating that all debt indicators are well below the relevant indicative debt burden thresholds, despite the overall increase in public debt over the last two years. Gross government debt for Kenya reached 54.4 percent of the country's GDP in 2016⁴. Among the other countries, the stock of debt as a percent of GDP indicates that both Eritrea and Somalia have considerably high debt ratio. In 2016, Eritrea's government gross debt amounted 126 percent of the country's GDP, while that of Somalia was around 80 percent. Djibouti and South Sudan have relatively low government gross debt among the IGAD economies with 31 and 33 percent respectively in 2016. Ethiopia and Kenya have accumulated government debt of 55 and 54 percent in 2016.

Table 7: General government gross debt (% of GDP)

	2012	2013	2014	2015	2016
Djibouti	43.3	42.4	38.8	33.7	31.3
Eritrea	127.6	128.4	126.5	127.1	125.5
Ethiopia	36.9	42.4	46.3	54.6	54.9
Kenya	41.7	44.0	48.6	52.4	54.4
Somalia	...	89.3	85.1	81.8	79.9
South Sudan	8.9	17.6	34.8	65.7	33.0
Sudan	94.2	89.9	77.3	72.9	64.2
Uganda	24.3	27.3	30.1	33.2	36.9

Source: IMF World Economic Outlook (2017) and staff reports

1.4. Investment & Savings

Despite some improvements in the financial sector and robust economic growth, aggregate savings still remain low in IGAD economies, compared to other developing region such as South East Asian countries. Ethiopia and Uganda, two well performing economies in the region for the last couple of years, have higher national savings rates of 32 and 20 percent of GDP in 2016, respectively. South Sudan, which has remained in political instability in the past three years, also had higher national savings of more than 20 percent in 2016. Kenya, which has relatively the most developed financial sector in the region, had stagnant savings rate for over five years through 2016, within the range of 11.4 to 15 percent of GDP. Eritrea and Sudan recorded the lowest savings in the region with 4 and 10.8 percent of GDP respectively in 2016.

Table 8: Gross national savings (% of GDP)

	Djibouti	Eritrea	Ethiopia	Kenya	S Sudan*	Sudan	Uganda
2004-12	20.9	-12.3	22.5	15.2	9.1	14.9	23.8
2013	19.8	3.6	28.1	11.4	8.9	11.0	20.3
2014	9.8	4.0	30.7	12.7	18.9	10.0	17.1
2015	19.0	1.3	31.3	14.4	7.3	9.3	17.9
2016	15.6	4.0	32.0	14.6	20.2	10.8	19.8

Source: IMF World Economic Outlook Database

For all countries and especially for those at low levels of economic development, investment supports and sustains the requisite capital critical to maintain economic growth. Countries in the IGAD region, with the exception of Eritrea have experienced noticeable improvement in investment (measured as percent of GDP)

⁴ <https://www.imf.org/external/pubs/ft/dsa/pdf/2017/dsacr1725.pdf>

over the last couple of years. Djibouti, Ethiopia and Uganda have much higher rates of investment among the member states. In 2016, total investment as a percent of GDP was recorded at 44 in Djibouti, 39 in Ethiopia and 26 in Uganda. In the last four years, Kenya's total investment hovered around 20 percent. Whereas in South Sudan and the Sudan, total investment of GDP in 2014-16 averaged about 17 percent.

Table 9: Total investment (% of GDP)

	Djibouti	Eritrea	Ethiopia	Kenya	S Sudan	Sudan	Uganda
2004-12	31.0	13.1	25.9	19.7	8.1	20.7	28.7
2013	41.3	8.7	34.1	20.2	12.8	19.6	27.3
2014	34.9	7.9	38.0	22.5	20.6	17.0	25.5
2015	50.8	7.6	39.4	21.2	14.5	17.1	24.5
2016	44.3	7.4	38.5	20.2	17.2	16.6	25.7

Source: IMF World Economic Outlook Database

The low level of national savings coupled with high requisite capital required to sustain the economic progress in these economies resulted in growing investment-savings gap (see below). In Djibouti, for instance, there is massive difference between the national savings (which was recorded 15.6 percent of GDP) and investment at 44 percent in 2016. In Ethiopia, the government's recent effort in mobilizing national savings through housing scheme and sale of bonds has paid off in financing various investment. As a result, while higher savings as well as investment is observed, there was an investment-savings gap of 6.5 percent of GDP. There was a significant savings investment gaps in Kenya, Sudan, and Uganda of 5.6 – 5.9 percent of GDP in 2016. In South Sudan, due to the prolonged instability and insecurity, the level of investment has been inadequate despite the country's low level of development.

Figure 4: National savings & investment (% GDP) in IGAD in 2016



Source: IMF World Economic Outlook Database

1.5. Capital Inflows

(i) Remittances inflows

To many developing countries including Sub-Saharan Africa, remittance inflows has been a key source of foreign exchange. Yet reports have shown that the unrecorded inflows outweighed the export revenue in many of these economies. The quality of the data on private remittances in the region is questionable on account of the sources of informal channels. Remittance inflows (measured in absolute terms) to the region at large have been considerable but measured relative to the size of the economies, it has remained low especially for the last four years. In absolute terms, Kenya Somalia and Uganda has been received sizeable remittance in recent year from their large Diasporas.

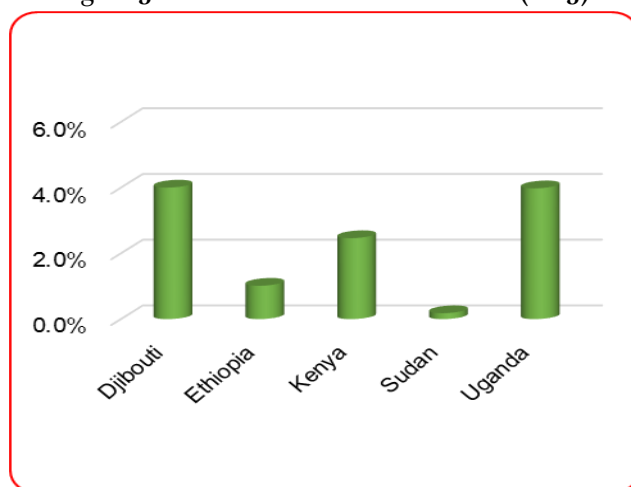
Table 10: Migrant remittance inflows (US\$ million)

	Djibouti	Ethiopia	Kenya	Somalia	Sudan	Uganda
2012	33	624	1,211	...	596	913
2013	36	624	1,304	1,300	620	941
2014	36	624	1,441	1,361	507	887
2015	63	624	1,561	1,424	151	1,049
2016	66	642	1,727	1,489	160	1,078

Source: World Bank Migration and Remittance Data (2017)⁵ and staff estimates

On top of the slow growth in official remittance inflow in to the region, it has also remained very low (as

Figure 5: Remittances as a share of GDP (2015)



Source: World Bank Migration and Remittance Data (2017)

percent of GDP) compared to other region. In 2015, remittance constituted only 1 percent of the GDP in Ethiopia and less than 0.5 percent in Sudan which is less than the Sub-Saharan average of 2.6 percent. Relatively Djibouti and Uganda had higher remittance inflows relative to their economic size. The inflow was 4 percent of GDP for both Uganda and Djibouti in 2015.

The level of remittances inflow to the region is adversely impacted by the high cost of sending money. World Bank Group report on migration and remittance in 2017 shows that

the Sub-Saharan Africa in general has the highest remittance cost in the world with 9.8 percent in 2017 which is higher than the global average of 7.4 percent⁶. The slow economic growth in the source countries and diversion from formal to informal channels also contributed to the slow growth in remittance receipts into

⁵ <http://www.worldbank.org/en/topic/migrationremittancesdiasporaissues/brief/migration-remittances-data>

⁶ World Bank (2017) Migration and Remittances: Recent Developments and Outlook. It can be available at <http://pubdocs.worldbank.org/en/992371492706371662/MigrationandDevelopmentBrief27.pdf>

these economies. The high economic growth in the sub-region (especially in Ethiopia) has also contributed to the stagnating GDP share of remittances (Gonzalez-Garcia et al, 2016)⁷.

(ii) *Foreign Direct Investment (FDI)*

Inflow of Foreign Direct Investment (FDI) in recent years has shown volatile pattern in the IGAD region. Some countries in the region (Kenya and Sudan) experienced decline in FDI inflow. In Kenya, FDI inflows dropped by more than 36 percent in 2016 alone, likewise Sudan's FDI inflow declined by 38 percent. South Sudan has continued to experience outflow of foreign direct investment from the country. Ethiopia has managed to attract much FDI following the expansion of the industrial parks especially in apparel and textile sectors. In 2016 alone, there was more than US \$ 3 billion inflows. The decline in FDI inflows to these economies could be attributed to the complicated procedures to register businesses which has been the main reason for drop in FDI (in Kenya and Uganda).

Table 11: Inward FDI flow to IGAD, 2012-16 (in millions of \$)

	2012	2013	2014	2015	2016
Djibouti	110	286	153	124	160
Eritrea	41	43	46	49	52
Ethiopia	278	1,343	1,855	2,193	3,196
Kenya	1,380	1,119	821	620	394
Somalia	107	258	283	306	339
S. Sudan	161	(793)	44	(71)	(17)
Sudan	2,311	1,688	1,251	1,728	1,064
Uganda	1,205	1,096	1,058	538	541

Source: UNCTADstat

(iii) *Official Development Assistance (ODA)*

External financial flows in the form of official development assistance (ODA) mainly from OECD countries have played a significant role for many developing countries despite its unpredictability. But the recent data shows that such capital inflows have declined especially to those middle income economies. Djibouti and Kenya, the two lower middle income economies in the region according to the World Bank's income classification, encountered considerable drop in 2015 in ODA. Similarly, Uganda received less ODA in 2015 relative to 2014. Ethiopia, on contrary, has seen consistently higher ODA over the last four years. In general, Ethiopia and Uganda are the largest recipients of ODA from OECD countries in absolute terms.

⁷ Gonzalez-Garcia, J., Hitaj, E., Mlachila, M., Viseth, A., Yenice, M. (2016) Sub-Saharan African migration: patterns and spillovers, Spillover notes 9, International Monetary Fund).

Table 12: ODA & other official flows from DAC to IGAD economies (2007-2015)

	2011	2012	2013	2014	2015
Djibouti	131	71	86	90	2
Eritrea	29	18	14	21	5
Ethiopia	1,792	1,916	1,871	2,224	2,673
Kenya	1,938	1,597	2,976	2,220	1,412
Somalia	765	668	722	768	664
S. Sudan	390	1,040	1,139	1,640	1,356
Sudan	1,295	642	1,087	479	511
Uganda	1,030	971	1,112	3,394	2,347

Source: OECD (2017)⁸

1.6. International Trade

i) Global exports

Just like any developing region, IGAD member states' export items are mainly dominated by few primary commodities such as agricultural raw materials, food items, beverages and tobacco. Also, the IGAD countries' trade pattern is predominantly with major industrial countries of Western Europe, US, Japan, China and the Middle East. Consequently these economies are highly susceptible to global commodity price shocks. Owing to trade pattern and commodity composition, almost all economies in the region (except Uganda) saw huge drop in merchandise export receipts in 2016 compared to the year in 2015 as the result of the global commodity price fall. Ethiopia, Eritrea, South Sudan and Sudan experienced significant decline.

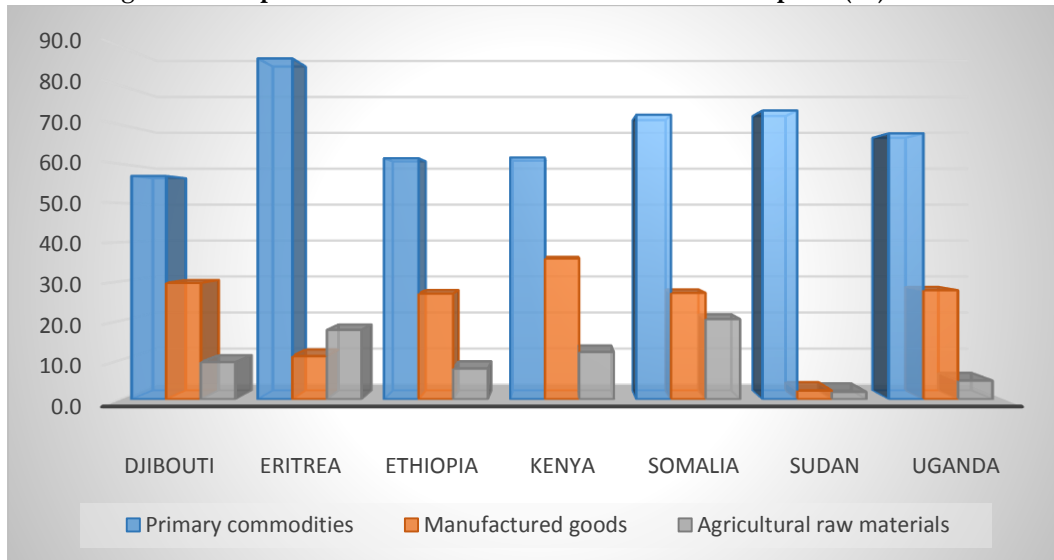
Table 13: Merchandise exports of IGAD countries measured in FOB (million UD \$) in 2012-16

	Djibouti	Eritrea	Ethiopia	Kenya	Somalia	S. Sudan	Sudan	Uganda
2012	280	237	2,911	5,794	478	139	3,365	2,358
2013	233	116	4,095	5,568	640	2,320	4,790	2,232
2014	259	602	5,689	5,770	608	4,085	4,350	1,982
2015	346	432	5,047	5,577	684	2,193	3,168	1,999
2016	345	291	1,743	5,338	628	1,382	2,599	2,026

Source: IMF Direction of Trade Statistics (2017)

⁸ OECD (2017), "Detailed aid statistics: Total receipts", *OECD International Development Statistics* (database). <http://dx.doi.org/10.1787/data-00079-en> (Accessed on 01 August 2017)

Figure 6: Composition of IGAD economies merchandise exports (%) in 2016

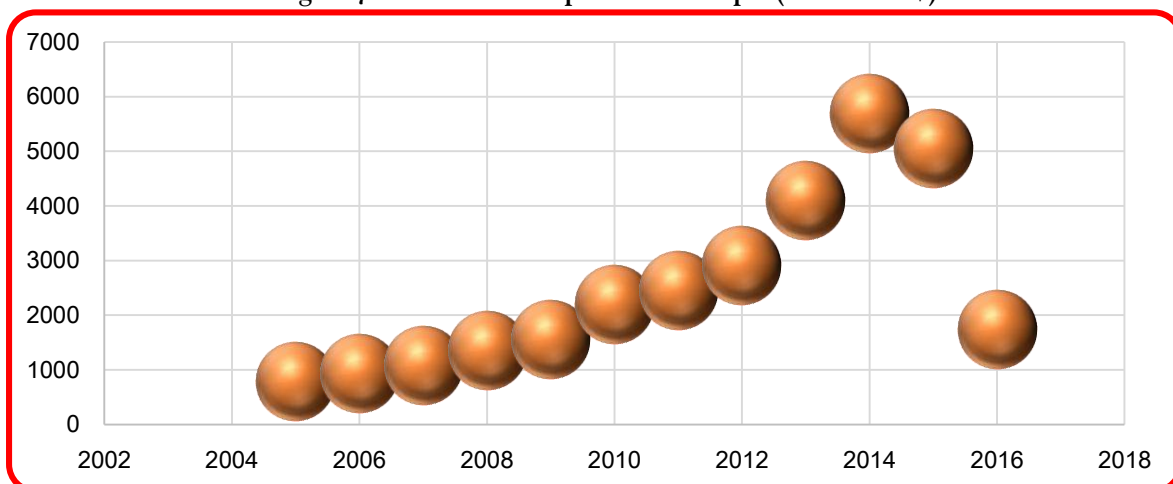


Source: UNCTADstat (2017)

The export composition and pattern of the IGAD economies like the rest of Sub-Saharan African make these countries vulnerable to global commodity price drop. Primary commodities (such as agricultural raw materials, food items, beverages and tobacco) constitute the largest share of these economies exports to the global market. In 2016, these commodities made more than 55 percent of the exports of IGAD member states; but in Eritrea it constituted around 87 percent. On the other hand, manufacturing exports made less than 26 percent of the exports of the IGAD member states except for Kenya, which has a more diversified economy in the region.

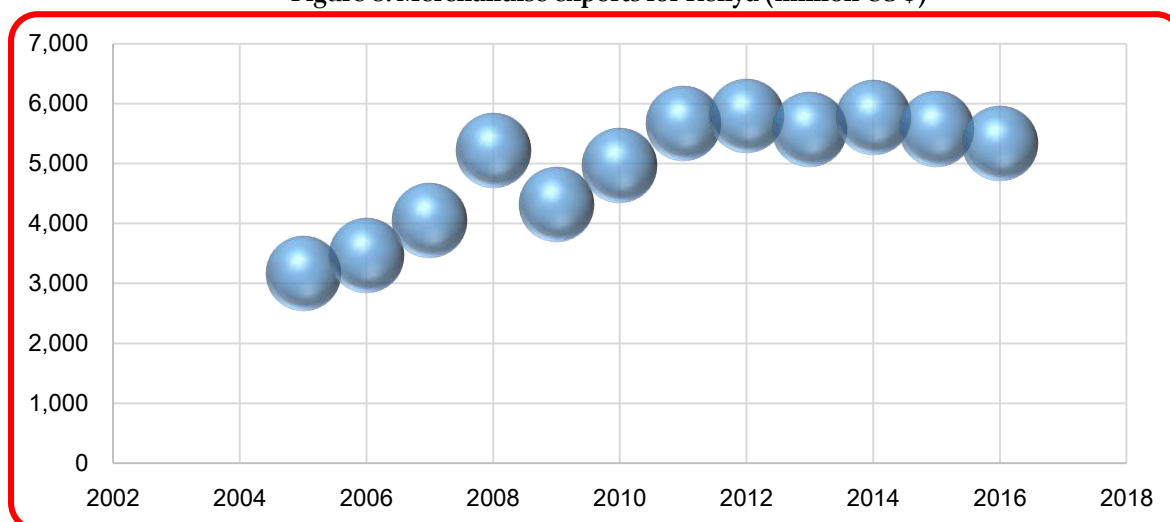
Over the last seven years or so, commodity prices have decelerated and remained weak which adversely impacts the commodity dependent economies (see figure). On top of weak global commodity prices, countries in the IGAD region with the exception of Uganda have experienced appreciating real effective exchange rate (REER) over the past few years contributing to slow growth and decline in some stances in value of merchandise exports (see fig above).

Figure 7: Merchandise exports for Ethiopia (million US \$)



Source: IMF Direction of Trade Statistics (2017)

Figure 8: Merchandise exports for Kenya (million US \$)



Source: IMF Direction of Trade Statistics (2017)

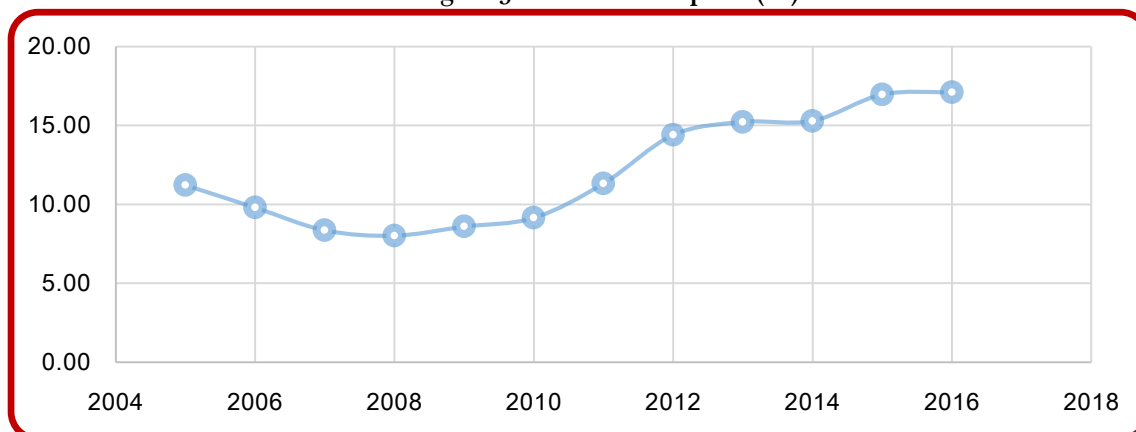
Table 14: Summary of baselines for medium term commodity prices (in U.S. \$ terms: 2005 = 100)

	2009	2010	2011	2012	2013	2014	2015	2016
<i>All commodities and Energy</i>	121	152	192	186	183	172	111	100
Non-fuel Commodities	127	161	191	171	169	162	134	132
Food	134	150	181	176	177	170	141	144
Beverages	154	176	206	167	147	178	173	164
Agricultural raw materials	94	125	154	134	136	139	120	113
Metals	137	202	230	191	183	164	127	120
Energy	117	147	193	194	191	177	98	82
Petroleum crude spot	116	148	195	197	195	180	95	80

Source: UNCTADstat

The level of intra-regional trade among the IGAD member states have recovered from its lowest level in 2008 which was only 8 percent to around 17 percent in 2016. Yet this low level of intra-trade is mainly between the two East African Community member states (Kenya and Uganda). Much of Uganda's exports go to Kenya and its imports come from Kenya. The other IGAD member states trade very little among themselves. Indeed there are reports that informal cross border trade especially between Somalia and Ethiopia is significantly high.

Figure 9: Intra-IGAD exports (%)



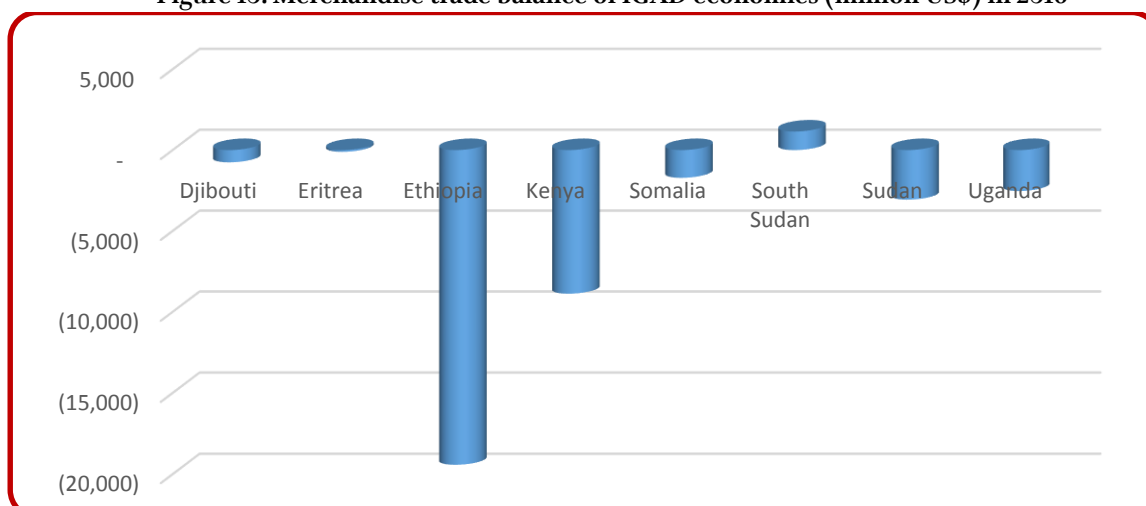
Source: UNCTADstat. Available at

1.7. External Balance

(i) Trade balance

Trade balance for all the IGAD member states has deteriorated for the past few years mainly owing to the drop in export receipts following the global commodity prices decline and appreciation of real effective exchange rates. Many of these economies have experienced appreciating real exchange rates, except Uganda making their exports uncompetitive in the international markets. But imports of these economies, which constitute mostly capital goods have gone up sharply. Ethiopia and Kenya have recorded the largest trade deficits among the IGAD economies. In 2016, Ethiopia's trade deficit (for merchandise items) was a staggering US \$ 19.4 billion whereas for Kenya it was US \$ 8.8 billion followed by Sudan with US \$3 billion, and Uganda for US \$2.5 billion. South Sudan is the only country in the sub-region which had a trade surplus in 2016 of US \$1.1 billion.

Figure 10: Merchandise trade balance of IGAD economies (million US\$) in 2016



Source: IMF Direction of Trade Statistics

(ii) Current account balance

All the IGAD states, with the exception of South Sudan, recorded current account deficits in 2016. Djibouti, Somalia and Ethiopia had the largest current account deficits of 28.6, 10.1, and 9.9 percent of GDP,

respectively. Kenya and Uganda also had significant deficits of 5.5 and 5.9 percent of GDP during the year. Eritrea had the smallest current account deficit of 0.1 percent of GDP while South Sudan had a current account surplus amounting to 6.2 percent of GDP. For some countries particularly for Djibouti, the growing investment-savings gap worsened the current account balance. In addition, increasing trade openness has contributed to growing current account deficit in the region.

Table 15: Current account balance (% of GDP)

	Djibouti	Eritrea	Ethiopia	Kenya	Somalia	S Sudan	Sudan	Uganda
2004-12	-10.1	-2.9	-6.6	-4.5	...	1.1	-5.9	-4.9
2013	-21.5	-0.1	-5.9	-8.8	-4.8	-3.9	-8.7	-6.9
2014	-25.1	0.6	-6.4	-9.8	-6.3	-1.6	-7.0	-8.3
2015	-31.8	-2.2	-11.6	-6.8	-7.2	-7.2	-7.8	-6.6
2016	-28.6	-0.1	-9.9	-5.5	-10.1	6.2	-5.8	-5.9

Source: IMF World Economic Outlook Database

Part II: The Status of Industrialization in IGAD

2.1. Background

Industrialization is key for speedy transition to middle income status. Only few countries in the world managed to transit from low to middle and high income status without industrialization, more importantly without expanding their manufacturing sector (Lin, 2011). Manufacturing enhances overall productivity of the economy via technology spillover across and within sectors. It facilitates structural transformation through industrialization and urbanization by facilitating resource reallocation from agriculture to industry. In 1990, China had 74% of its citizens in rural areas. Three decades later, the country managed to reduce this proportion to a mere 27% by expanding its manufacturing sector and transforming its rural areas into new urban centers (See Lin, 2011). Manufacturing has a potential to create massive employment opportunity and hence poverty reduction. China lifted 270 million people out of poverty mainly through jobs created by the industrial sector, particularly manufacturing. Outside of being a resource rich country, a developing manufacturing base is the best known path to higher income per capita. The experiences of East Asian countries including Japan, Korea, Taiwan and most recently China demonstrates this fact. In 1990, China was a low income country with a GDP per capita (PPP) of USD 987, which was lower than the IGAD average of USD 1,119 in the same period. Kenya, Djibouti and Sudan had higher GDP per capita than China. In 2016, China is a middle income country with a per capita GDP (PPP) of USD 15,535, which is five times larger than the IGAD average (USD 2,867).

Assessment of the economic performance of the IGAD countries shows that the region has registered high economic growth recently. However, the source of growth shows that there is little progress, if any, in structural transformation. For the year 2016, IGAD's share of manufacturing in GDP was 7.7%, which is less than SSA's average of 10.5% and much less than South East Asia's 16.1%. Industry's share in GDP has been stagnant or declining except in Ethiopia and Uganda since 1981. Manufacturing value added (as % of GDP) has been stagnant or declining during the same period. Poverty is still high though declining, over the last two decades. According to the recent available data, the proportion of people living below the nationally estimated poverty line was 19.5% in Uganda in 2012, 29.6 % in Ethiopia in 2010, and 50.6% in South Sudan in 2009. With 255 million population, more than half being younger than 25 years, unemployment in the region is serious. Export of IGAD member countries is predominantly in primary commodities, which are vulnerable to global price shocks. Proportion of rural population in IGAD has declined little from 76% in 1986 to 68.3% in 2016.

With weak industrialization and manufacturing sector, the region has made little progress in structural transformation over the last three decades. Due to the absence of a strong manufacturing sector, the region still has serious unemployment, significant poverty, and an export sector vulnerable to global price shocks.

Recently, there is a renewed international and national interest in industrialization and expanding manufacturing in developing countries. One of the sustainable development goals (SDG #9) adopted by the UN in 2015 emphasizes industrialization as key driver of sustainable development. Likewise, industrialization is key agenda for IGAD countries as emphasized in the National Development Plans (NDP) of Uganda and Kenya as well as the Industrial Development Strategy (IDS) of Ethiopia. It is thus imperative to revisit the

challenges and prospects of industrialization, particularly manufacturing in the region and indicate policy pathways to strengthen the sector in the region.

2.2. Overview of Manufacturing in IGAD

Industrialization in the IGAD member countries began mostly in the 1960s and 1970s as part of the effort to reduce current account deficit. To this end import substitution industries were set up. These include textile, cement, soap, and beer in Uganda; textile, garment, paper, food processing, leather tanning and footwear in Kenya; textile, cement and food processing in Ethiopia; as well as food, beverage, cement, chemicals, petroleum refinery and fertilizer production in the Sudan. Governments in most of the IGAD countries encouraged FDI firms to invest in their countries, which largely succeeded. The import substitution strategy of the 1960s and 1970s had mixed results. While it led to expansion of the manufacturing sector, particularly in textile and food processing (See Gebreyesus, 2013; Ngui et al, 2014); but, it also led to inefficiency, under capacity utilization due to limited markets and production of low quality products for lack of global competition.

The nationalization policies of governments in the 1970s in Ethiopia, Sudan and Uganda caused loss of organizational knowledge, inefficient management of industries and industrial production. As a result, the growth of a promising manufacturing sector were hindered. In Uganda, industrial production came nearly to a halt by 1980 (Shinyekwa et al., 2014). In Ethiopia, state owned manufacturing relied on government subsidy to survive by the end of the 1980s (Gebreyesus, 2013).

The IGAD economies observed liberalization in the late 1980s and the 1990s, following the adoption of the IMF sponsored Structural Adjustment programs (SAPs). The financial assistance from the IMF was key to revitalize private investment in the region. As a result, the industrial sector has shown a steady growth, although its share of GDP has grown very little, if at all (see Table 16). Uganda registered the highest growth of industrial value added in GDP during 1981-2007, although it declined a decade later in 2016. Ethiopia's industrial value added has been stagnant during 1980-2007, but increased significantly afterwards reaching to 21.31% in 2016 from its level of 12.47% in 2007. This was mostly driven by huge public investment in construction that has been taking place since 2006. Sudan has seen a sharp plunge in its industrial value added reaching 2.61% in 2016 compared to 30.62% in 2007. This is likely due to the secession of South Sudan, when Sudan retained less than half of the oil refineries before South Sudan's secession.

Table 16: Industrial value added (as % of GDP)

	1981	1989	2007	2016
Djibouti	...	20.57	16.89	...
Ethiopia	9.27	10.92	12.47	21.31
Kenya	20.28	19.03	21.82	19.05
Sudan	...	14.42	30.62	2.61
Uganda	6.74	10.70	26.60	19.73

Source: WDI (2017)

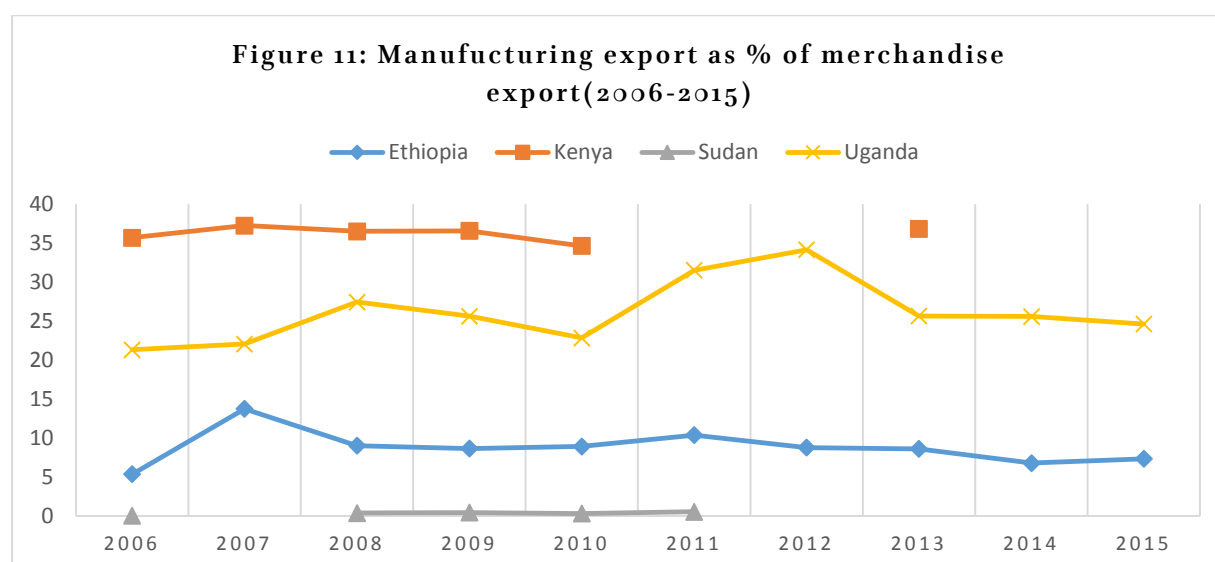
Two-three decades after 1981, manufacturing share of GDP has been stagnant or declining for all countries as shown in table 17; and three-four decades after 1981, Ethiopia, Kenya and Sudan have shown a decline in manufacturing value added; Uganda is the only country that has shown a steady increase in manufacturing value added over the last 3-4 decades.

Table 17: Manufacturing value added as % of GDP (1981-2016)

	1981	1989	2007	2009	2016
Djibouti	...	5.5	2.5	...	...
Eritrea	...	...	5.7	5.7	...
Ethiopia	4.7	5.1	4.9	4.1	4.3
Kenya	12.3	11.7	14.5	13.4	10
Sudan	7.4	8.7	6.2	6	...
Somalia	4.6	4.5	...	...	...
Uganda	1.9	5.9	7.6	7.7	8.8

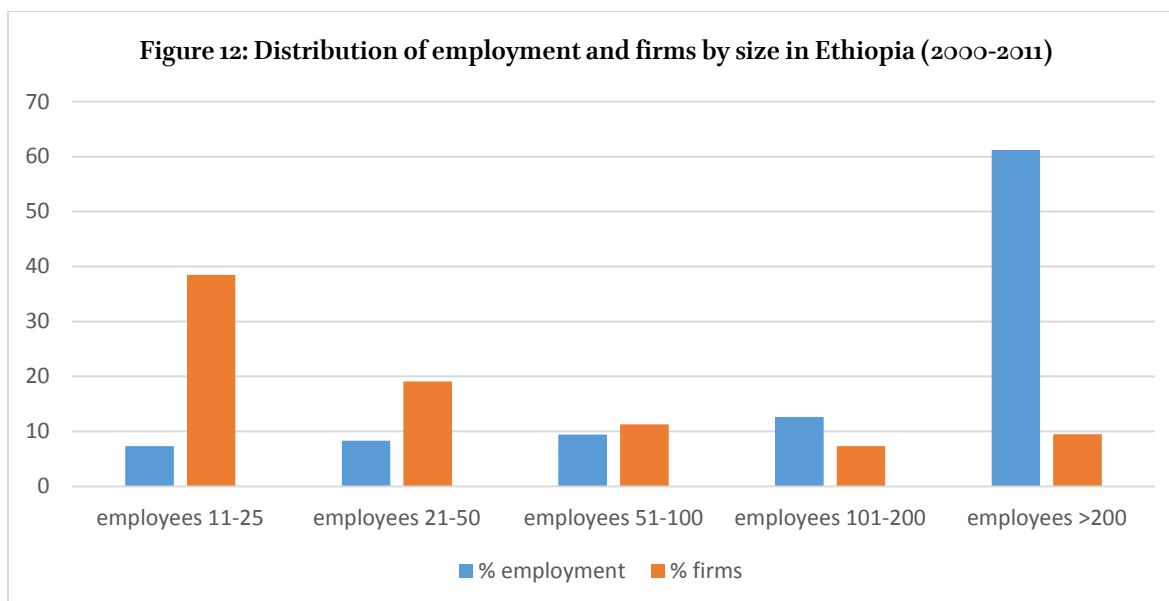
Source: WDI (2017)

A more robust indicator of the performance of the manufacturing sector is manufactured exports (as % of merchandise exports) because it shows its resilience to global competition. As Figure 11 shows, share of manufacturing export in IGAD countries has been stagnant during 2005-16. Within the region, however, Kenya and Uganda performed much better. Some attribute the rise in manufactured share of exports in Uganda to new market opportunities in Sudan, DRC and Rwanda (Shinyekwa et al., 2014). Kenya's increased manufactured exports were due to revival of the East African Community (EAC), enactment of the African Growth Opportunity Act (AGOA) and Kenya's deeper participation in COMESA (Ngui et al, 2014).



Source: WDI (2017)

The size distribution of the manufacturing sector in IGAD countries reveals that the majority are of small or medium size. The firms registered in Uganda in 2006/07 comprise of; 58% small size, employing 10-20 people; 9% medium size, employing 20-50 people; and 3% large enterprises, employing more than 50 people (Shinyekwa et al, 2014). Kenya's manufacturing sector has a rapidly growing informal sector. Small and medium enterprises (SMEs) share of manufacturing employment has been increasing. Likewise, the Ethiopian manufacturing sector has been dominated by small and micro enterprises. However, medium and large scale manufacturing contribute 83% of manufacturing value added as well as more than 60% of manufacturing employment. As Figure 12 shows, large firms with employees exceeding 200 contributed to 61.2 % of manufacturing employment during 2000-11. On the other hand, Sudan's small scale manufacturing contributed about one-third of manufacturing value added as of 2001 (UNIDO, 2001).



Source: Gebreyesus (2013)

Looking at the geographic distribution of manufacturing firms in the IGAD region reveals concentration in very few urban centers where infrastructure and public services are relatively better. Considering Uganda, 42% of firms are concentrated in Kampala as of 2007. Kenya’s overwhelming majority of firms are located in Nairobi, Mombasa and Kisumu. In Sudan, Khartoum and central regions hosted 60% of firms as of 2001, while in Ethiopia 40% were in Addis Ababa as of 2010.

There is huge disparity in productivity by size and manufacturing sub sector. In Ethiopia for instance, large firms are five times more productive (using manufacturing value added to labor ratio) than micro size firms and four times more productive than medium size firms. Also, basic iron and steel, non-metallic minerals, fabricated metal are relatively more productive while textile and apparel are among the least productive (Gebreyesus, 2013).

2.3. Challenges: Why Weak Manufacturing in IGAD

The manufacturing sector in IGAD countries have little export participation, although Kenya and Uganda have relatively more manufacturing share of merchandize export. Low quality and productivity of the sector means that its global competitiveness is weak. Empirical studies in developing countries have shown that export raises productivity of firms by exposing them to global competition (Newman et al., 2017). It also helps firms to grow by providing access to larger markets. Most firms in the IGAD countries have weak organizational capability—tacit knowledge and work practices that affect productivity and quality. South East Asian industrialization experience shows that there is productivity gain through supply chain linkages between high productive large firms and low productive small firms.

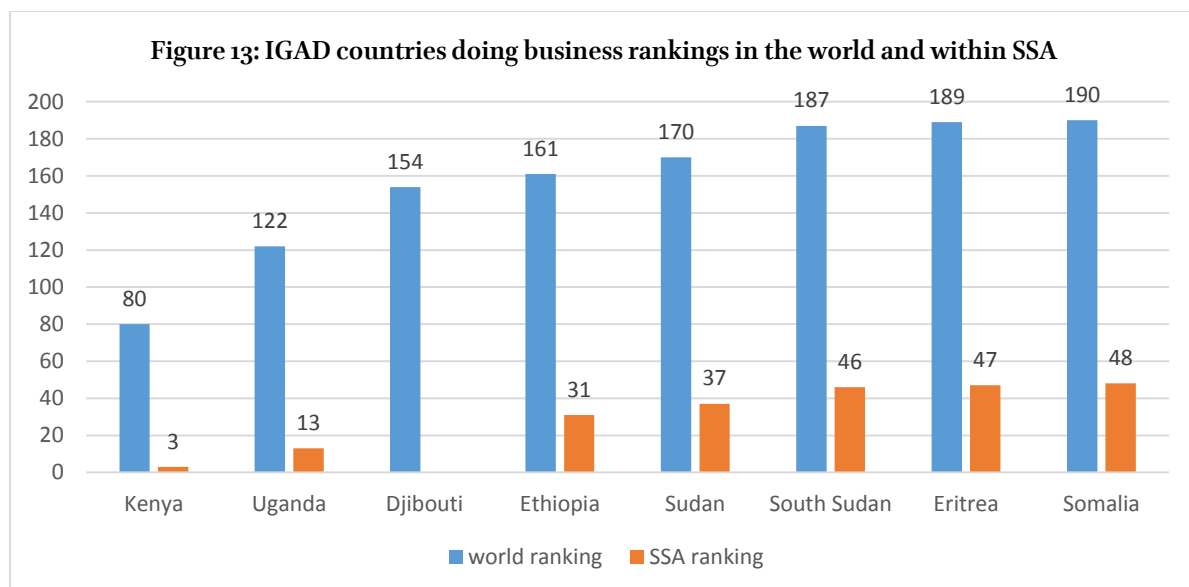
Supply chain linkages in IGAD countries is very thin. Most of the large size firms import their raw materials from abroad as opposed to the East Asian experience where large firms increasingly source their raw materials from local firms, thereby allowing productivity gains for the small firms. The Special Economic Zones (SEZs) in IGAD countries perform poorly in four indicators, namely, attracting FDI, job creation, exports, and productivity spillover. Notable exception is Ethiopia where its SEZs have shown early sign of

success in attracting FDI in textile; the country ranked 2nd in textile FDI after Vietnam in 2016, and in job creation⁹.

The manufacturing sector in IGAD countries faces binding constraints including inadequately educated workforce, poor transportation, and custom clearance, security costs, shortage of finance, and inefficient bureaucracy among others.

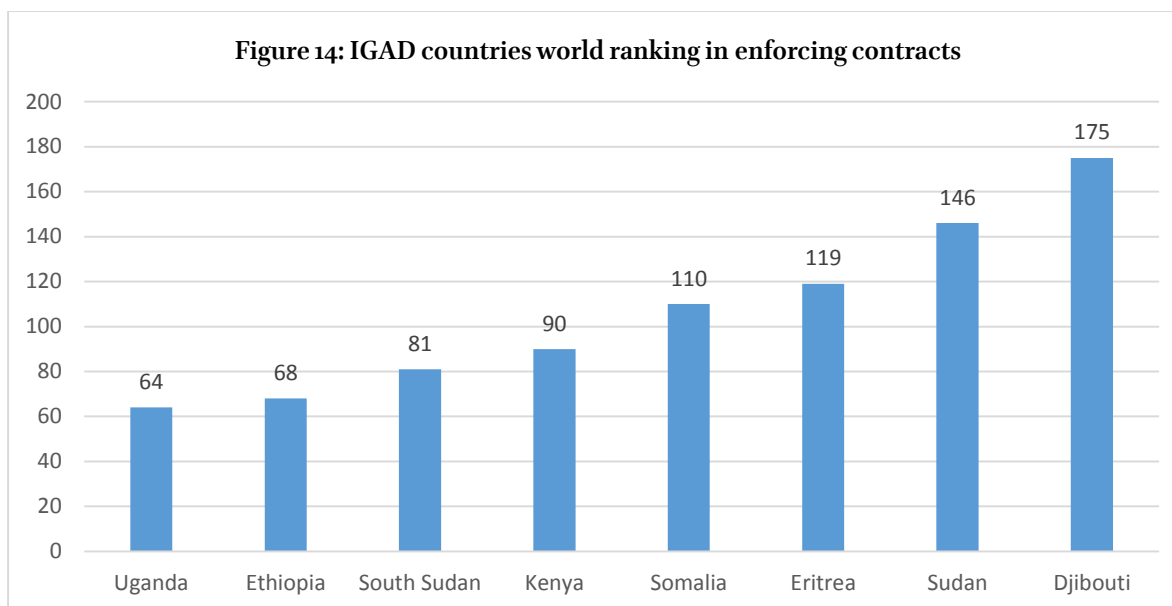
(i) IGAD's comparative regional standing in Ease of Doing Business

Regulatory environment is among key factors affecting the starting and operation of manufacturing industries. The World Bank makes annual rankings of countries based on aggregate scores of 10 topics: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. A country with a high ease of doing business ranking means that the regulatory environment is more conducive for starting and operating a business. Figures 13 and 14 below show IGAD countries' ease of doing business rankings in the world and in SSA. Among the countries in the region, Kenya, Uganda and Djibouti in their order are the better performing ones in ease of doing business.



Because the rankings are aggregate scores from a variety of doing business indicators, where some are most important than others for starting and operating a business, they may not necessarily be the best indicators of the relative performance of countries in promoting manufacturing. This warrants the need to look at the disaggregated indicators. Figure 14 below shows rankings of IGAD countries in one of the ease of doing business topics, i.e. enforcing contracts. Uganda, Ethiopia and South Sudan in their order are the three countries with the strongest regulatory environment regarding contractual enforcement.

⁹ The Hawassa industrial park inaugurated in 2017 was ranked first in the Middle East and Africa in job creation in the first half of 2017

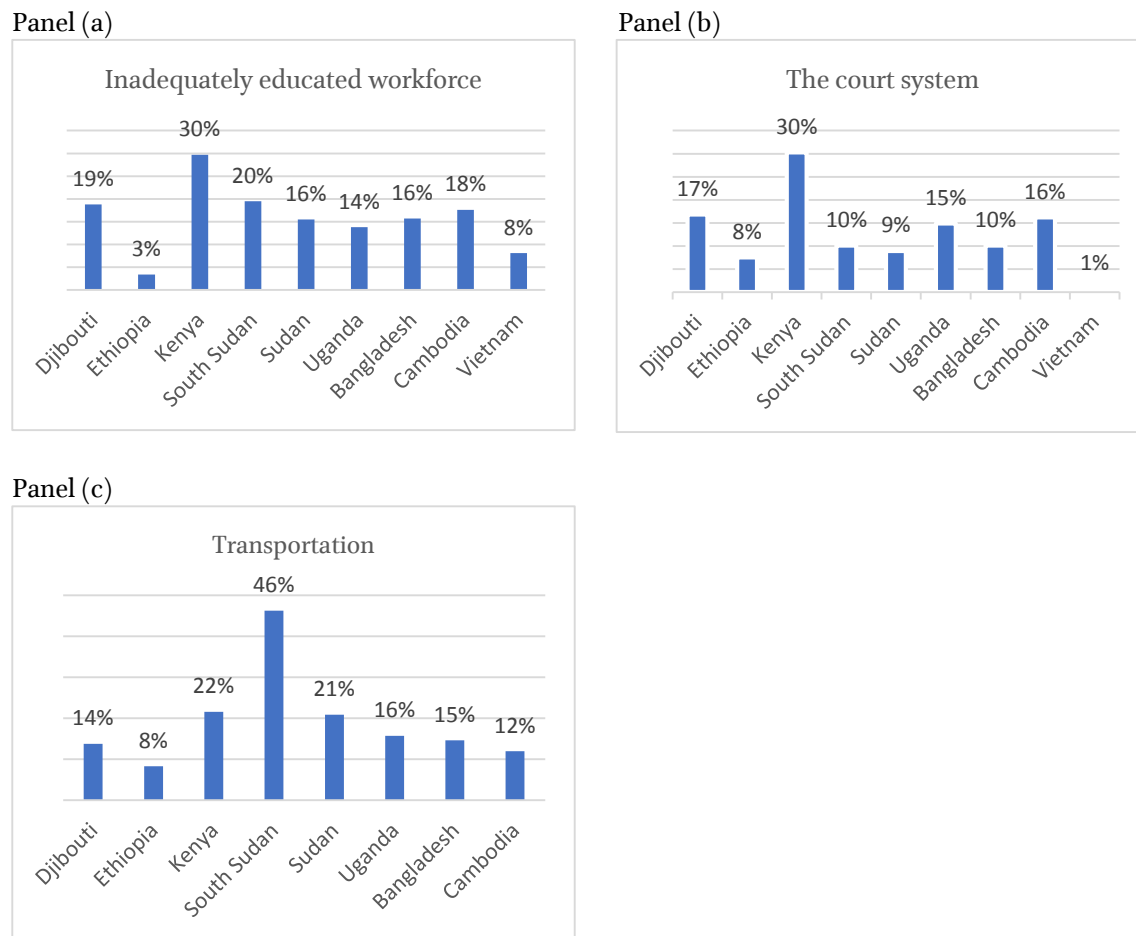


(ii) Constraints to manufacturing in IGAD vis-à-vis Bangladesh, Cambodia and Vietnam

Figures 15 and 16 below present manufacturing survey results on the challenges facing manufacturing firms in IGAD and selected Asian Countries. Figure 15 shows the proportion of firms identifying inadequately educated work force, the court system, or transportation as a major constraint. The three Asian countries, Bangladesh, Cambodia and Vietnam (hereafter Asian 3) are selected because they are developing countries and most importantly they compete with IGAD countries in attracting FDI in labor intensive industries, particularly from China (see Lin, 2011). Thus, the information from figures 15 and 16 tells us not only the current challenges facing manufacturing sector in IGAD but also how well countries in the region position themselves to attract FDI in labor intensive industries relative to their counterparts in Asia.

Panel (a) shows that IGAD countries are comparable to the Asian 3 regarding availability of educated workforce. In fact, inadequately educated workforce is much less of a problem for firms in Ethiopia than the Asian 3. Inadequately educated workforce is relatively more severe in Kenya, South Sudan and Djibouti among IGAD countries. Moreover, as can be seen from panel (b), almost one-third of the firms reported the court system as a major challenge in Kenya, while much less proportion of firms in Ethiopia, South Sudan and Sudan find the court system particularly challenging. Among the Asian 3, Vietnam performs exceptionally well in perception of firms about its court system. As rule of law is an important determinant of manufacturing investment both by local and foreign investors, IGAD countries, particularly Kenya, Djibouti and Uganda have to improve their judiciary system to build confidence on the side of investors. Panel (c) shows that transportation is a major challenge for considerable proportion of firms in many of the IGAD countries, most notably in South Sudan. However, some Asian 3 countries are not particularly well off compared to IGAD countries in transportation.

Figure 15: Percent of firms identifying inadequately educated workforce (panel-a), the court system (panel-b) and transportation (panel-c) as major constraints



Note: due to incomplete data overtime, the latest year, where data is available during 2013-2016 is selected for a given country.

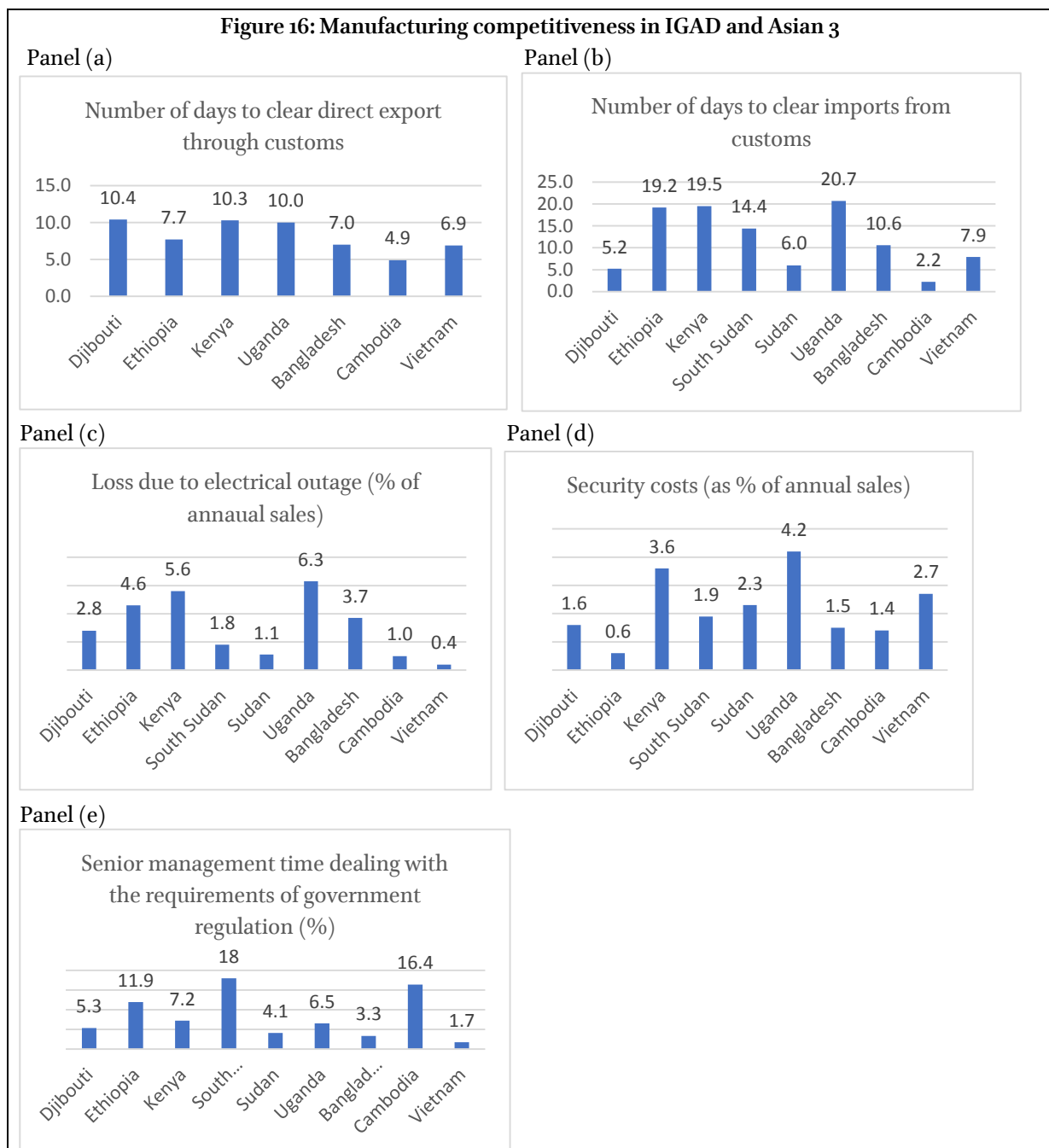
Source: World Development Indicators (2017)

Figure 16 below presents performance of IGAD and Asian 3 countries in manufacturing competitiveness using different indicators including efficiency in custom clearing, loss related to electric outage, security costs and government bureaucracy.

On average the Asian 3 are more efficient than IGAD countries to clear their exports through customs (panel a). Ethiopia performs relatively better in clearing its exports through custom. Again, the Asian 3 on average perform much better in clearing their imports through customs. It takes IGAD countries much longer to clear their imports through customs compared to clearing their exports. Custom clearing for imports is particularly lengthy in Ethiopia and Kenya (panel b). Given most of the raw materials are imported from abroad, this poses a challenge in timely acquisition of the required raw materials for firms to avoid underutilization of their capacity. Panel (c) shows the loss associated with electrical outage. On average, firms in IGAD incur a greater loss, as a share of their sales compared to firms in Asian 3. Firms in Uganda, Kenya and Ethiopia, in that order, incur greater loss as share of their sales. Improving manufacturing competitiveness in these countries entails a more reliable electricity supply.

Panel (d) shows that firms in the IGAD region incur larger security cost as a share of their annual sales compared to Asian 3 countries. However, firms in Ethiopia and Djibouti spend even less than two of the Asian 3 countries. Security costs are particularly severe in Uganda and Kenya. Security, being key determinant of investment, the two countries have to take the safety of their investors among their priorities.

Panel (e) reveals that many IGAD countries have more inefficient bureaucracy compared to that of Asian 3. Senior management of firms have to spend a large share of their time dealing with government requirements, particularly in South Sudan and Ethiopia. These two countries have to go a long way to reduce bureaucratic bottlenecks facing firms in their respective countries to increase their competitiveness. Other challenges include shortage of access to finance, foreign exchange shortage, low technology absorption, which cause underutilization of capacity.



Source: World Development Indicators (2017)

(iii) Narrow industrial policy scope, weak implementation, lack of direct government support

Industrial policy in IGAD has been narrowly defined and its implementation lacks coordination between different policy organizations. Industrial policy intervention has been mostly confined to the use of trade policy, and tax policy to support selected sub sectors based on endowment induced comparative advantage. However, industrial policy encompasses any policy affecting the sectoral composition of the economy and choice of technology (see Stiglitz, 2015). Hence, all aspects of public policy affecting structural transformation are industrial policy instruments. Among others, these include macroeconomic policy, land policy, financial policy, corporate governance, exchange rate policy, competition policy, and education policy. Reform in any of the above public policies should take in to account its potential impact on industrialization. The practice in IGAD countries is that the different public policy instruments are implemented separately to achieve certain objectives, without due regard to their impact on industrialization. For instance, the bank of Uganda has maintained interest rates high for a long time to achieve its primary target of fighting inflation. This makes investment in treasury bills by commercial banks attractive, leaving little fund available for lending to manufacturing investments particularly for SMEs, which constitute 90% of the firms (Shinyekwa et al, 2014).

Moreover, industrial policy in most IGAD countries tend to focus on sectors within the traditional boundaries of comparative advantage exploiting and developing domestic resource based industries. Focus on the narrow definition of comparative advantage will keep IGAD's manufacturing sector to be stuck in little value addition, limiting its potential for learning and technology spillover, thereby slowing structural transformation. Industrial policy in IGAD should facilitate latent comparative advantage based on learning. This requires encouraging the private sector to invest in new industries through risk sharing, providing cheap credit on a long term basis and alleviating other bottlenecks.

The national industrial policies of Kenya and Uganda emphasize that the government will only have an indirect support for the industrial sector by creating an enabling environment for the private sector to thrive. Uganda's national development plan (2010/11-2014/15) identified bottlenecks for firm level competitiveness across different sub sectors. The government's role is limited to alleviating these identified bottlenecks to enhance manufacturing competitiveness in general without focus on alleviating challenges for selected sub sectors based on potential for technology spillover to other sectors. Kenya's national industrial policy (NIP), which was drafted in 2007 identified priority sectors to drive the industrialization in the short, medium and long term (MoI, 2010). These include sub sectors both in resource induced comparative advantage such as agro processing as well as sub sectors with latent comparative advantage based on learning such as biotechnology, electrical and electronics as well as petrochemicals. The declared policy also planned to alleviate infrastructure bottlenecks weakening manufacturing competitiveness in general. However, the policy does not clearly indicate targeted intervention by the government to support specific sectors. The industrial policy of the two countries rely on the market forces to guide the industrialization process. However, without active government intervention to correct for market failure, the industrialization progress is likely to be very slow. Active government intervention is required for the following reasons:

- (i) Imperfect risk and capital markets. Even if investment in new industries has potential for technology spillover to other industries, the financial market provide little insurance for such risky investments. Likewise, accessing credit for such ventures is difficult or has very high borrowing costs. When risky

investments has a potential to spillover technology and knowledge to other sectors, government should design policies to mitigate under investment in learning. The experience of successful industrial policies in East Asia reveal that funding is provided for investments in R&D at commercial rates (Stiglitz, 2015).

- (ii) Structural transformation. Markets do not guarantee movement from agrarian to industrial economy by themselves. Risk and capital market intervention means that individuals who want to move from agriculture to industry need to be protected from external competition for certain period (stiglitz, 2015). Premature liberalization during the structural adjustment program destroyed Kenya's textile industry and kept Uganda's manufacturing small (Nguï et al, 2014).
- (iii) Limited resources to devote to manufacturing competitiveness. As long as the private gains vary from social returns, the market fails to allocate these limited resources efficiently. Hence, active government role in allocating these limited resources to strategically selected sectors is vital to speed up structural transformation. This has been shown successfully by the East Asian countries such as Taiwan and Korea.

Ethiopia's comprehensive industrial development strategy (IDS) designed in 2002/03 emphasizes an active role of government in guiding the industrialization process. The strategy outlines a two-way government intervention—creating an enabling environment for the private sector and making direct support for selected industries. These include maintaining macroeconomic stability, building a functioning and well-regulated financial sector, creating dependable infrastructure, developing skilled and effective human resources, creating an efficient civil service and legal framework, and developing industrial zones (Gebreyesus, 2013). The government also provided economic incentives (through tax, duty, credit and land), capacity building and direct public investment. The incentives were largely for exporting firms. The government provided extensive direct support for textile and leather sector which were identified as priority sectors during the PASDEP (2005/06-2009/10). To enhance the global competitiveness of the textile and leather sectors through capacity building, the government established the textile industry development institute (TIDI) and the leather industry development institute (LIDI). The government also provided additional support in benchmarking, twinning programs between TIDI and LIDI on the one hand and international technology institutes on the other. The Ethiopian government demonstrates a clear example of socializing risks to encourage the private sector to invest in priority sectors. Other countries in the region need to adopt a more direct support of the government for strategically selected industries.

Despite the extensive support from the government, the exports from both industries fell far short of the targets. A recent study by Gebreyesus and Demile (2017) have argued that the additional economic benefits provided to exporters compared to those who produce for the local market are too little to motivate them to export, especially given the anti-export bias in the economy. For instance, exporting firms in selected industries have only 2 more years of income tax exemptions, given they export 80% of their produce. This is hardly attractive, given the anti-export bias associated with logistics related extra cost.

On the contrary, the flower industry, which was not initially identified by the government as priority sector became a celebrated sector. It started with experimentation by few private entrepreneurs who recognized the potential, and sought support from the government. The government later learned the export potential

of the industry and swiftly responded to alleviate bottlenecks by providing access to land, access to long term and cheap credit through the development bank of Ethiopia (DBE), air transport, advocacy and capacity building. The quick government response to directly support the flower Led Ethiopia to be currently the second largest flower exporter in Africa, next to Kenya and fourth largest exporter in the world.

One important lesson from Ethiopia's industrial policy experience is that there should be flexibility and continuous updating of priority sectors through public private dialogue and research. Industrial policy should be flexible and open to learning. Another lesson is that active government support to enhance international competitiveness of strategic industries can bear fruit in other IGAD countries.

2.4. Prospects for Industrialization in the IGAD Region

Despite the challenges facing the manufacturing sector, there is a promising prospect for the IGAD region in revitalizing this sector and propel structural transformation. First, there is a growing recognition from governments in the IGAD region that industrialization is the only way to reduce unemployment and poverty in the most effective way. IGAD governments have also recognized that successful implementation of industrial policy depends on a strong political will and commitment at the highest echelons of government. This is clearly stated in the industrial policy documents of Ethiopia and Kenya for instance (See IDS, 2003; MOI, 2010).

Governments have also identified bottlenecks to the manufacturing sector in their respective countries and started taking action to alleviate these bottlenecks to enhance the competitiveness of the sector. To this end, national and regional infrastructure investments have been taking place recently. These include investment projects in roads, railway, power generation, SEZs, and ports among others. In what follows, we discuss selected national and regional infrastructure projects expected to enhance the competitiveness of the manufacturing sector in IGAD countries.

a) Ongoing and recently completed infrastructure projects

(i) Ethiopia

Ethiopia and Djibouti have built a 756 km long Standard Gauge and electrified Railway (SGR) which has been testing operations over the last year and is expected to be fully operational in November 2017. The largest proportion of Ethiopia's import and export transit via the port of Djibouti. The Addis Ababa-Djibouti railway will make access to the Djibouti port much faster, reducing the cost of imports and exports for manufacturing firms in the country. This is part of a 5,000 km-long railway nationwide railway network that will connect all regions of Ethiopia upon completion.

Transportation time is expected to be slashed from 3 days to 8 hours, with significant cost reduction in time in transporting containers. The country has also built 8 dry ports as of 2017 to reduce rental cost of containers at the port of Djibouti. Power production in Ethiopia has increased steadily in the last decade, with 99% sourced from renewable energy in the form of hydro power. Ethiopia has the second largest hydro power potential in Africa and the country is seeking to exploit this potential to support its industrialization. The Grand Ethiopian Renaissance Dam—the largest hydro power dam in Africa, being built on the Nile River, is expected to generate 6,000MW. This coupled with other small dams as well as wind power projects will help

the country to provide a far more reliable power supply to its manufacturing sector. The country has already the cheapest electricity in the world at US\$ 0.04/KWh (EIA, 2017).

Figure 17: Hawasa industrial park inaugurated in June 2017



Ethiopia has 7 operational industrial parks. Eight other parks are being built or will be commissioned in few months' time according to industrial parks Development Corporation of Ethiopia. Most of these industrial parks will be located along the planned 5,000km railway lines connecting the port of Djibouti and most parts of the country.

(ii) Kenya

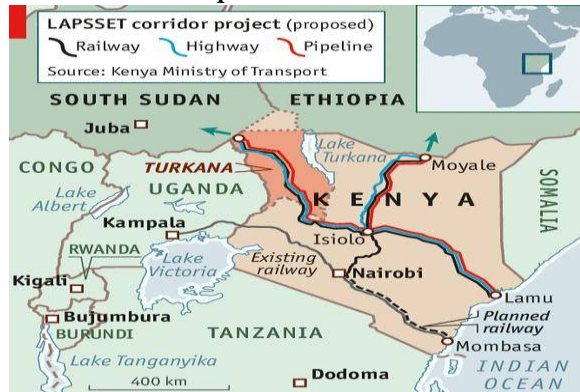
Kenya's vision 2030 includes construction of new roads and rehabilitation of existing roads. A standard gauge railway project constitutes development of a modern high speed, high capacity railway for passengers and freight within the northern corridor. It will have a speed of 80 kph for freight and 120 kph for passenger trains. The railway will stretch from port city of Mombasa to Rwanda's capital Kigali and South Sudan's juba. It creates an opportunity to run freight trains with 54 double stack flat wagons carrying 216 TEUs per trip (GoK, 2007). The Mombasa-Nairobi railway line was inaugurated in May 2017. The benefits include: reducing congestion at Mombasa port by providing fast efficient and reliable mode of transport; reducing transport cost of a container from KES 90,000 by road to KES 50,000 using the SGR; drastically reduce travel time and spurring industrialization.

The dredging of Mombasa port is one of the vision 2030 projects and is aimed at allowing access to post-panamex vessels to come to the port of Mombasa and to restore the designed water depths within the existing harbor. This will speed up the delivery of cargo to Kenya, Uganda, Rwanda, Burundi, DRC, Northern Tanzania, South Sudan, Ethiopia and Somalia.

One of the flagship projects is the lamu port and new transport corridor development to Southern Sudan and

Ethiopia (LAPSSET). The project constitutes the development of a new transport corridor from the new port of lamu through to isiolo where it branches to Ethiopia's Moyalle and South Sudan border. The transport corridor will have a highway, a railway line and an oil pipeline connecting the three neighbors.

Figure 18: Lamu port and a transport corridor to Ethiopia and South Sudan



Source: Kenya Ministry of Transport

capacity in infrastructure development through technology and skill transfer.

As a result of the project, travel time between moyale to Nairobi will be down from 3 days to 8 hours. There will be increased commodity supply to the region, increased market access to livestock from the region.

There will be crude oil pipeline from Juba to Lamu and oil pipeline from Lamu to Addis Ababa. The vision 2030 flagship projects include generation and distribution of 23,000 MW power from different sources, including geothermal, wind, hydro power, and coal energy.

(iii) Uganda

Uganda plans to build 273km long Standard Gauge Railway (SGR) project connecting Kampala with Malaba, at Kenya's western border. Within Uganda the SGR network will comprise three major routes with a total

Figure 19: Malaba-Kampala SGR



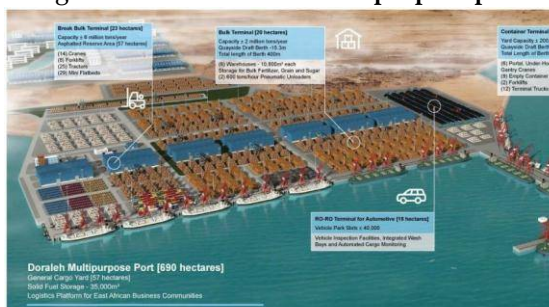
length of 1614km. the eastern route will connect Malaba and Kampala. The northern route will connect Tororo, Gulu, and Nimule, while the western route will connect kamala with Mpondwe at the DRC border.

The Kampala-Malaba railway line will be connected with Kenya's Mombasa port. According to SGR Uganda, the railway is estimated to reduce cost of freight from Mombasa by 69% from its current level of \$160 to \$50. The travel time will be cut to a single day from its current

level of 7-14 days. Connecting Uganda, Kenya, Rwanda, South Sudan, Burundi and DR Congo, the SGR will allow greater market access to Uganda's manufacturing products.

(iv) Djibouti

Figure 20: The Doraleh multi-purpose port



reduce Ethiopia's cost of import and export.¹⁰

Djibouti's Doraleh multipurpose port (DMP) was inaugurated in May 2017. DMP is a versatile port complex aimed at providing a world class logistics services. It will be linked to roads and railway lines. According to the Port of Djibouti, the DMP, when operational, will allow three times more efficient unloading of vessels. As the DMP will be connected to the Ethio-Djibouti railway network, it's expected to

b) Changing global environment with a potential to strengthen manufacturing

The IGAD region has the potential to attract FDI in labor intensive manufacturing from emerging economies that are graduating from labor intensive manufacturing. Firms and governments in emerging economies such as China and India are keen to expand FDI in developing countries, in search of global competitiveness. Chinese FDI is already growing in IGAD. It grew from USD 2.7 million in 2003 to USD 636 million in 2014 (HESPI, 2016).

More importantly, the shift in growth dynamics of emerging economies provide an opportunity for IGAD countries for industrialization. China is of a particular interest, because of its sheer size. After sustaining a high growth of nearly 10% per annum for more than three decades, the Chinese economy is undergoing a slowdown and rebalancing. China can no longer sustain growth mainly driven by manufacturing investment and export as it used to. This is because the surplus labor is vanishing in China and manufacturing wages are increasing. As was the case in other Asian countries such as Japan, Korea and Taiwan, China will have to upgrade its industrial structure to maintain a dynamic growth. As China moves up the industrial structure, it will leave enormous space at the lower end of the structure for developing countries to take over. IGAD countries should seize this opportunity and position themselves to take their fair share in the labor intensive industries.

China dominated the global market share in labor intensive industries in the year 2009 starting from a low base in 1976. But the dwindling surplus labor and rising wages in China will erode its competitive edge in such products. Dynamic growth for China requires relocating its labor intensive industries to low wage developing countries as Japan, did in the 1950s, Korea in 1960s, and Taiwan in 1980s. One of the potential destinations for Chinese FDI is the IGAD region.

With increasing demand for these products as well as the desire by Chinese firms to move to low cost production places, IGAD countries have a huge potential to increase their market share in labor intensive industries, thereby facilitating structural transformation and sustained growth.

To have a perspective of the potential benefit that could accrue to IGAD countries from relocating some Chinese labor intensive industries is higher. China has about 85 million manufacturing workers, mostly in

¹⁰ Currently over 90 % of Ethiopia's import and export is made via the port of Djibouti.

the labor intensive industries. In 2015 alone China earned USD 274 billion from textile and clothing export while IGAD exported just USD 989 million (WITS, 2017). Relocating 1% of China's export to IGAD countries will increase IGAD's export of textile and clothing by about 374%. This shows the significance in the potential gain for IGAD countries from China's industrial upgrading, which depends on how quickly IGAD countries formulate and implement a proactive industrial policy.

2.5. The Way Forward for IGAD Policy Makers and the International Community

The previous sections highlighted the challenges and prospects of the manufacturing sector and structural transformation in the IGAD region. Mitigating the challenges and turning the prospects into reality require effectiveness in designing and implementation of industrial policy in the region. In this context, the policy options for IGAD governments to support industrialization and speed up structural transformation are detailed.

IGAD governments shall identify areas of doing business that are more critical to investors and where they are performing particularly poorly. They shall undertake policy reforms in those areas to encourage starting up of new manufacturing as well as expanding the existing manufacturing investment.

Policy makers should focus on carefully identified key sectors that are aimed at sustaining growth and facilitating structural transformation. Identification of priority sub sectors shall be guided not just by endowment related comparative advantages but by potential for technology spillover to firms within the industry and outside the industry. These include sub sectors where the country have both revealed comparative advantages and latent comparative advantages that can be developed through learning, government direct support, risk sharing as well as temporary protection. Selection of sectors only based on endowment induced comparative advantages in agriculture and natural resource exploitation has kept industrialization stagnant. Empirical evidence shows that Japan, Taiwan and Korea are examples where the government supported industries they did not have comparative advantage (e.g. steel, automobile), while at the same time supporting comparative advantage sectors such as textile and shoes. Japan entered the automobile sector in the 1950s, Brazil the aircraft sector in the 1960s, and Korea the steel industry in the 1960s by taking leaps but succeed beyond expectation (Stiglitz, 2015). The lesson for IGAD countries is that they begin from light manufacturing and gradually as technology improves and through FDI facilitate production of high end manufacturing to enhance production capabilities and benefit from high value addition. When to leapfrog is not easy to answer, but there needs to constant monitoring of the domestic capacity and global situation to get the timing right.

Without government coordination and guidance, firms may enter in to too many different industries. Government coordination, facilitation and guidance helps to form clusters of related industries where backward, forward and horizontal linkages allow knowledge diffusion; where the government can pool limited resources. In IGAD countries, industrial policies should prioritize these sectors while spending resources to ease sub sector specific bottlenecks. Where industries are new to local firms, governments could encourage foreign firms to enter, as the later would be attracted by competitive advantage. As infrastructure is poor in IGAD countries, setting up SEZs or industrial parks will ease these bottlenecks.

The extent to which SEZs succeed as an instrument to catalyze long term industrialization depends on the level at which they are integrated with the domestic economy outside the zone. Gradually there needs to be

integration between firms in the zone and outside the zone by way of supplying raw materials and intermediate products. Comparison between south Korea and the Dominican republic on the role of SEZs indicate that while south Korea successfully transform its SEZs as a major market for locally manufactured capital and intermediate goods, SEZs in the Dominican Republic continue to import their inputs from abroad either because there were no domestic firms that could supply these inputs or because the inputs are of lower quality and did not have competitive price (Newman and Page, 2017). This example shows the necessity of treating SEZs within the context of a broader industrial policy framework rather than considering them as a standalone solution to sustainable industrialization. IGAD is a late comer in building SEZs compared to other regions including West Africa. However, many SEZs have been built in the IGAD countries since the turn of the millennium. Except in Ethiopia, SEZs are not progressing well, even after 5-10 years of operation in the four major performance indicators: FDI attraction, job creation, productivity spillovers, and exports (Newman and Page, 2017). FDI in to IGAD's SEZs is low compared to SEZs in Asia. While countries in Asia such as Vietnam and Bangladesh significantly increase their manufacturing exports after introduction of SEZs, this has not happened in IGAD and other countries in Africa. Employment performance of the SEZs in IGAD has also been limited.

Also, Industrial policy should coordinate broader public policy instruments beyond the traditional ones such as trade policy. Changes in other public policy spheres such as land policy, competition policy, corporate governance, financial policy, etc. should be seen in light of their effect on the performance of the manufacturing sector and structural transformation.

Moreover, Industrial policy should be open for continuous learning, and be flexible and responsive to private sector needs. There should be updating of the priority sectors based on changing global environment, getting feedback through public private forum and research on the countries latent comparative advantage. As discussed in Newman and Page (2017), one reason why industrial policy in Mauritius has been successful is that there is organized dialogue where the private sector has seats in many of the public organizations implementing industrial policy. Mauritius industrial policy organizations diversified investment sources after the financial crisis and continued to attract investment. On the other hand, Kenya's export processing zones authority made little changes and was not as successful in attracting investment. Moreover, the effectiveness of the incentive schemes should be continuously evaluated and revised. The lesson from export incentives in Ethiopia is that they are too little to motivate firms to export.

Assessment of the challenges reveal that firms in the IGAD region face challenges ranging from inadequately educated workforce, unreliable court system, limited transportation system, inefficient custom clearing, inadequate supply of electricity, significant security costs, and bureaucratic inefficiency, among other things. Specific challenges are particularly more severe in some countries than others as discussed earlier. There are ongoing efforts being made to alleviate these challenges, and governments need to beef up efforts to mitigate the challenges.

A globalized world means that IGAD countries can learn from successful industrial policies of other countries, especially Asia. There are success stories in SEZs, industrial park development. Also, donor support should focus on infrastructure and skill development relevant to manufacturing, institutional development for SEZs, investment agencies; development of firm capabilities; and regional economic infrastructure.

2.6. Conclusions

Manufacturing enhances overall productivity of the economy through technology spillover within and across sub sectors. As a result, a strong manufacturing sector is the most recognized pathway to higher per capita income. The development experiences of Japan, Korea, Taiwan and most recently China demonstrate the vitality of the manufacturing sector to transition from a low income to a middle income and then a high income country. In 1990, China had a lower per capita GDP than the IGAD average. In 2016, however, China's per capita GDP is five times larger than that of IGAD's average. China has lifted 270 million people out of poverty, is the world's top exporting country and has become the second largest economy in the world through infrastructure investment and manufactured exports. On the other hand, manufacturing sector in IGAD remains weak, and the share of manufacturing in most countries has either declined or remained stagnant for the last three decades, rendering little structural transformation in the region. As a result, poverty is still significant, unemployment is serious, and exports are vulnerable to global price volatility.

However, there is a renewed global and national interest in industrialization and strengthening the manufacturing sector in IGAD and other developing countries. Among the Sustainable Development Goals (SDGs), # 9 recognizes industrialization as key driver for sustainable development. Likewise, national development strategies of some of the countries in the region underscores the vitality of industrialization (the National Development Plan of Kenya and Uganda as well as the Industrial Development Strategy of Ethiopia). It's in this context that HESPI's flagship report devotes this year's thematic section to assess the challenges and prospects of the manufacturing sector in the region and indicates policy options for IGAD policy makers as well as development partners.

The size distribution of the manufacturing sector in IGAD countries reveal that the majority are of small or medium size. Those small and medium size firms account for more than half of manufacturing employment in Kenya and Uganda. In Ethiopia, however, large scale manufacturing firms account for more than half of manufacturing employment, although they represented less than one-tenth of the number of establishments during 2000-11.

The manufacturing sector in IGAD countries faces binding constraints including inadequately educated workforce, poor infrastructure, and poor customer clearance, shortage of finance and foreign exchange, and inefficient bureaucracy. The sector limited exports participation, which drives firm growth and productivity through increased market access and competition. Also, most firm in IGAD have weak organizational capacity—tacit knowledge and work practices that affect productivity and quality. Moreover, supply chain linkages in IGAD countries is very thin, limiting the prospect of productivity spillover through backward and forward linkages.

Industrial policy in IGAD has been narrowly defined and its implementation lacks coordination between different industrial policy organizations. In Kenya and Uganda, the governments offer indirect support by ensuring an enabling environment, unlike in Ethiopia where the government provides a direct support in building the capacity of selected sub sectors to enhance their global competitiveness.

Despite the challenges facing the manufacturing sector in IGAD, there are good prospects for the region to revitalize the sector. IGAD governments, particularly in Kenya, Uganda and Ethiopia have started to alleviate

bottlenecks in the manufacturing sector. National and regional infrastructure investment projects in road, railway, power generation, port developments and SEZs are taking place.

The changing global environment, particularly in Asia, also provides huge opportunity for IGAD countries to strengthen their manufacturing sector. Due to rising wages in China, labor intensive industries are looking for low cost countries to relocate. The IGAD region is a prospective destination for the 'flying geese' from China. This creates a huge opportunity for the region to enormously increase its manufacturing exports as well as increase employment. There is also unprecedented support from development partners to revitalize manufacturing in developing countries including the IGAD region.

To seize the opportunity for a stronger manufacturing sector in the region, IGAD governments should have a more active and direct role in pooling the limited resources they have to alleviate bottlenecks in carefully identified strategic sub sectors. Industrial policy should coordinate broader public policy instruments including land policy, competition policy, education policy, corporate governance, and macroeconomic policy. Industrial policy should also be responsive to private sector needs and changing global environment. Finally, donor support should corroborate regional governments' efforts in infrastructure and skill development relevant to manufacturing, capacity building of investment agencies, and development of firm capabilities.

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