



Quarter 3, 2014

7 October 2014

Highlights

- Global economic growth weak for the past three years, high divergences in advance economies and below long run growth levels in developing countries
- Sub-Saharan Africa grows moderately
- Economic growth in EAC buoyant; the EAC to sustain an average real growth rate of 6.5% for five years from 2014
- Investment in infrastructure, rebound of agriculture and buoyant service sectors remain key growth drivers in Sub-Saharan Africa
- Ebola outbreak key health risk in SSA if not contained rapidly
- Large budget deficits and high global financial market volatilities are potential sources of risks and vulnerabilities
- Inflation remains benign in the EAC at average of 5.7% annually; increase in food prices a source of short term spikes for some economies
- Yields on government securities remain very high across all EADB Member States on account of expansionary fiscal policy
- High fiscal deficits could be a source of fiscal instability in the EAC if not contained in the long run
- External markets remain stable with minor currency fluctuations and gradual depreciation on account of growing current account deficits

ECONOMIC PERFORMANCE AND OUTLOOK

Global Economy

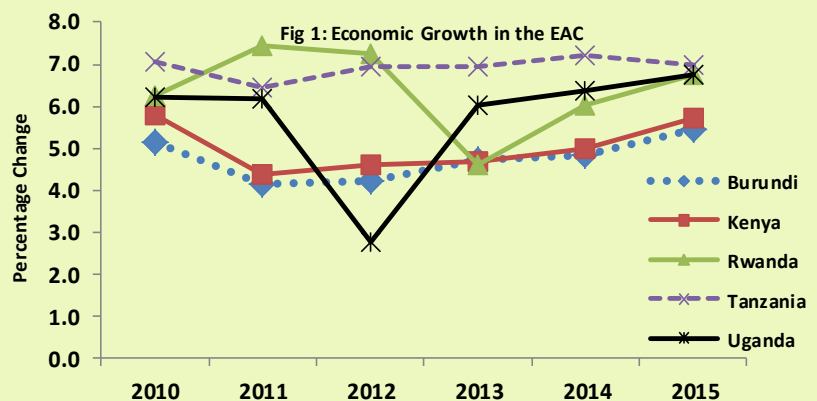
The pace of global economic growth has remained weak for the past three years with divergent trends in high income countries and below the long run growth level in developing and emerging countries (Table 1 in pp 3). The global economy has been growing at 3.3% for the past three years up until 2014. Growth is expected to pick up gradually through the fourth quarter of 2014 before reaching 3.8% in 2015. Worsening geopolitical tensions as well as potential for stagnant growth in both advanced and emerging economies pose major risks to global growth forecasts.

Economic Developments in Sub-Saharan Africa

Growth in Sub-Saharan Africa (SSA) is expected to expand by 5.1% in 2014, the same as in 2013 and is projected to increase by 5.8% in 2015. Infrastructure gap remains the major constraint to growth in most countries in SSA. Key drivers for growth include investment in public infrastructure, a rebound of agriculture and a buoyant services sector. The Ebola outbreak in West Africa is set to have an acute impact on the affected countries and if not rapidly contained, the risk of wider contagion grows with far-reaching social and economic consequences. Transport, cross border trade and supply chains could be severely disrupted should the disease spread beyond West Africa. Global financial market volatility and large budget deficits could also be a source of vulnerability and risks.

Economic Growth for EAC Partner States

Economic growth remains buoyant in East Africa (Fig 1) despite subdued global growth. For the past four years up until 2013 the EAC has been growing at an average of 5.5% annually as compared with the Sub-Saharan growth rate of 5.1%. In 2014, Growth is expected to average 5.9% for EAC Partner States.(cont. p2)



Source: EAC Member States Bureau of Statistics; EADB

ECONOMIC GROWTH FOR EAC PARTNER STATES

Burundi: Real GDP is estimated to grow at an average rate of 4.6% for the past five years up until 2014. Economic growth is estimated to accelerate to 4.8% and 5.4% in 2014 and 2015 respectively. Improvements in real GDP is mainly on account of improved agriculture particularly a rebound in coffee production and investment in major public infrastructure projects. Further regional integration within the EAC will spur investment into services sector particularly in wholesale and retail, finance and telecommunications. The IMF considers the macroeconomic outlook to be difficult due to intensification of election-related uncertainty, economic disruptions and violence, which

would affect investment and growth and employment pressures following reintegration of repatriated refugees. Governance issues or delays in making measurable pro-

GDP in Burundi to accelerate to 5.4% in 2015 with a rebound in agriculture and investment in infrastructure driving the economic growth; election related uncertainties and employment pressures could dampen growth prospects

gress in public financial management (PFM) reforms, and heightening of political tensions could curtail donor support. Protracted slow growth in the Euro area could cause a slowdown in economic growth. There is limited fiscal space for countercyclical policies should these risks materialize.

Vulnerabilities persist in the context of lower international coffee prices and potential inflationary pressure in the run-up to elections in 2015. Burundi is a small landlocked country with poor transport infrastructure and access to markets so it suffers increased costs of doing business. Households spend 50% of their income on food products, and half of these are imported.

ROBUST GROWTH FORECAST FOR EAC IN 2015

GROWTH IN EAC TO AVERAGE 5.9% IN 5 YEARS FROM 2014

Kenya: Economic conditions in Kenya continue to strengthen after modest growth for the past two years. The country overcame the challenges resulting from shocks related to slow global economic growth which affected Kenya's horticulture and tourism industry. Adverse weather curtailed growth in agriculture—the mainstay of Kenya's economy. Supported by a stable macroeconomic environment, improved supply of basic goods, lower cost of electricity, stable international oil prices and increased investor confidence, GDP is expected to

grow by 6.3% in 2014 as compared to 4.7% in 2013 and 4.6% in 2012. Below average rains in 2014 will constrain agriculture and hydroelectricity generation. GDP growth is expected to accelerate in 2015-18, at an annual average rate of 6.3% helped

Helped largely by investment in infrastructure, improvements in consumption, improved global conditions and increased regional trade Kenya is expected to grow by 6.3%; in 2015 continued security threats and adverse weather pose major risks to forecasts

largely by investment in infrastructure and private consumption, improvements in global conditions which will boost export demand, and increased regional trade. Security concerns and adverse weather remain major risks to growth prospects in Kenya. The performance of the tourism sector relies mainly on an improved security situation while the performance in the dominant agriculture sector depends on favourable weather. Continued security threats and drought may lead to less than forecast growth.

ECONOMIC GROWTH FOR EAC PARTNER STATES

Rwanda: Strong macroeconomic policies, good governance and a business-friendly environment contributed to growth in excess of 8% for 10 years until 2012. In 2013 Rwanda economic growth slowed to 4.6%, the lowest rate in a decade and well below the government's target of achieving an average growth rate of 11% in 2012-17. The growth target was missed mainly on account of contraction of the services sector. Growth is expected to

rebound to 6% in 2014 before reaching 6.7% in 2015 supported mainly by the con-

Growth to rebound to 6.7% in Rwanda supported mainly by construction sector and services sector; infrastructure remains major barrier to growth & manufacturing is constrained by strong regional competition

struction sector mainly through donor and government financed infrastructure

projects. The services sector will remain the fastest growing sector mainly in communications services and expansion in transport activities.

Infrastructure remains the highest barrier to growth. The manufacturing sector may be constrained by strong regional competition mainly from Kenya and high electricity prices. Downside risks include lower foreign aid and unfavourable weather conditions.

INVESTMENT IN PUBLIC INFRASTRUCTURE, A REBOUND IN AGRICULTURE AND BUOYANT SERVICES SECTOR KEY DRIVERS OF GROWTH IN EAC

Tanzania: Real GDP growth is estimated to reach 7.2% in 2014 which is slightly higher than the previous year, and higher than other EAC Partner States. Transport and communication infrastructure, financial intermediation and construction services are key drivers of growth.

It is expected that Tanzania will continue to enjoy steady and fast growth in the medium term. The outlook is for projected growth at the rate of 7% in medium term driven by investment in natural gas, strong private consumption, an expand-

ing services sector. Favourable monetary policy and im-

Tanzania continuous to enjoy fast and steady growth in the region with growth forecasted 7%; extractive and services sectors to drive the economy; while infrastructure deficiencies and irregular power supply remains major risks to growth prospects

proved power supply will support robust growth in the me-

dium term. Agriculture which is the main stay of the economy is expected to expand at less than 5% due to continued dependency on rain-fed agriculture while the services sector is expected to expand, rapidly driven by financial services and communications technology. The mining sector is expected to pick up in 2014 with the commencement of uranium mining. A major potential risk to the economic growth is likely to be irregular power supply that might be brought about by shortfalls in rain and inadequate infrastructure.

ECONOMIC GROWTH FOR EAC PARTNER STATES (cont. from p3)

Uganda: The pace of economic growth in Uganda will accelerate to 6.5% in 2014 up from 5.6% in 2013. A pick-up in GDP growth will be supported by improving confidence, an accommodative monetary policy stance and stable oil prices (supporting real disposable incomes). Domestic demand is also expected to benefit from a less restrictive fiscal policy stance in the coming years and from gradually improving credit supply conditions.

Overall activity will be increasingly supported by the favorable impact of strengthening of external demand on exports, albeit initially partly mitigated by the impact of the past appreciation of the effective exchange rate of the shilling.

Investment in infrastructure will be

key driver for growth from 2014. The 600MW Karuma dam whose construction is expected to commence in 2014 will likely double electricity production capacity. Oil

Growth expected to reach 7% in Uganda driven mostly by large infrastructure spending and strengthening demand; excessive Government expenditure could crowd out the private sector

production is expected to reach 100,000 barrels/day (b/d) in 2018 while the construction of a 60,000 b/d oil refinery is planned for financial year 2015/16. Uganda plans to invest USD 8 billion for the regional railway link with Kenya and Rwanda and more than USD 500 million

for roads infrastructure linking Kampala with major cities. Investment in infrastructure will provide a large economic boost and is expected to lift the real GDP growth to double digits by 2018.

Downside risks stemming from excessive government expenditure that may crowd out private investment. Foreign direct investments in the infrastructure sector and, in the long run, increased oil revenue may strengthen the Ugandan currency thus making manufacturing and agriculture exports less competitive (the Dutch disease syndrome). Drought and a slowdown in global economic growth could hurt agriculture production and exports.

Table 1: Economic Growth - World, Selected Regions and Countries (cont. from p1)

	Projections			
	2012	2013	2014	2015
World Output	3.4	3.3	3.3	3.8
Advanced Economies	1.2	1.4	1.8	2.3
United States	2.3	2.2	2.2	3.1
Japan	1.5	1.5	0.9	0.8
Euro Area	-0.7	-0.4	0.8	1.3
United Kingdom	0.3	1.7	3.2	2.7
Emerging Markets & Developing Economies	5.1	4.7	4.4	5.0
Middle East, North Africa, Afghanistan and Pakistan	4.9	2.5	3.1	4.8
Sub-Saharan Africa	4.4	5.1	5.1	5.8
EAC Partner States (Average)	5.2	5.4	5.9	6.3

PRICES AND MONETARY POLICY

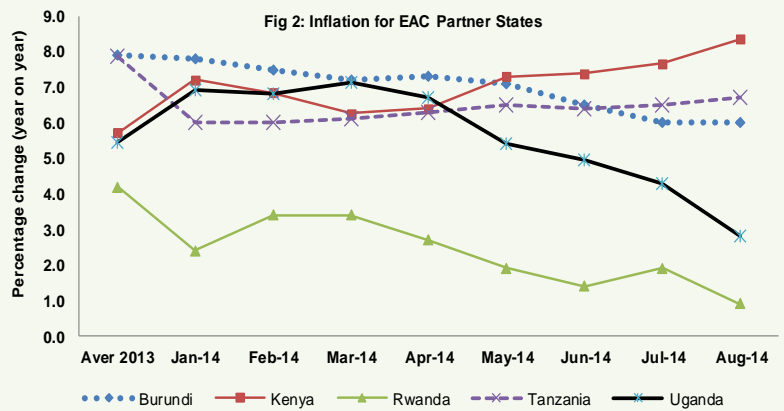
Inflation

EAC Partner States continued to enjoy low inflation throughout the period from January up until September 2014. The average inflation rate was around 5.7%, slightly lower than the 6.2% figure in 2013. Increased food prices explain the surge in inflation from the third quarter of 2013. In general, all Member States have maintained single digit inflation for most of the year. With low inflation, monetary authorities adopted loose monetary policies.

Kenya: Year-on-year inflation jumped to 7.3% in May 2014 and continued on an upward trend reaching 8.4% in August 2014, because of price rises for food, energy and transport. Inflationary pressure is expected to recede during the last three months of 2014 on account of monetary policy measures.

Inflation in **Rwanda** remains the lowest in the region. The inflation rate has not gone beyond double digits for more than four years. The average inflation rate for Rwanda in 2014 is around 2.3%. The lowest ever inflation was recorded in August 2014 at 0.9%. Inflationary pressure is expected to remain at less than 3% throughout the remainder of 2014 supported by low global food and oil prices. Loose monetary policy is unlikely to lead to inflationary pressure.

Tanzania: Inflation moderated to an average of 6.3% in



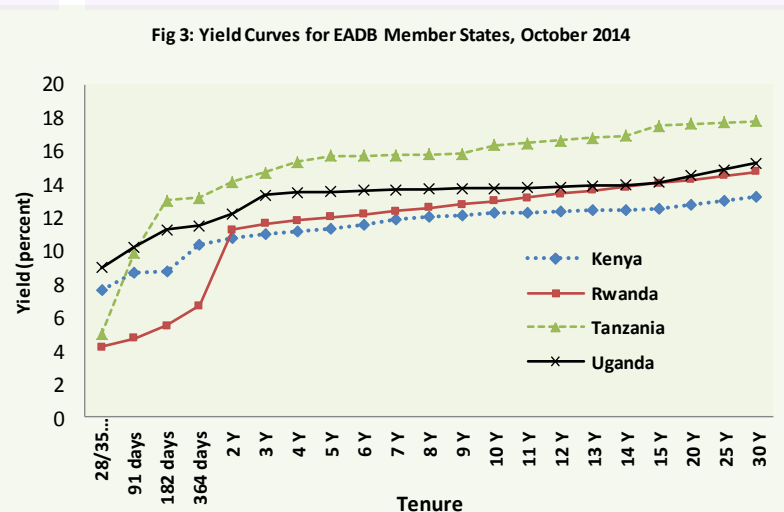
Source: EAC Partner States Bureau of Statistics; EADB

2014. The prospects for food inflation appear benign and core inflation remains subdued. Supply-side risks to inflation seem to be limited, in view of a strong harvest and stable global oil prices; the monetary stance is projected to contain demand pressures. Increase in electricity tariffs in January 2014 and a tax on beverages in the financial year 2014/15 as well as a weakening shilling have been key factors in rising inflation.

Uganda: After hitting a record high inflation rate of 30.5% in October 2011 the inflation rate has been decelerating ever since. The annual headline inflation declined to 2.8% year on year in August 2014, the lowest since 2010. Good weather has boosted the domestic harvest and lower global energy prices have subdued price pressure. Inflation will remain subdued towards the end 2014 before increasing slightly above 7% in 2015 as global commodity prices remain muted. Pre-election spending could push inflation to double digit in 2016 before easing from 2017.

Yields

Yields on government securities in East Africa remain very high across all Partner States. Fig 3 shows high yields for medium and long term government securities. As at October 2014 yield on 2-year Government Securities for Kenya, Rwanda, Tanzania and Uganda were at 10.74%, 11.25%, 14.12 and 12.2% respectively. Longer tenure securities have even higher yields with Tanzania experiencing the highest yields as compared to other countries. The yield on a 10-year bonds in Tanzania is 16.32% which is higher than a 30-year bonds issued in Kenya with a yield rate of 13.2%.



Source: EADB Member States Central Banks; EADB Estimates

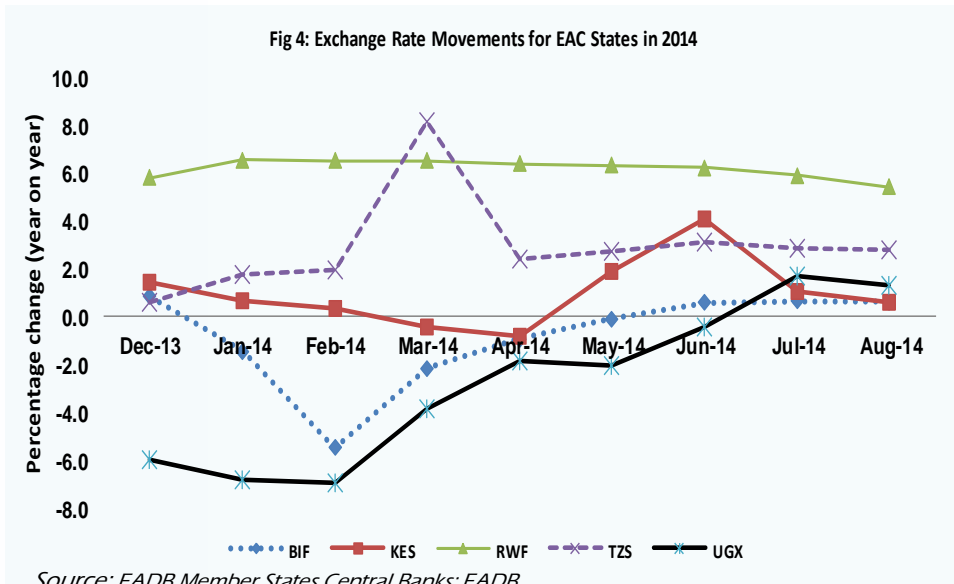
PRICES AND MONETARY POLICY (cont. from p.5)

Foreign Exchange Markets

Foreign exchange markets have remained stable across EADB Member States. The currencies have fluctuated mildly in 2014 (Fig 4). Monetary authorities in the EADB Member States have continued to maintain stability in foreign exchange markets in face of currency volatilities during the review period. The impact of widening current, fiscal deficit and foreign inflows will continue to weigh heavily on exchange rates across the EADB Member States.

Kenyan Shilling (KES): Significant year-on-year depreciation was experienced in June 2014 when the Kenyan shilling depreciated by 4.1% from the exchange rate in same period last year. Throughout the year the shilling has been depreciating gradually against the USD mainly on account of a downturn in the price of tea, the main export commodity, and weak tourism inflows because of terrorism threats and concerns on the potential spread of the Ebola virus to Kenya. While the Kenyan shilling remains vulnerable to global monetary tightening foreign exchange reserves would help to cushion the shilling and minimise volatilities in exchange rates. The Euro bond worth USD 2 billion, the ongoing donor financing and increased foreign direct investments are expected to increase reserves closer to 5 months of imports. The medium term outlook will see the shilling sliding further beyond the current average exchange rate of KES 87.07: 1USD for eight months period up until August 2014. Depreciation will be underpinned by current-account deficit and high inflation.

Rwandan Franc (RWF): The exchange rate market is stable with the Rwandan Franc consistently depreciating at an annual average of 6.3% year on year. The currency has highest year on year depreciation compared to other currencies in East Africa (Fig 4). While the depreciation of the Franc follows the decision by the monetary authorities to adopt flexible exchange rate regime from the pegged system, economic fundamentals remain key drivers for exchange rate depreciation. Lower than budgeted aid inflows and growing current ac-



count deficit impact negatively on reserves and foreign markets. The current account deficit is estimated to increase by 50% in 2014 as compared to last year. The Rwandan Franc is expected to continue sliding against the USD. It is forecast that the exchange rate will slide to an average of RWF685: USD1 in 2014. By the end of 2014 the rate will be around RWF 705: USD1 and by end of 2015 the exchange rate will around USD 746.50:USD1.

Tanzanian Shilling (TZS): The shilling remains stable over the years supported by aid inflows and tight liquidity. Gradual depreciation is expected over the years on account of deteriorating current account. The highest depreciation year-on-year was recorded in March 2014 at the depreciation rate of 8.2%. The average exchange rate is expected at TZS 1649: USD 1 for 2014. The shilling is expected to weaken further in the medium term as the wide fiscal and current-account deficits weigh on the currency.

Uganda Shilling (UGX): The first half of 2014 saw the Ugandan shilling appreciating significantly at an average annual rate of 4% with the highest year on year appreciation experienced in February 2014 when the currency appreciated by 7%. The appreciation was on account of increase in portfolio inflows and growing foreign direct investment. The currency started to lose ground against the USD from June, and by July the year on year depreciation was recorded at 1.7%. Gradual depreciation is likely to persist for three years as the fiscal and current account pressure outweighs the impact of steady economic growth and foreign inflows.

FISCAL SUSTAINABILITY

There has been an unprecedented increase in total budget across the East African Community Member States in the financial year 2014/15 as compared to year ending June 2014 or December 2013 for the case of Burundi whose financial year is aligned to the calendar year. The increase is from as low as 4.5% in Rwanda to as high as 35% in Uganda. Country specific analysis shows that the budget increase is sustainably matched, more or less with a proportionate with increase in domestic revenue for all countries with the exception of Uganda. While there is an increased effort to mobilize resources across EAC Countries, domestic revenues remain low as measured by the ratio of revenue to GDP with the exception of Kenya. All EAC Countries are running high fiscal deficits. (cont. next page)

FISCAL SUSTAINABILITY (from p.6)

While there is a decline in external aid across EADB Member states, dependency on aid remains high for Rwanda and Uganda and, to some extent, Tanzania. All EADB Member States are yet to attain the critical macroeconomic convergence criteria of fiscal deficit of less than 5% of GDP. There is a need for fiscal consolidation for Kenya and Tanzania to ensure that the growing debt burden does not compromise critical expenditures in infrastructure and the social sector in the medium to long term. The composition of public expenditure is highly skewed in favour of recurrent expenditure for most EADB partners, implying that more is being spent for consumer goods and services rather than on investment expenditure.

Country specific analysis below illustrates the above scenario and further reinforces the fact that while fiscal sustainability appears to be holding in the short to medium term, the current expansionary policy, if not supported by increased domestic revenue, could bring about fiscal instability in the long run and compromise the attainment of fiscal convergence criteria which is critical for sustainable development and successful monetary union within the EAC.

Kenya, the biggest economy in East Africa with a budget of USD 18 billion saw a budget increase of 16.7% from last financial year. Domestic revenue is estimated to increase by 15.5% during this financial year. Kenya has the most efficient tax regime in the region with a tax-to-GDP ratio of more than 25%. The domestic revenue as a percent of total budget excluding borrowing is equally the highest in the region at 75%. The proportion of external resources to the budget is the lowest at 13%. While indicators may point to a sustainable fiscal position, the fiscal deficit to GDP ratio excluding grants is estimated at 8%. Kenya has the highest debt to GDP ratio currently estimated at 52% against the IMF benchmark of 50%. Increasing public debt could pose the potential risk of debt distress in the long run.

In **Rwanda** while the total budget increased by 4.5%, the annual increase on domestic revenue more than quadrupled. The domestic revenue to GDP ratio is currently at 17.2% and is improving over time. While these are very positive developments, Rwanda still has a high donor-dependent budget. The total domestic revenue as a percentage of total budget is the lowest at 52.6% while external resources as percentage of total budget are the highest at 38%. The flow of aid to Rwanda in the past contributed to its low debt levels currently estimated at less than 30% of GDP, the lowest as compared to other EADB Members.

There is sustainable positive development in **Tanzania**. Domestic revenue is projected to increase by more than 25% as compared to budget increase of 16%. The ratio of domestic revenue to GDP currently at 20% is improving over time. But external aid and grants as percentage of total budget is still higher at more than 20%.

Uganda has the highest annual budget increase at 35% as compared to a 21% increase in domestic revenue. The total budget to GDP is, at 14.4%, the lowest in the region. Total domestic revenue excluding borrowing is around 60%. More than 31% of revenue is financed by external resources in form of aid and grants. Uganda's public debt remains low at 35.7% of GDP but fiscal deficit before and after grants remains high at 9.3% and 7.7% of GDP.

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