

East Africa Economic Outlook 2021

Debt Dynamics:
The Path to Post-COVID
Recovery



AFRICAN DEVELOPMENT BANK GROUP



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EXECUTIVE SUMMARY

This report reviews the economic performance of the 13 countries under the African Development Bank's East Africa Regional Development and Business Delivery Office: Burundi, Comoros, Djibouti, Eritrea, Ethiopia, Kenya, Rwanda, Seychelles, Somalia, South Sudan, Sudan, Tanzania, and Uganda.

East Africa is the only region in Africa that avoided a recession in 2020, thanks to better performance in agriculture, sustained public spending on large infrastructure projects, and increased regional economic integration. But political fragility in some countries and limited economic diversification in others were major impediments to growth. East Africa's GDP growth is projected to recover to 3.0 percent in 2021 from 0.7 percent in 2020, supported by the global economic recovery. However, the slow rollout of COVID-19 vaccines and risks of spikes in infections could dampen that outlook.

East Africa is experiencing a progressive change in the composition of GDP, from predominantly agriculture to services. But the transition to higher value-added economic activities—which signals structural transformation—has been slow.

COVID-19 has had diverse impacts across the region. Countries highly dependent on tourism (like Seychelles) have been hit hardest. Countries that are more diversified (like Kenya) have experienced fewer adverse impacts. And commodity exporters (like Tanzania) have been slightly more resilient due to rising prices for commodities, particularly gold.

East Africa's fiscal deficits widened in 2020 as a result of increased public spending in response to COVID-19 amid falling domestic revenues, as domestic containment measures and disruptions in global supply chains took a toll on the region's economies. Still, fiscal deficits were lower than in other regions of the continent (except Central Africa). Similarly, current account deficits widened as exports fell during the pandemic. Monetary policy was accommodative to support the economic recovery and inflation remained stable and in single digits in 10 of the region's 13 countries—reflecting moderating food inflation and lower energy inflation.

COVID-19 could hold back progress on reducing poverty in East Africa. The pandemic has had sharper impacts on the poor, with the number of people falling below the poverty line projected to increase. COVID-related shocks have increased poverty in the region, with the share of people living in extreme poverty rising to 35 percent in 2021, or 134.3 million human beings. All told, COVID-19 caused 12.3 million people in the region—3.4 percent of the 2019 population—to fall into extreme poverty.

Several East African countries have implemented measures to mitigate the impacts of the pandemic, including emergency responses to strengthen healthcare, fiscal and monetary policy stimulus packages to support economic activity, and increased social spending to protect vulnerable livelihoods and groups. Other measures have included rationalizing nonpriority spending to create fiscal space as revenues fell and rescheduling debt service obligations to free up

resources. These policy measures have helped most of the region's countries avoid sliding into recessions. They have also helped reduce the number of vulnerable populations falling into poverty. But long-term strategies—like establishing industrial clusters to accelerate structural transformation and diversification—are needed to consolidate the short-term gains achieved through the policy measures.

This report focuses on the dynamics of public debt in East Africa. In recent years the region's public debt has risen, driven by a slowdown in real GDP growth, substantial nominal exchange rate depreciations in countries with a large share of foreign currency debt, emergency spending measures in the health sector, and reduced inflows of commodity revenues.

East Africa's external public debt, like that in many African countries, has become more market-based and less concessional—increasing rollover risks because reduced foreign currency reserves, high interest expenditures relative to revenues, and limited refinancing access to international markets pushed several countries to enter the high risk of debt distress. Many of the continent's most indebted economies are in East Africa, including three in debt distress.

To stabilize public debt, countries must deal with debt related to state enterprises and contingent liabilities, clear domestic arrears, and improve debt governance and transparency. In addition, increased nondebt equity or donor-funded capital, along with innovative financing instruments and risk-sharing tools, must be explored to combine funding for East Africa's development needs.

A mix of policy interventions is needed to accelerate East Africa's recovery and build post-COVID resilience, including procuring COVID-19 vaccines and rolling out mass vaccinations across the region; designing and implementing economic stimulus packages and post-COVID recovery strategies in the context of credible fiscal consolidation programs; strengthening debt management and institutional capacities; accelerating structural transformation through digitalization, industrialization, and diversification; and consolidating peace, security, and stability in the region.

CHAPTER 1

RECENT MACROECONOMIC TRENDS AND DEVELOPMENTS

Key messages

- East Africa is the only region in Africa that avoided a recession in 2020. This outcome was due to strong performance in agriculture, which was the main driver of growth, and sustained public spending on large infrastructure projects. But political fragility in countries like Burundi and South Sudan as well as limited within-sector diversification were major hindrances to growth. East Africa's GDP growth is projected to recover to 3.0 percent in 2021 from 0.7 percent in 2020, supported by the global economic recovery. But the slow rollout of COVID-19 vaccines and uncertainties about the spread of subsequent waves of infections may dampen the outlook.
- East Africa is experiencing an economic transformation from mainly agriculture-based to more service-oriented activities. But the transition to higher value-added activities that marks structural transformation has been slow, and some countries in the region are experiencing deindustrialization.
- COVID-19 has had heterogeneous impacts across the region, with countries highly dependent on tourism—like Seychelles—experiencing the most severe impacts, while countries that are relatively diversified—like Ethiopia and Kenya—experiencing fewer adverse impacts. Commodity exporters like Tanzania were slightly more resilient due to rising commodity prices.
- In 2020 East Africa's fiscal deficits widened due to falling domestic revenues as lockdowns took a toll on the countries' economies. Still, deficits remained lower than in Africa's other regions. Similarly, current account deficits widened because exports fell during the pandemic. Monetary policy, on the other hand, was accommodative to support economic recovery. Moreover, inflation remained stable and in single digits in 10 of the region's 13 countries thanks to moderating food inflation and lower energy inflation in the first quarter of 2020.
- COVID-19 could slow progress on reducing poverty in the region. The pandemic has had heavier impacts on poor people, with the number of those falling below the poverty line projected to increase. The share of East Africans living in extreme poverty rose to 35 percent in 2021, equivalent to 134.3 million people. Some 12.3 million people in the region—3.4 percent of the 2019 population—drifted into extreme poverty due to COVID-19 and its aftermath.
- Several countries in the region implemented measures to mitigate the impacts of COVID-19, including emergency responses to strengthen the health sector, policy (fiscal and monetary) stimulus packages to support economic activity, increased social spending to protect vulnerable livelihoods, rationalization of nonpriority expenditures to create fiscal space as revenues fell, and rescheduling of debt service obligations to free up resources. These policy measures helped most of the region's countries avoid recessions. They also helped reduce the number of vulnerable people falling into poverty. But long-term measures are needed to cement the short-term gains achieved through the policy measures.

East Africa showed great resilience despite the devastation caused by the COVID-19 pandemic (box 1.1), and was the only region in Africa that escaped a recession in 2020. The region grew 0.7 percent in 2020, compared with the continental average of –1.8 percent (figure 1.1). All the other African regions went into recessions in 2020, with Southern Africa recording the worst performance of –6.3 percent, down from 0.3 percent in 2019 mainly due to spillovers from weak growth in South Africa to other countries of the region. East Africa’s resilience was supported by strong growth in Djibouti, Ethiopia, Kenya, and Tanzania, which recorded positive growth supported by more diversified services sectors and sustained public spending on large infrastructure projects. The pandemic had more adverse effects on countries highly dependent on tourism or that have less diversified services sectors, as well as fragile countries.

Political fragility, climate change, and limited economic diversification in some of the region’s countries remain a major source of vulnerability. East Africa is home to some of Africa’s most fragile countries—including Burundi, South Sudan, and Sudan—which have limited revenue bases and are vulnerable to external shocks like COVID-19. Furthermore, several economies in East Africa—including Comoros, Seychelles, South Sudan, and Sudan—are heavily dependent on single commodities for export, exposing them to changes in global market conditions for these commodities. East African countries have also experienced extreme weather events (such as droughts, floods, and erratic rainfall) due to climate change, affecting key sectors such as agriculture, which remains the main source of livelihood for most of the region’s population.

This chapter has five sections. The first discusses East Africa’s macroeconomic performance and prospects, the second analyzes the region’s macroeconomic fundamentals, and the third the region’s socioeconomic outcomes. East Africa’s medium-term outlook and the associated risks are assessed in the fourth section, and brief policy recommendations are provided in the fifth.

1.1 MACROECONOMIC PERFORMANCE AND PROSPECTS

The global economy is expected to recover in 2021—supported by the rollout of COVID-19 vaccines and improving prices for oil and nonoil commodities—but the speed of vaccine uptake and the strength of policy actions to support the recovery might affect that outlook. The global economy went into a recession in 2020 following lockdowns in many countries to contain COVID-19. Global economic growth is projected to recover to 6.0 percent in 2021 and 4.4 percent in 2022 as more people get vaccines, after contracting 3.3 percent in 2020 (IMF 2021b).

Strong economic stimulus packages have helped mitigate the impacts of COVID-19 in many countries—particularly advanced ones such as the United States, where the \$1.9 trillion American Rescue Plan was approved in March 2021 after a \$483 billion fiscal package in April 2020. In April 2020 Japan rolled out a universal cash transfer program that provided households with about \$83 billion in support. But the discovery of new strains of the virus and an imminent third wave of infections are raising possibilities of renewed lockdowns in 2021, which could dampen the growth outlook.

Other global factors likely to shape the global outlook for 2021 include rising commodity prices, which are likely to fire growth in many commodity-producing countries and help fill the revenue gaps caused by COVID-19. Brent crude oil prices rose steadily between July 2020 and July 2021, from \$43.24 to \$75.17 a barrel. The rise in oil prices was boosted by the pickup in transport demand as lockdowns eased across the globe, rollout of COVID-19 vaccines from December 2020 (which increased hope for the end of the pandemic), reduction of U.S. shale production and inventories, and cuts in oil production by Saudi Arabia in February 2021. Prices of nonoil commodities, including metals, are also expected to rise in 2021 and support the recovery. The speed of rollout of COVID-19 vaccines will determine how quickly economies reopen and the global recovery accelerates. The quantity of

the vaccines produced is not yet sufficient to cover large swaths of the world's population. In addition, reluctance and safety concerns about some of the vaccines might slow their uptake.

Emerging and developing countries are projected to record the strongest growth in 2021, at 6.7 percent in 2021—up from –2.2 percent in 2020—driven by growth of 8.4 percent in China and 12.5 percent in India, though that outlook may be affected by the outbreak of the third wave of the pandemic in India in 2021. Both countries instituted strong fiscal and monetary policy support and containment measures. Other emerging and developing countries will face a slower easing of cross-border travel and trade restrictions, which may affect the outlook.

Advanced economies, on the other hand, are projected to grow by 5.1 percent in 2021 compared to –4.7 percent in 2020, supported by faster rollout of the vaccines to larger portions of their populations and stronger fiscal and monetary policy support to their economies to aid the recovery. Strong recoveries are projected in Canada, France, Spain, the United Kingdom, and the United States, which are expected to record growth rates above 5 percent in 2021.

The recovery in the global economy is expected to support the recovery in East Africa as more trade routes reopen and increased global demand boosts exports from East Africa to the rest of the world.

1.1.1 Africa's growth was more resilient in 2020, but subsequent waves of infections and new COVID-19 strains will likely weaken the outlook

The continent went into a recession in 2020, with real GDP growth contracting 1.8 percent (see figure 1.1), down from 3.3 percent in 2019, mainly due to disruptions in global supply networks, falling revenues, and increased social spending to mitigate the impacts of COVID-19. East Africa led the continent's regions and was the only region that did not go into a recession in 2020 due to better performance in agriculture, sustained public spending on infrastructure projects, and increased regional economic integration. Southern Africa, on the other hand, went into a recession mainly due to spillovers from South Africa, which was severely affected by the pandemic and instituted long lockdowns, weakening its growth to –7.0 percent in 2020 (down from 0.2 percent in 2019).

Africa's oil-importing countries experienced a steeper recession of –2.5 percent in 2020 compared with oil-exporting countries' –1.2 percent. Rising oil prices helped oil exporters recover some revenues lost in services. Similarly, tourism-dependent countries experienced a contraction of –11.5 percent in 2020 as travel restrictions took a toll across the continent, with Mauritius (–15.0 percent), Seychelles (–12.0 percent), and Cabo Verde (–8.9 percent) experiencing the sharpest declines.



Figure 1.1: GDP growth in Africa and its regions, 2017–22



Source: African Development Bank statistics.

Note: Data are estimates for 2020 and projections for 2021 and 2022.

East Africa will cede its position as Africa's leader on growth to North, Central, and Southern Africa in 2021 and to North Africa in 2022 due to the strong recoveries expected in those regions, supported by rising oil prices and rebounds in tourism arrivals in tourism-dependent countries (see figure 1.1). A third wave of COVID-19 infections, which is already sweeping the globe, has not spared the continent. Countries like Kenya and South Africa have introduced a second phase of partial lockdowns to curb the spread of this third wave. These lockdowns are expected to weaken the outlook for 2021 and 2022 as economic activity, public revenues, and export performance could slow.

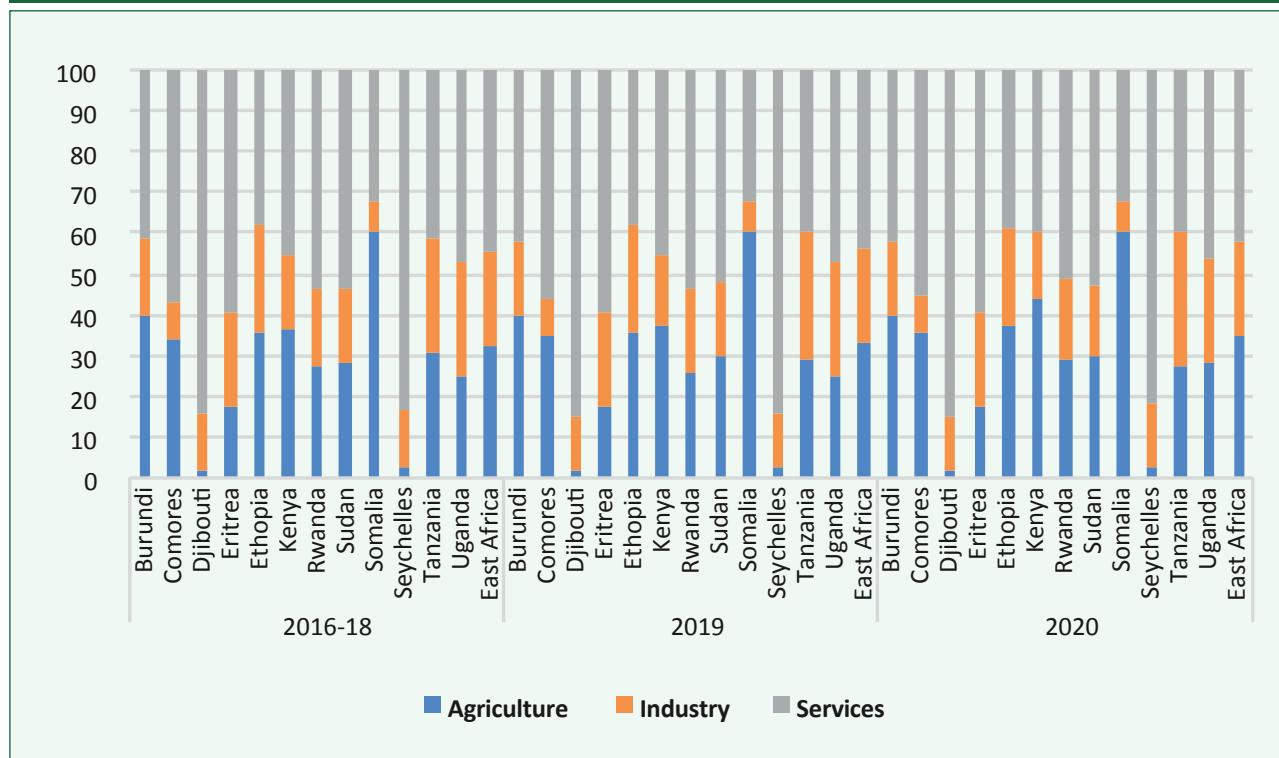
1.1.2 East Africa's economic performance was held back by COVID-19, and the outlook reflects a partial recovery

East Africa's economies are dominated by services, though their share of economy activity has recently declined. In 2020

the service sector's share in East Africa's economy was 42.4 percent, followed by 34.8 percent for agriculture and 22.8 percent for industry (figure 1.2). But the share of services in the region's economy was lower in 2019–20 than in 2016–18. The dominance of services in the region's economy is due to the expansion of information and communications technology (ICT), particularly internet penetration, which has enabled innovations like mobile payments.

East Africa leads other African regions in internet-based transactions, which include the pioneer mobile payment service M-PESA in Kenya, internet banking, and e-savings, all of which have expanded financial services, retail trade, and communications. Ethiopia's efforts to liberalize telecommunications will have important implications for regional trade and financial integration, especially in the context of the African Continental Free Trade Area (AfCFTA) agreement. A consortium led by Safaricom of Kenya won a bid for the country's first private-use license in telecommunications.

Figure 1.2: Sectoral contributions to nominal GDP (at basic prices) in East Africa by country, 2016–20 (Percent)



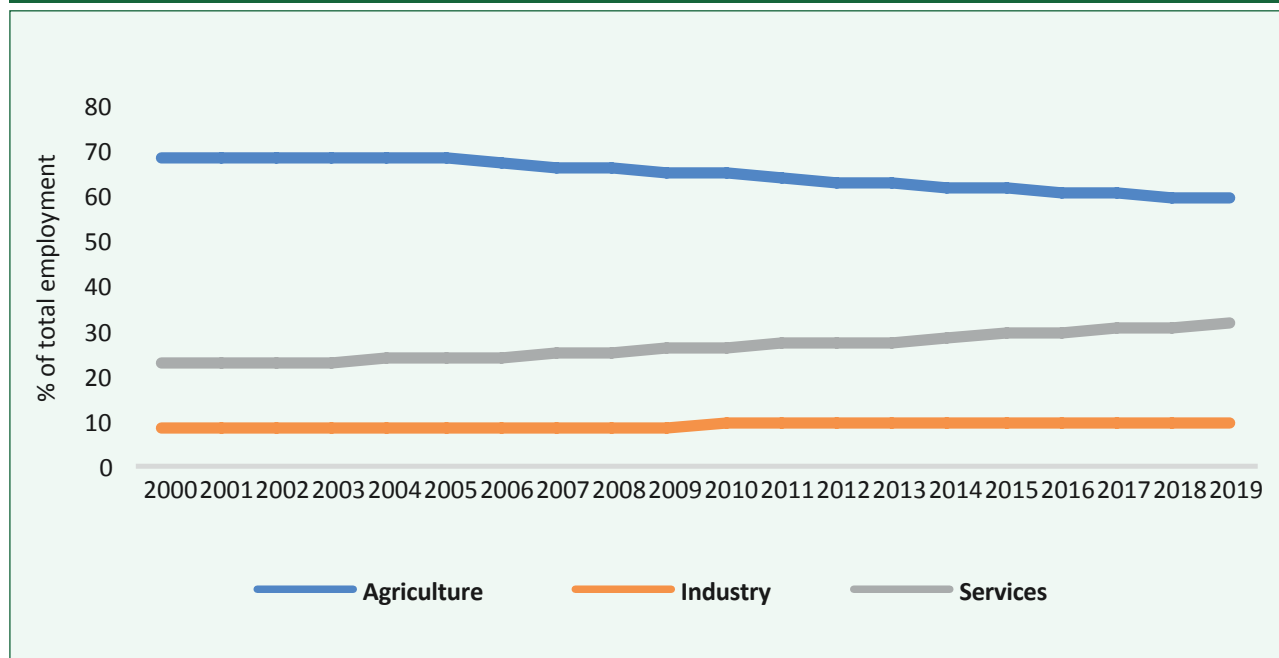
Source: African Development Bank statistics.

Note: Data for 2020 are estimates. Data are not available for South Sudan.

Consequently, East Africa has experienced progressive economic transformation, even though some countries have stagnated on industrial progress. Employment in agriculture in the region fell from 68.8 percent in 2000 to

59.0 percent in 2019 as workers have sought better opportunities in the other sectors—partly driven by increasingly deteriorating productivity in agriculture (figure 1.3).

Figure 1.3: Economic transformation in East Africa by sector, 2000–19
(Percentage of employment)

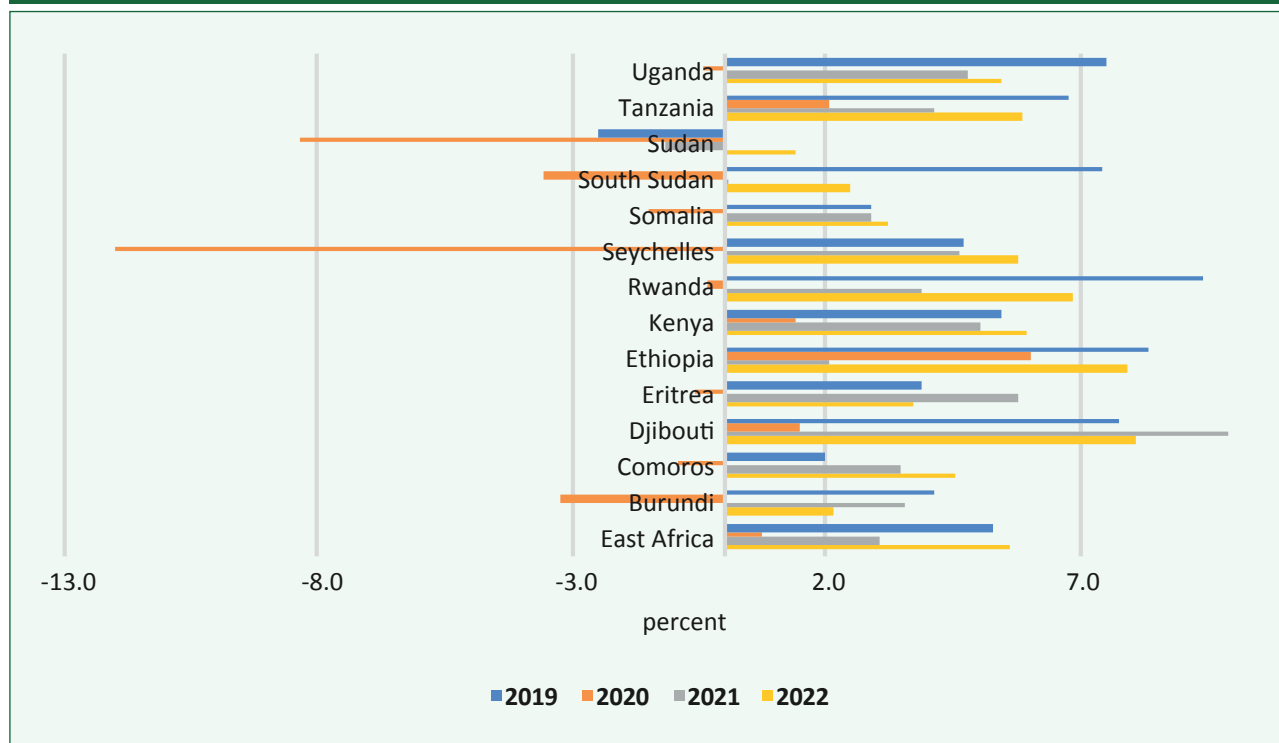


Source: African Development Bank statistics.

Industry has been attracting labor, mainly from agriculture—but not as much as services, where employment increased 37.5 percent between 2000 and 2019. But this general trend does not hold for fragile countries in the region, including Eritrea and South Sudan, both of which have experienced stagnation in industrial progress in the recent past due to political instability and macroeconomic imbalances, respectively. In South Sudan employment in industry (as a percentage of total employment) fell from 18.9 percent in 2013 to 16.4 percent in 2019.

Though East Africa avoided a recession in 2020, inadequate economic diversification in some countries remains a key impediment to growth. While East Africa grew by an average of 0.7 percent in 2020, there were significant differences by country. Countries suffering from political instability and those more dependent on tourism were hit hardest by COVID-19. Seychelles, highly dependent on tourism, went into recession in 2020, with the economy contracting 12.0 percent from 4.7 percent growth in 2019 (figure 1.4).

Figure 1.4: GDP growth in East Africa by country, 2019–22 (Percent)



Source: African Development Bank statistics.

Note: Data are estimates for 2020 and projections for 2021 and 2022.

Burundi, Somalia, South Sudan, and Sudan also experienced weak economic performance for several reasons including political instability, limited within-sector diversification, and (in Burundi) declining external financing of the budget. Burundi's agricultural sector, which had already been weakened by climate conditions, was also affected by the difficulties of obtaining agricultural inputs, particularly during the second quarter of 2020.

By contrast, Djibouti, Kenya, and Tanzania—all of which

recorded positive growth rates—are more diversified and enjoy relative political stability. Ethiopia, which also recorded positive growth, is also relatively more diversified and enjoyed relative political stability until recently. Positive growth in those countries was also as a result of high public spending on large infrastructure projects including rail, energy (large dams), road and port infrastructure, with Kenya and Tanzania constructing Standard Gauge Railway lines, Djibouti building rail and port infrastructure, and Ethiopia developing a dam and roads.

Box 1.1: Economic and social impacts of COVID-19 in East Africa

COVID-19 has had unimagined effects on economic and social development. The economic impacts have been transmitted through changes in travel and tourism, commodity prices, trade, and foreign inflows including foreign direct investment and remittances. The social impacts have been felt through in education, health, poverty and inequality.

Travel and tourism. COVID-19's most consequential economic impact, particularly for tourism-dependent countries, was a significant drop in tourism as countries locked down and closed borders to contain the virus. As a result, tourism receipts plummeted, causing massive job losses as businesses closed or scaled down operations in the sector. Travel restrictions also disrupted global supply chains, affecting both demand and supply. For example, demand for oil, conference facilities, and accommodations fell at the start of the pandemic as travel declined and public gatherings were limited, while supply of raw materials for industrial production declined—leading to higher prices and inflationary pressures. Job losses have increased the number of people living in poverty.

Commodity prices. At the onset of the pandemic the slowdown in global demand and travel weakened demand for oil, leading to a fall in oil prices and an increase in the prices of other metals (including gold) as investors sought safe havens. Brent crude oil prices tumbled to \$9.12 a barrel in April 2020. But that month's agreement by the Organization of Petroleum Exporting Countries (OPEC) countries to cut production, the easing of lockdowns around June 2020, and the prospect of COVID-19 vaccines buoyed the market, leading crude oil prices to rise to \$48.73 a barrel by December 2020. Prices of gold, on the other hand, rose from an average of \$1,392.5 per troy ounce in 2019 to \$1,770.3 in 2020. These price movements had different implications for net oil importers like Kenya, which benefited from lower oil import bills in the first half of 2020, and gold importers like Tanzania, which saw the share of gold in merchandise exports increase from 41.2 percent in 2019 to 46.0 percent in 2020.

Trade. With reduced global demand, prolonged containment measures, and employees working from home, many businesses experienced reduced liquidity, profits, and turnover, necessitating operation cuts and job losses and closing down some businesses. Intra-African trade was also affected. The job losses raised poverty because the number of people unable to meet daily living needs increased. Further, the deterioration in private businesses' balance sheets cut demand for credit and expanded the share of nonperforming loans.

Foreign inflows. Contrary to many predictions at the onset of the pandemic, some East African countries have experienced increases in foreign inflows, including remittances. In Kenya remittances in the year to January 2021 rose to \$3.11 billion from the \$2.81 billion in the year to January 2020, reflecting increased support from relatives and businesses living outside the country. On average, remittance flows to Sub-Saharan Africa (excluding Nigeria) increased 2.3 percent in 2020. By contrast, foreign direct investment in Burundi, Ethiopia, Kenya, Rwanda, Tanzania, and Uganda fell 18.6 percent between 2019 and 2020, from \$6.25 billion to \$5.09 billion.

Social channels. COVID-19 has affected populations through its impacts on education and health, undermining progress toward universal coverage. Containment measures, including the closing of education institutions—including in Kenya a nine-month closure of private schools, during which the schools had no revenues but were required to pay utility bills and staff costs—increased dropout rates. In addition, fear of contracting infections at health facilities reduced the number of people seeking care.

Source: Staff analysis based on African Development Bank statistics.

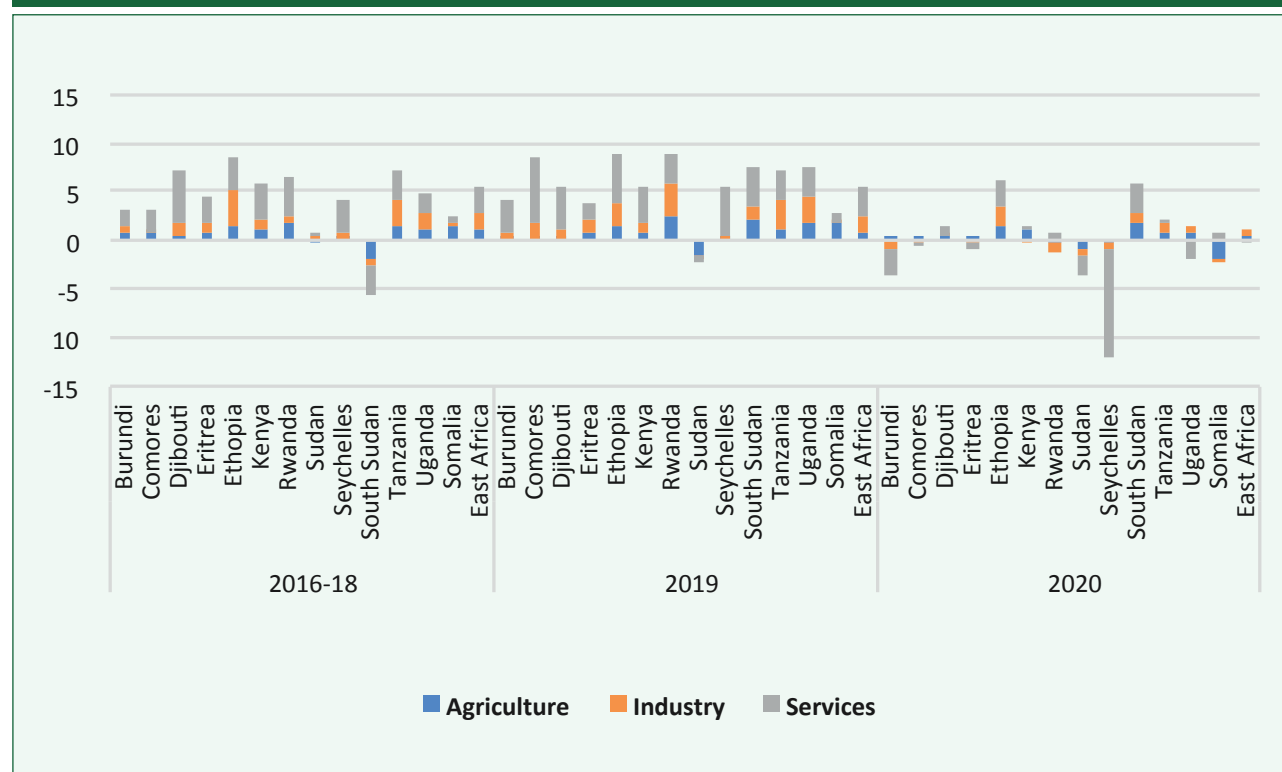
1.1.3 On the supply side, growth in East Africa has been driven by services—but limited within-sector diversification severely affected the sector's contribution in 2020

Services contracted in 2020 as a result of the sector's poor performance in tourism-dependent countries like Seychelles, where services accounted for 11.2 points of the 12.0 percent contraction in the country's GDP (figure 1.5). Burundi's services sector also recorded a steep contraction in 2020 due to the dominance of a few subsectors including financial services, which were significantly affected by COVID-19—implying that within-sector diversification is important for growth resilience. As a result, agriculture was the main driver of growth in East Africa in 2020, accounting for 0.6 percentage

point of the region's 0.7 percent growth. Industry contributed 0.5 point thanks to public spending on large infrastructure projects.

In many countries—Djibouti, Ethiopia, Kenya, and Tanzania—construction, supported by acceleration in public investments (particularly in large infrastructure projects), drove growth on the supply side. In 2020 Tanzania's industrial sector accounted for 0.6 percentage point of the country's 2.1 percent growth, driven by construction and manufacturing, while services contributed 0.8 point, agriculture 0.6 point, and taxes on goods and services 0.2 point. In Ethiopia the industrial sector accounted for 2.6 percentage points of the country's 6.1 percent growth, again driven by construction and manufacturing, followed by services (2.1 points) and agriculture (1.4 points).

Figure 1.5: Sectoral contributions to GDP growth (at basic prices) in East Africa by country, 2016–20 (Percent)



Source: African Development Bank statistics.

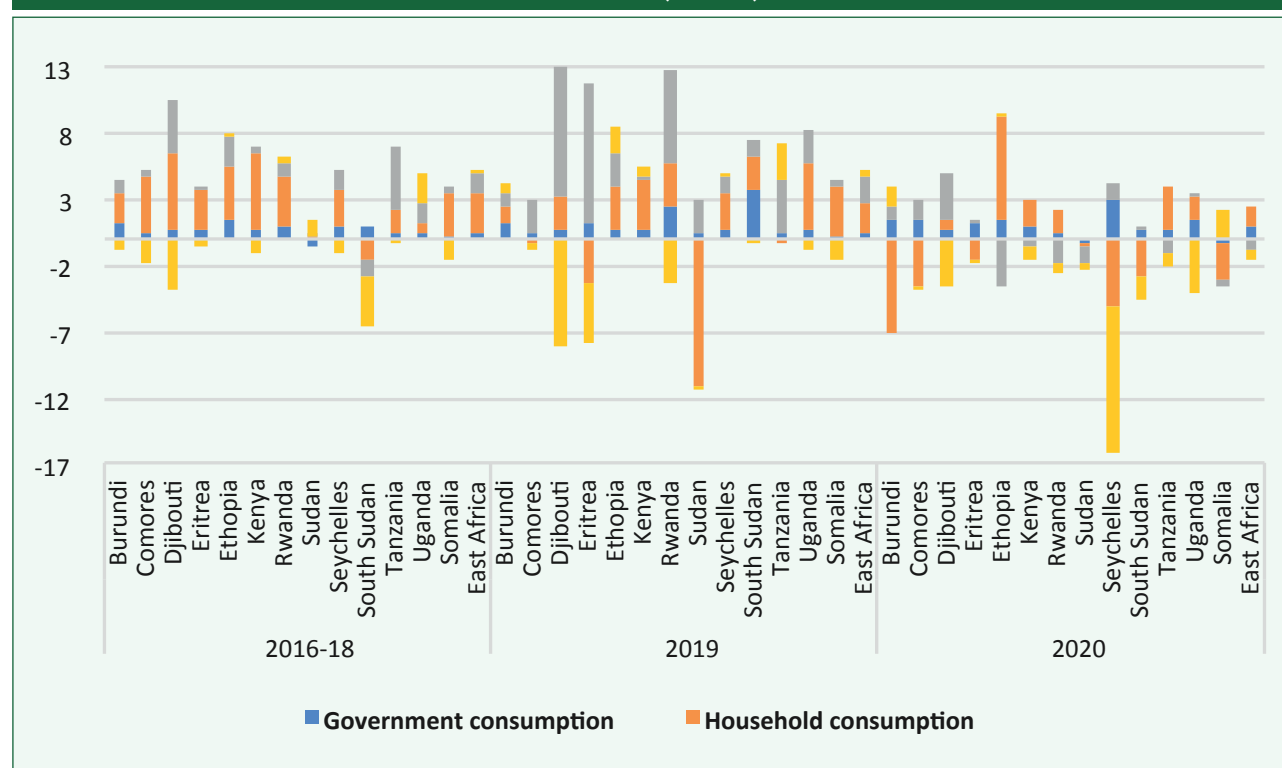
Note: Data for 2020 are estimates.

1.1.4 On the demand side, growth in East Africa is driven by household consumption

Household consumption contributed 1.4 percentage points of the region's 0.7 percent growth in 2020, followed by public consumption (figure 1.6). Investments and net exports, on the other hand, contracted 0.8 point and 0.7 percent growth in 2020 compared with contributions of 1.8 point and 0.7 point respectively to 2019's 5.3 percent regional growth. The decline in the contribution of investments was mainly due to

stays in investment decisions because of the dampened demand caused by COVID-19 and disruptions in the supply of raw materials for production. Weak exports in a number of countries drove the drop in net exports. But these averages mask cross-country differences in the demand-side drivers of growth. In Tanzania, for example, investments accounted for an estimated 2.0 percentage points of 2.1 percent real GDP growth in 2020, followed by final consumption at 1.2 points, while net exports and errors accounted for -1.1 points.

Figure 1.6: Demand-side contributions to GDP growth (at market prices) in East Africa by country, 2016–20 (Percent)



Source: African Development Bank statistics.

Note: Data for 2020 are estimates.

1.2 EVOLUTION OF MACROECONOMIC FUNDAMENTALS

This section covers monetary policy, inflation, fiscal deficits, current accounts, intra-African trade, and currency depreciations.

1.2.1 In many East African countries monetary policy was accommodative to support economic recovery

East African countries use different monetary policies, with Rwanda, Seychelles, and Uganda operating under inflation

targeting and the rest under monetary targeting. Though there is no systematic evidence that inflation targeters had better or worse inflation outcomes than monetary policy targeters, low inflation in several countries was instrumental in supporting the countries' accommodative monetary policies.

Countries instituted several monetary policy stimulus packages to complement the fiscal measures put in place to mitigate the economic impacts of COVID-19. Instruments included lowering central banks' policy rates and minimum reserve requirements, introducing loan repayment moratoriums, easing mobile payment regulations to encourage noncash transactions, and imposing a haircut on government securities (the difference between the market value of the security and the value at which the securities are booked at central banks for collateral purposes).

In 2020 Kenya's Central Bank lowered its rate and cash reserve ratio and lengthened the tenor of repurchase agreements from 28 to 91 days. The Bank of Tanzania cut the discount rate from 7 to 5 percent and the minimum reserve requirement from 10 to 6 percent. It also reduced the haircut on government securities from 10 to 5 percent for Treasury bills and from 40 to 20 percent for Treasury bonds, and introduced a loan repayment moratorium for borrowers experiencing financial difficulties. To boost economic activity, the Central Bank of Comoros reduced the minimum reserve requirement from 15 to 10 percent. And the National Bank of Ethiopia provided additional liquidity of nearly 0.5 percent of GDP to private banks to facilitate debt restructuring, which increased broad money by 17 percent.

A few countries in the region maintained tight monetary policy, mainly to contain inflation. For example, the Central Bank

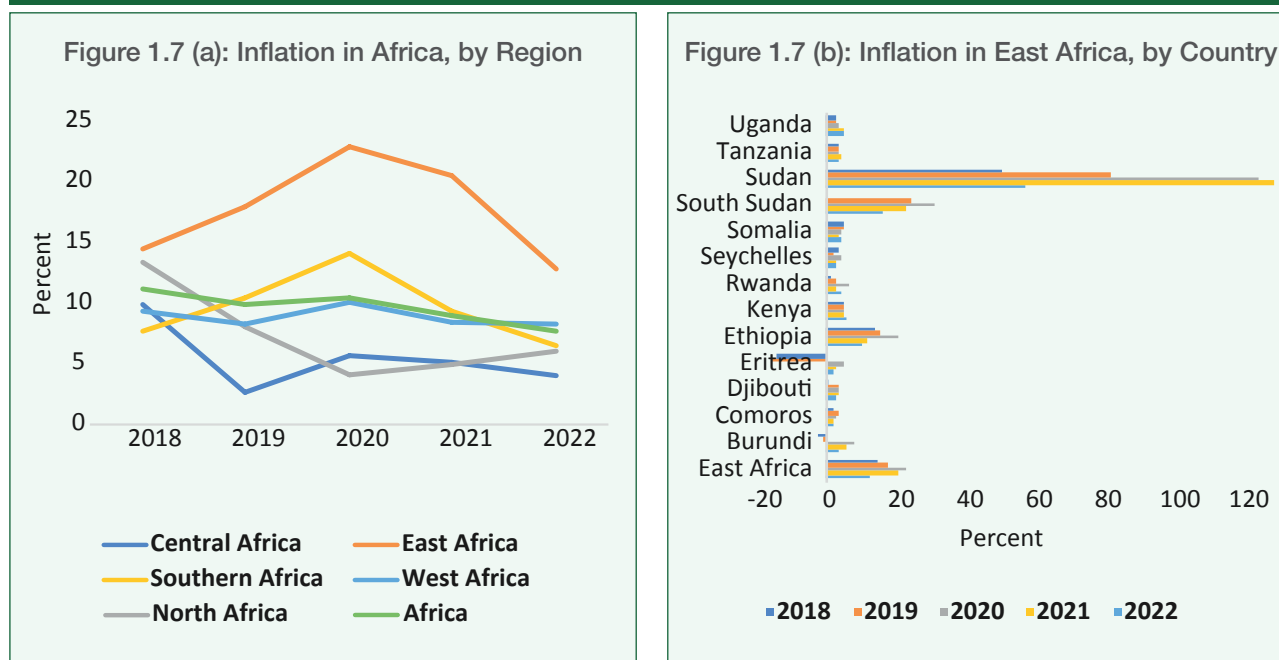
of South Sudan raised the cash reserve ratio to 20 percent from 10 percent, increased the reserve requirements ratio to 20 percent from 18 percent, and raised the reference rate to 15 percent from 10 percent. Many of these measures have remained in place to support recovery in 2021 and 2022, though some countries have started to roll them back.

Though the stimulus measures helped East African countries absorb the impacts of COVID-19, credit growth in many countries remained subdued and nonperforming loans increased in 2020, partly due to a significant slowdown in private sector activity resulting from a slowdown in overall economic activity. In Kenya the share of gross nonperforming loans in gross loans increased to 14.1 percent in December 2020 from 12.0 percent in December 2019 and was concentrated in real estate, transport, communications, and agriculture.

1.2.2 Inflation pressure remains elevated in East Africa compared to other regions of Africa but is expected to ease in the medium term

Despite high inflation in East Africa—averaging 23 percent in 2020 and the highest on the continent (figure 1.7a)—10 of the region's 13 countries recorded single-digit inflation due to stable food inflation and lower energy inflation in the first quarter of 2020. The region's high inflation in 2020 was largely due to high inflation in Sudan, which jumped to 125 percent in 2020 from 82 percent in 2019 (figure 1.7b) because of the 118 percent depreciation of the Sudanese pound in 2020 (compared to a 66 percent depreciation in 2019) and monetization of the fiscal deficit. Other factors that affected food supply and added inflation pressures in the region included the disruptions in global supply chains due to COVID-19 and adverse weather events (including drought, floods, and desert locust invasions) in some countries.

Figure 1.7: Inflation in Africa and its regions and in East Africa by country, 2019 (Percent)



Source: African Development Bank statistics.

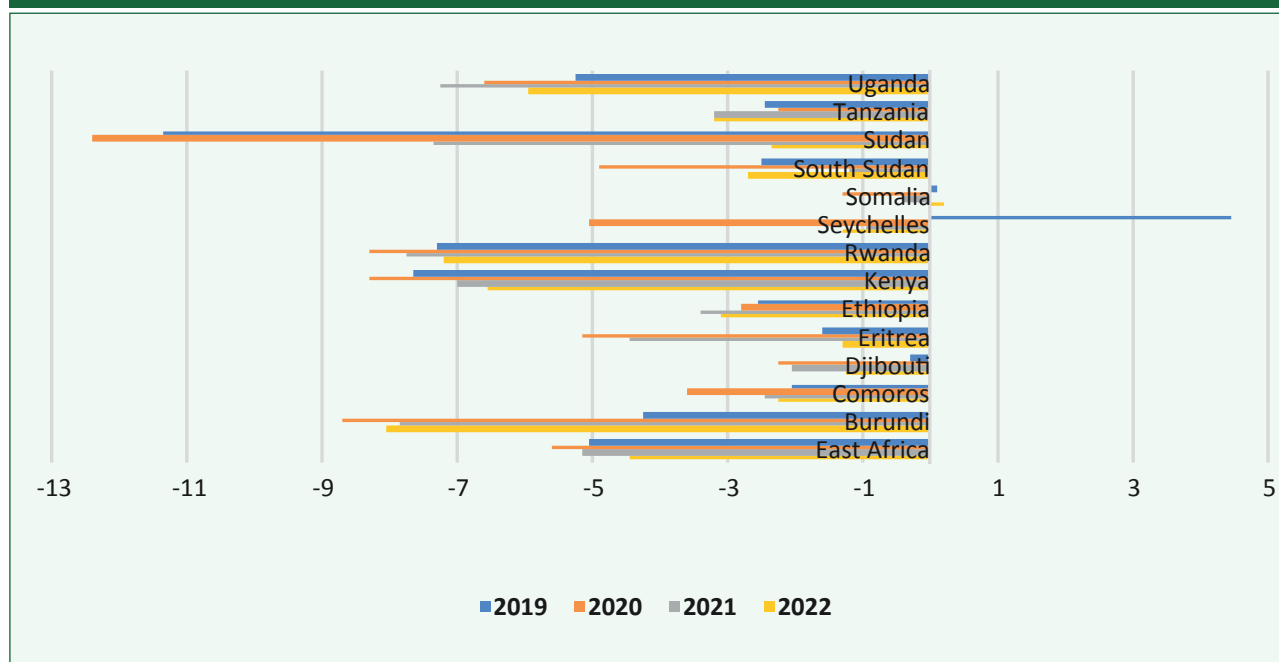
Note: Data are estimates for 2020 and projections for 2021 and 2022.

While COVID-19 was both a demand and supply shock, depressing demand through the containment measures and supply through the disruption of supply chains, the supply-side impacts more than offset the subdued demand, increasing inflationary pressures in the region. The effects of disruptions in regional and global supply and value chains was manifest in Eritrea, for instance, which has been experiencing deflation since it replaced currency in circulation in November 2015. The country recorded positive inflation for the first time in 2020 due to price hikes as the pandemic cut regional food supply networks. Similarly, in Ethiopia inflation reached 20.6 percent in 2020, mainly due to supply chain disruptions. In South Sudan supply shocks induced by flooding and desert locust invasions, coupled with monetization of the 2019/20 deficit and currency depreciation, increased inflation to an estimated 31.1 percent in 2020 from 24.5 percent in 2019. East Africa's inflation is projected to drop to 20.5 percent in 2021 and 12.8 percent in 2022 as global supply networks unlock.

1.2.3 East Africa's resilience was reflected in its lower fiscal deficits relative to other African regions

Despite widening in 2020, East Africa's fiscal deficit was lower at 5.6 percent of GDP than in the other regions of Africa (except Central Africa, which was 2.9 percent) and Africa's average of 8.3 percent (figure 1.8). Elevated fiscal deficits in 2020 were mainly due to falling domestic revenues resulting from subdued economic activity, tax measures introduced to mitigate the socioeconomic impact of COVID-19, import-intensive public infrastructure investment, and sluggish export performance. All the countries in the region recorded deterioration in their fiscal balances, with Seychelles recording the biggest widening, from a surplus of 4.5 percent of GDP in 2019 to a deficit of 5.0 percent in 2020 as a result of falling tourism revenues (see figure 1.8).

Figure 1.8: Fiscal deficits in East Africa by country, 2019–22 (Percentage of GDP)



Source: African Development Bank statistics.

Note: Data are estimates for 2020 and projections for 2021 and 2022.

The mild deterioration in some countries was helped by the continued pursuit of fiscal consolidation. Ethiopia's public spending fell to 14.5 percent of GDP in 2020 from 14.9 percent in 2019, in line with the country's fiscal consolidation strategy. Overall, 8 of the 13 countries in the region had fiscal deficits above 5 percent, which is the medium-term target in most countries. Thus accelerated efforts may be required to reduce deficits to below medium-term targets. Burundi, Kenya, Rwanda and Uganda are projected to have fiscal deficits above 5 percent in 2021–22. While many of these countries already had fiscal deficits above 5 percent before the onset of COVID-19, their acceleration toward double-digit deficits in 2020 and the persistence of high deficits in 2021–22 are worrisome. Measures to accelerate domestic resource

mobilization and rationalization of spending, including possible suspension of legacy projects that have not progressed due to limited financing and proper public investment planning, will be of utmost importance to manage the deficits.

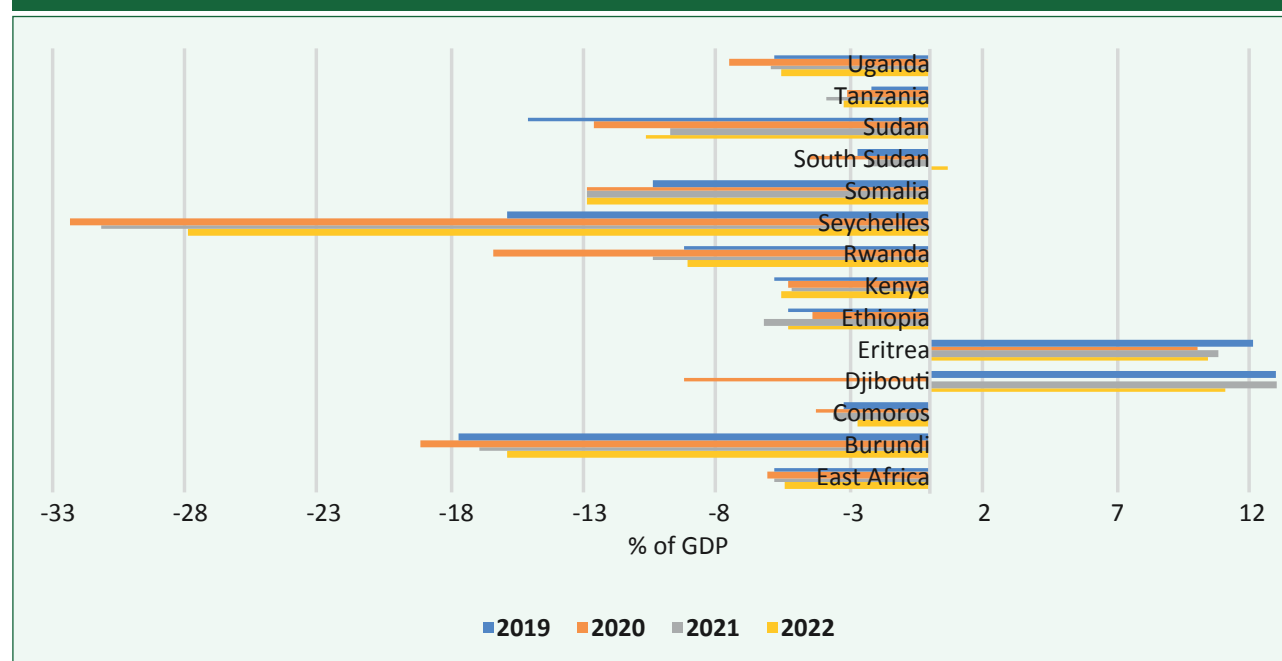
The deficits were financed mainly by increased external borrowing, including COVID-19 emergency loans from bilateral and multilateral sources. Some COVID-19 social spending will likely be sustained in 2021, keeping recurrent expenditures high and putting pressure on East African countries' fiscal deficits. Still, the region's fiscal deficit is projected to narrow to 5.2 percent in 2021 and 4.4 percent in 2022 as revenues recover due to the expected global and continental economic recovery.

1.2.4 Though the current account deficit deteriorated in East Africa, the widening in some countries was moderated by rising commodity prices

East Africa's external current account deficit increased slightly between 2019 and 2020, from 5.9 percent to 6.1 percent of

GDP (figure 1.9), but was still above Africa's average of 5.5 percent. The widening deficit was mainly due to weak exports, particularly of services. Countries that saw their current account balances improve between 2019 and 2020 included Ethiopia, Kenya, and Sudan, while the ones most adversely affected included Rwanda and Seychelles.

Figure 1.9: Current account balances in East Africa by country, 2019–22 (Percentage of GDP)



Source: African Development Bank statistics.

Note: Data are estimates for 2020 and projections for 2021 and 2022.

Kenya's improved current account position was aided by a sharp reduction in oil import bills, while the improvement in Ethiopia was supported by exports, which increased 12 percent in 2020 compared with 1.7 percent for imports. Ethiopia's export growth was led by gold, flowers, coffee, and chat. All the other countries in the region experienced mild deterioration in their current accounts in 2020. Most current account deficits in the region were financed by grants and external debt, as other financial flows—including foreign direct investment (FDI)—declined. In Ethiopia new disbursements of grants and loans increased almost 72 percent in

2020, compensating for a nearly 20 percent reduction in FDI (to 2.2 percent of GDP) and 10 percent drop in remittances (to 5.3 percent of GDP).

1.2.5 Efforts to improve the region's exports and current account positions through increased regional integration were hampered by slow ratification of the AfCFTA

The African Continental Free Trade Area (AfCFTA) agreement entered force on May 30, 2019, after 24 countries deposited

their instruments of ratification with the African Union. Trade under the agreement started on January 1, 2021, with two Ghanaian manufacturers of cosmetics and alcoholic beverages shipping their products to other African countries. Some countries in East Africa have signed but not ratified the AfCFTA agreement, while Eritrea has not signed it and remains the only African country not to do so. In East Africa only Djibouti, Ethiopia, Kenya, Rwanda, and Uganda had ratified the agreement and deposited their instruments of ratification as of March 2021, while Somalia has ratified but has yet to deposit its instruments of ratification. Burundi, Comoros, Seychelles, South Sudan, Sudan, and Tanzania have signed but not ratified the agreement.

Given the high number of countries in East Africa that have not ratified the agreement, steps should be taken to raise awareness of its net benefits. Initiatives could include cost-benefit analyses to allay fears of net losses and analytical studies to evaluate countries' competitiveness in the context of the AfCFTA and identify business opportunities for the private sector.

1.2.6 Most East African countries experienced nominal depreciations of their currencies due to fiscal, debt and external factors

East African countries use different exchange rate regimes. Burundi, Kenya, Rwanda, Seychelles, South Sudan, and Tanzania have floating exchange rates, while Eritrea, Ethiopia,¹ and Sudan have fixed ones. Several of the countries using floating exchange rates experienced nominal depreciations in their currencies between 2019 and 2020 due to narrowing fiscal space, reduced external inflows (remittances, export earnings, and so on), and increasing debt vulnerabilities. During 2019–20 period Kenya's public debt rose 19 percent, leading to the country's reclassification from to high risk of debt distress. Partly due to the increased debt vulnerabilities,

reduced fiscal space, and falling exports, Kenya experienced a 9 percent nominal depreciation of its currency, from 100 shillings to the U.S. dollar in December 2019 to 109 in December 2020.

Similarly, the Ethiopian birr was devalued by about 8 percent to 35 per U.S. dollar as of November 2020 as exports declined and fiscal space narrowed, though the premium between the official and parallel market exchange rates was about 30 percent and the real effective exchange rate is overvalued by 12–18 percent. Rwanda, which was reclassified from low to moderate risk of debt distress, also experienced a 4.6 percent depreciation of its franc due to reduced external inflows. By contrast, in Tanzania—where the fiscal position and debt have remained stable with a low risk of debt distress (and supported by stable exports)—nominal exchange rates were stable, recording only a 0.46 percent depreciation between December 2019 and December 2020.

Gross foreign exchange reserves have deteriorated in some countries in East Africa but have largely remained within the countries' thresholds. Still, other countries have precariously low foreign exchange reserves. South Sudan's reserves, for instance, remain weak and fragile, at 0.4 month of imports cover in 2020. In Ethiopia gross reserves declined to \$3.1 billion in 2020, representing 2.5 months of imports.

1.3 SOCIOECONOMIC OUTCOMES

This section focuses on poverty, inequality, employment, and education and health outcomes.

1.3.1 COVID-19 has amplified the challenges of reducing extreme poverty

In East Africa COVID-19 has had heavier impacts on poor people, with the number of those living below the poverty line

¹ Ethiopia's de facto exchange rate regime is classified by the authorities as a managed float, while by the IMF as crawl-like due to the stability of the exchange rate and the National Bank of Ethiopia's intervention policy.

projected to increase. Ending extreme poverty in the region remains an unfinished agenda, and COVID-19 threatens to move things further off track in achieving the Sustainable Development Goals (SDGs) target of lowering extreme poverty to less than 3 percent of the population by 2030. Before the pandemic, East African countries were already slow in their progress of achieving that target despite the robust decade-long growth in the region.

In 2019, 33 percent of the region's population lived in extreme poverty, equivalent to 122.02 million people (table 1.1). COVID-19 shocks have pushed poverty up, with the

share of the population in extreme poverty rising to 35 percent in 2021, equivalent to 134.34 million people. Of East Africa's 13 countries, only Seychelles has achieved the SDG target of ending extreme poverty by 2030. Comoros, Djibouti, Ethiopia, Kenya, Rwanda, Tanzania, and Uganda are off track and have minimal chances of meeting the target. Burundi, Eritrea, Somalia, South Sudan, and Sudan are experiencing significant increases in poverty and so will not achieve the target. Across the region, 12.32 million people—equivalent to 3.4 percent of the 2019 population—drifted into extreme poverty because of COVID-19 and its aftermath.

Table 1.1: Estimated impacts of COVID-19 on poverty in East Africa by country, 2019–21

Country	% of population living in extreme poverty, 2019	% of population living in extreme poverty, 2021	Poverty trend, 2019–21 (% of population)	Poverty trend, 2019–21 (number of people)	Poverty relative to Sustainable Development Goal target
Burundi	78	80	Rising	Rising	Rising
Comoros	21	22	Rising	Rising	Off track
Djibouti	14	13	Falling	Constant	Off track
Eritrea	72	71	Falling	Rising	Rising
Ethiopia	22	23	Rising	Rising	Off track
Kenya	16	16	Constant	Rising	Off track
Rwanda	47	45	Falling	Rising	Off track
Seychelles	0	0	N/A	N/A	Achieved
Somalia	58	61	Rising	Rising	Rising
South Sudan	83	85	Rising	Rising	Rising
Sudan	16	22	Rising	Rising	Rising
Tanzania	45	45	Constant	Rising	Off track
Uganda	37	38	Rising	Rising	Off track
East Africa	33	35	Rising	Rising	Off track

Source: Based on World Data Lab 2021 data.

Note: These data are preliminary because the pandemic is still evolving. As things become clearer, more robust estimates may be produced using tested methodologies.

COVID-19 hit fragile and less diversified countries especially hard. The pandemic's effects on poverty were more severe in countries emerging from conflict and those that depend on one main export, such as oil or tourism. Seychelles, which mainly depends on tourism for export earnings, experienced a steep recession in 2020. South Sudan and Sudan, which are dependent oil, recorded similar slumps. In 2020 more than 1 million people slid into extreme poverty in 2020 in South Sudan, and over 3 million in Sudan.

Aside from the pandemic, the increase in poverty in 2019–21 was exacerbated by floods and an invasion of desert locusts in the Horn of Africa. Generally, poverty persistence in East Africa is perpetuated by, among other things, lack of economic diversification and competitiveness, low productivity, weak economic governance, and pockets of fragility.

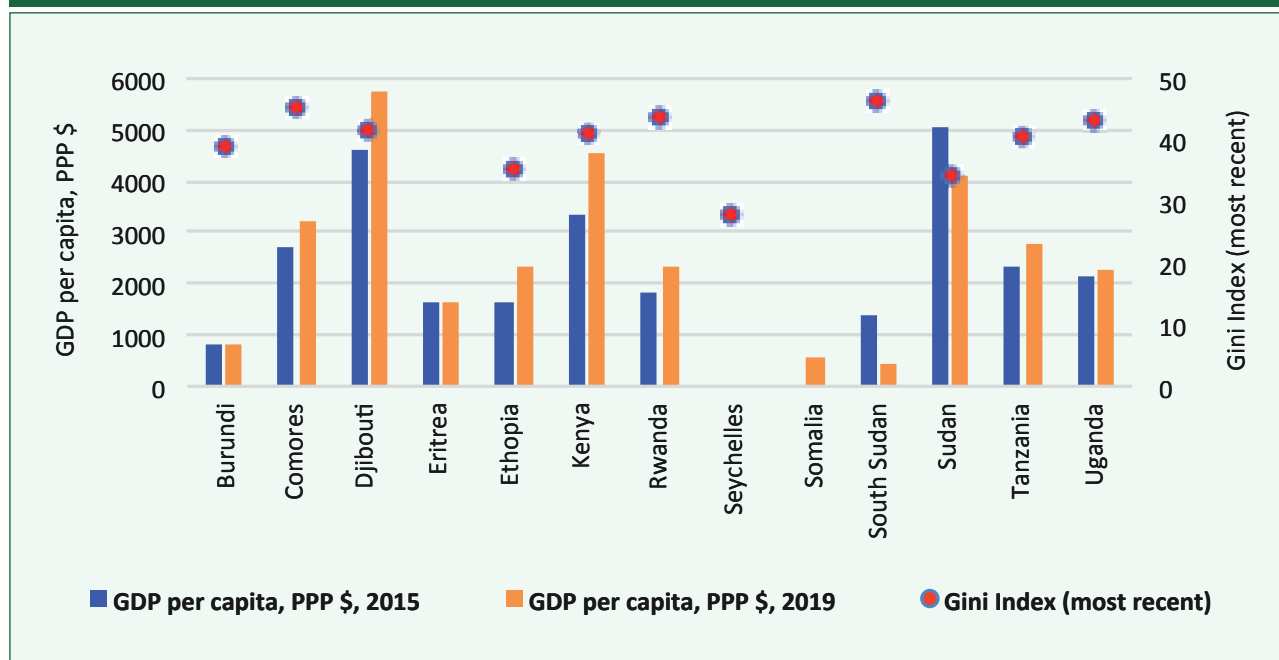
1.3.2 Income inequality persists

Despite East Africa's impressive pre-COVID growth, inequality

persisted, exacerbated by the pandemic's severe impacts on livelihoods. Excluding Seychelles, the region's average GDP per capita rose 6 percent between 2015 and 2019, from \$2,508 to \$2,648, while income inequality as measured by the Gini index remained high at an average of 41.4 percent—a decline of less than 2 percentage points from a decade ago.

But these averages mask variations in performance across countries. Of the region's 13 countries, only Burundi and Sudan saw per capita income slip between 2015 and 2019 (figure 1.10). These drops could have been due to heightened fragility against the backdrop of the recent political and security crises in the two countries. And despite Tanzania become a lower middle-income country in July 2020 and having one of Africa's fastest-growing economies, inequality persisted there with a Gini index of 40.5 percent in 2019. That was due to a growth pattern driven by sectors, including construction, with limited impacts on employment.

Figure 1.10: GDP per capita and income inequality in East Africa by country, 2015 and 2019



Source: Based on World Bank 2021.

a. Seychelles' GDP per capita, PPP\$ was \$24,067 in 2015 and \$30,516 in 2019.

Note: Gini index data are not available for Eritrea and Somalia.

1.3.3 COVID-19 has dampened employment and human capital outcomes

East African economies' ability to create and sustain decent employment opportunities with fair and equitable remuneration has improved, but COVID-19 has slowed the momentum. Average growth in labor productivity in the region fell from 2.5 percent in 2000–02 to 1.5 percent in 2016–19, implying that most countries were able to create and sustain decent jobs before the pandemic. This indicates that the region was on the right path in terms of growth in investment, trade, technological progress, and social protection, which helped reduce vulnerable employment and working poverty.

COVID-19 has reversed some of those gains. The pandemic severely affected sectors where female employment is disproportionately high, such as hotels and restaurants. In Kenya a

World Bank survey found that about 65 percent of female working-age respondents (18 and older) stopped working during the pandemic, compared with about 57 percent for male respondents (World Bank 2021). In South Sudan the female proportion was 42 percent, and the male proportion was 39 percent. As workplaces closed, earnings decreased or disappeared for self-employed and hourly wage workers. The region has lost up to 38 million jobs due to COVID-19 and related shocks (UNECA 2020).

Before COVID-19, nearly 5 million adolescents and 8 million children in East Africa were out of school, with Sudan accounting for about 2.6 million of the children, Ethiopia for 2.3 million, and South Sudan for 2.2 million. The large number of children out of school relative to adolescents indicates limited access to education, particularly at the pre-primary level. East African countries also face high dropout rates—

especially at the primary level, where the rate rose from 35.0 percent in 2010–14 to 49.7 percent in 2015–18. Sudan had the highest primary school dropout rate, at 65 percent, followed by Uganda, Burundi, and Rwanda.

COVID-19 has further dampened educational outcomes in the region. Millions of learners lost almost a full year of learning in 2020, and this may continue due to the uncertainties given the subsequent waves of infections and slow rollout of vaccinations. All East African countries except Burundi closed all their institutions of learning for varying periods at the onset of the pandemic. Some countries, like Kenya, reopened schools after nine months as the COVID-19 curve flattened, but closed them again in March 2021 as the third wave intensified. The closure of schools is likely to create longer-term human capital issues including increased dropouts due to pregnancies, which may further widen learning inequalities and hurt vulnerable children and young people—particularly girls—who may never return to schools even after they reopen.

COVID-19 also exposed the inadequacy of the region's health systems. The pandemic showed that many countries' systems could not deal with a fast-spreading virus. Isolation facilities were lacking at the onset of the pandemic, and intensive care units and ventilators are in short supply in many countries. Personal protective equipment and health workers were also sparse. Some countries have strengthened health-care systems, but more needs to be done to prepare them for similar pandemics or possible escalation of the same. Though the region's healthcare systems have become more focused on COVID-19, other diseases like malaria, HIV, and tuberculosis—which are also major burdens on the systems—seem to have taken a back seat. Climate-related outbreaks such as typhoid, diarrhea, cholera and dysentery also need to be planned for because floods are projected to increase in frequency and intensity in the region.

On the demand side, losses of incomes and livelihoods related to COVID have resulted in declining healthcare use. Up to a quarter of people surveyed in the region reported that they or someone in their household missed or delayed healthcare

services due to the pandemic, and more than a third reported difficulties in obtaining medicines in Africa (Prevent Epidemics 2021). Sudan, Uganda, Kenya, and Ethiopia are among the top 20 African countries that reported the most difficulties in obtaining medicines and the most delays in healthcare visits.

To mitigate the economic and health impacts of the pandemic, the African Development Bank has provided various types of support to the region's member countries. In South Sudan the Bank approved a \$4 million Crisis Response Facility in June 2020 to support the emergency response to COVID-19 and strengthen the health system's capacity for emergency preparedness, including the procurement of personal protective equipment. In May 2020 the Bank approved similar support of €188 million for Kenya.

1.4 MEDIUM-TERM OUTLOOK AND RISKS

This section assesses the medium-term outlook and risks for East Africa. Recommended policies to accelerate the region's recovery and build resilience are provided in chapter 3.

1.4.1 Medium-term outlook

Though East Africa is expected to recover in 2021–22, the speed of vaccination rollouts and the discovery of new strains of COVID-19 may dampen that outlook. Real GDP growth in the region is projected to increase from 0.7 percent in 2020 to 3.0 percent in 2021 and 5.6 percent in 2022. The recovery will be supported by the expected recovery of the global economy, to 6.0 percent growth in 2021, up from –3.3 percent in 2020. Oil- and commodity-exporting countries region including South Sudan (oil), Sudan (oil), and Tanzania (gold) are expected to benefit from rising prices during the period. In addition, Africa's growth is expected to recover from –1.8 percent in 2020 to 3.4 percent in 2021 and 4.6 percent in 2022. The anticipated strong global and continental recovery is largely based on the anticipated rollout and uptake of COVID-19 vaccinations and the subsequent resumption of economic activities globally.

Lower reliance on primary commodities and greater diversification are expected to support resilience at the country level. The top performers on growth in 2021 are projected to be Djibouti (9.9 percent), Eritrea (5.7 percent), Kenya (5.0 percent), Tanzania (4.1 percent), and Rwanda (3.9 percent). In 2022, the top performers are projected to be Djibouti (8.1 percent), Ethiopia (7.9 percent), Rwanda (6.9 percent), Kenya (5.9 percent), and Seychelles and Tanzania (both at 5.8 percent). The drivers of the projected recovery in the region vary by country. Djibouti's growth prospects will be supported by the rapid recovery of port activities as international trade and world demand pick up, free zones, and foreign direct investment returns. Kenya's economic rebound is based on the assumption that economic activity resumes and the economy fully reopens, backed by strong inflows of remittances and implementation of the economic stimulus program and the post-COVID-19 economic recovery strategy. Ethiopia's 2021 growth will be subdued due to the delayed impacts of COVID-19 and the ongoing internal conflict in the Tigray region, but a strong rebound in 2022 would be driven by industry and services.

Fragile countries are expected to drag down the region's growth in 2021, with growth projected at -1.1 percent in Sudan, 0.1 percent in South Sudan, and 3.5 percent in Comoros and Burundi—the slowest growth among all the region's countries. Key drivers of growth in Sudan, which include agriculture and mining on the supply side and private consumption and investment on the demand side, remain subdued. In South Sudan the projected partial economic recovery will be supported by the projected rebound in oil production and exports, but uncertainties about full implementation of the peace deal are expected to slow growth. For Comoros, economic recovery will be supported by the expected higher prices for the country's main exports and the continuation of remittances from the diaspora. Constraints to economic growth recovery in Burundi include reduced government and private consumption due to a drop in grants from foreign donors.

Higher oil and commodity prices and the expected recovery of services, particularly tourism, will help narrow the region's

fiscal deficits. Fiscal deficits are projected at 5.2 percent of GDP in 2021 and 4.4 percent in 2022, a significant improvement from the estimated 5.6 percent in 2020. The projected improvement in the region's average fiscal deficit will be strongly boosted by Seychelles, South Sudan, and Sudan. The anticipated improvement in Seychelles will be driven by recovery in services, especially tourism. In South Sudan, Sudan, and other commodity exporters in the region, the expected reduction in fiscal deficits will be due to ongoing and anticipated improvements in global commodity prices. Among the 13 East African countries, only Uganda is expected to report a bigger fiscal deficit, widening from 6.6 percent in 2020 to 7.3 percent in 2021 before narrowing to 6.0 percent in 2022. Uganda's widening fiscal deficit in 2021 will be driven by the continued need for investments in roads, power, and water, with the Ministry of Finance estimating a potential funding gap of 2 trillion Ugandan shillings (1.6 percent of GDP) in 2021.

East Africa's inflation is expected to ease in the medium term, supported by prudent monetary policies and improved food supplies. But rising oil prices may increase inflation in some oil-importing countries. The region's inflation is projected to ease to 20.5 percent in 2021 and drop further to 12.8 percent in 2022 as global supply chains reopen, but rising oil prices are expected to put pressure on nonfood inflation. The high average inflation projected for the region is due to projected hyperinflation in Sudan (129.7 percent in 2021 and 57.5 percent in 2022), South Sudan (23.3 and 16.0 percent), and Ethiopia (12.0 and 9.9 percent). Sudan's inflation escalation will be driven by the recent currency depreciation and monetization of fiscal deficit, but prioritization of public spending and tighter monetary policies should moderate inflation in the medium term. In South Sudan the supply shocks induced by recent floods and desert locust invasions, COVID-19 disruptions, monetization of the 2019/20 deficit, and currency depreciation will continue to push up inflation, but it will ease progressively due to tight monetary policy. In Ethiopia the delayed supply chain disruptions induced by COVID and expansionary monetary policy to stimulate economic activity are projected to sustain inflationary pressure in 2021, but the increased use of open-market operations is expected to gradually reduce inflation.

In Tanzania and Uganda inflation is expected to edge up due to the impacts of higher oil prices on nonfood inflation. Kenya continues to enjoy low inflation and is expected to remain within the authorities' target band of 5.0 plus or minus percent thanks to prudent monetary policy, favorable weather conditions, and stable demand for nonfood items. In Somalia sustained low inflation is on account of recent tax relief on essential foods, improvements in food supply, and the relative stability in the Somali shilling. Similarly, Comoros and Tanzania are expected to maintain low inflation in the short to medium term because of declines in food inflation, stable exchange rates, high foreign exchange reserves, and the tight monetary policy due to Comoros' commitment under the franc zone.

Higher exports will help narrow the region's current account deficits, but overdependence on a few commodity exports in some countries is a source of vulnerabilities should COVID-19 escalate. The region's current account balance—the highest among Africa's regions—is projected to narrow to –5.8 percent of GDP in 2021 and –5.4 percent in 2022, down from –6.1 percent in 2020. But that outcome remains vulnerable to potential lockdowns, particularly in countries like Seychelles, South Sudan, Sudan that depend on a few export commodities and markets.

Burundi, Rwanda, Seychelles, and Somalia are projected to report double-digit current account deficits in 2021, largely because of sluggish recovery of exports and remittances that suppress foreign exchange receipts. Eritrea, on the other hand, is expected to continue reporting a double-digit current account surplus, though declining on account of fluctuations in national savings. Uganda's current account deficit is projected to narrow as exports pick up, reflecting global economic recovery. Finally, current account balances in South Sudan and Sudan are expected to narrow gradually in 2021 and 2022 on the backdrop of improving global oil prices and oil export revenues and planned reforms to accelerate economic recovery.

1.4.2 Risks to the outlook

Economic risks. Rising global oil prices are a major downside risk given that most East African countries are net oil importers.

Though the anticipated increase in oil prices is good news for the region's few oil-exporting countries, it remains a major risk to the economic recovery for the rest. Forecasts project a consistent increase in global oil prices from \$41 a barrel in 2020 to \$65 a barrel in 2021 and \$66 a barrel in 2022. These projected increases would reflect the costs of production and doing business in the region's oil exporters, which is not only inflationary but also lowers aggregate demand.

The elevated risks to tax revenues of public debt distress and increasing debt service have reduced the scope for sustained public investments in transformative infrastructure. COVID-19 has exacerbated the region's already worrisome debt situation, with many countries' risk of debt distress increasing and the cost of debt service skyrocketing. Increased budget allocations to debt financing and the drawing down of foreign exchange reserves to finance external debt reduce access to external financing for infrastructure spending. Given that real GDP growth in several East African countries is driven by public investments, these factors will slow the region's growth prospects and advancements toward Sustainable Development Goals like elimination of extreme poverty and inequality and creation of good-paying formal sector jobs.

Slow structural transformation remains a major risk for development in the region. Though employment in industry was relatively constant over the past two decades, agriculture's share of employment fell from 68.8 percent in 2000 to 59.0 percent in 2019, while employment in services increased from 22.8 percent to 31.4 percent. No major changes are anticipated in the medium term unless bold actions are taken to expedite this transformation. Post-COVID recovery will be realized if services become more vibrant and productive, and growth of industry is accelerated. Excessive dependence on unprocessed agricultural commodity exports amid volatile international commodity prices and a subdued global growth and investment finance outlook will likely reduce public investment financing sources and impede the region's growth prospects.

Social risks. New waves of COVID-19 infections and slow uptake of vaccines remain major risks to recovery in East Africa. The new waves have already led to reimposition of lockdowns and quarantines in Kenya and Uganda, and these

could expand to other countries in the region—slowing or derailing the region’s recovery. As with the initial ones, new lockdowns and quarantines could affect the region by reducing global commodity prices, disrupting trade, lowering foreign direct investment, cutting tourism visits, increasing volatility in financial markets, and disrupting healthcare and education.

It was initially anticipated that the arrival of COVID-19 vaccines in the region would significantly boost recovery efforts. But uncertainties continue to surround vaccinations. In addition to the limited number of vaccine doses available in the region due to procurement challenges with the AstraZeneca vaccine, uptake remains slow, with only 1.1 percent of the region’s population fully vaccinated as of June 2021 (excluding Seychelles and countries with no reported vaccination data²), putting the region at the risk of reoccurrence of subsequent waves of infection.

Political risks. Conflict-related events and incidents heighten policy uncertainty and dampen investor confidence. Civil unrest in a few countries in East Africa remain a threat to national and regional cohesion and socioeconomic progress. The region has made remarkable progress in implementing political reforms, improving governance, and strengthening peace

and security. But challenges remain. For instance, some of the presidential elections in 2020 in the region saw heightened political tensions and civil protests, political arrests, internet interruptions, and claims of electoral irregularities. Internal conflicts in the region are also likely to continue undermining investor confidence and dragging recovery in the short to medium terms. In addition, should governments continue to reimpose COVID-19 preventive and restrictive measures in response to new waves of infections, a large portion of the region’s population would be adversely affected economically, potentially leading to increased insecurity, crime, and even political instability.

Environmental and other exogenous risks. Weather-related shocks and invasions of locust swarms threaten agricultural production in East Africa. Some countries in the region were invaded by desert locusts in 2020, and a second wave of invasion is already being experienced in the Horn of Africa (Ethiopia, Kenya, and Somalia). This is likely to remain a significant risk to the region’s recovery because agriculture employs about 60 percent of workers, contributes more than a third of GDP, and accounts for over 60 percent of merchandise exports in the region. In addition, unpredictable weather conditions pose a major risk to the region’s agricultural production, given the recent history of frequent droughts and floods.

² In Seychelles 69 percent of the population had been vaccinated as of June 2021, while data on vaccinations are not available for Burundi, Ethiopia, Eritrea, and Tanzania.

CHAPTER 2

DEBT DYNAMICS AND FINANCING ISSUES

Key messages

- Public debt in East Africa rose from 40 percent of GDP in 2011 to 67 percent in 2019, driven by large infrastructure investments and a relative slowdown in real GDP growth. Public debt increased further to 73 percent of GDP in 2020 due to COVID-19 amid substantial nominal exchange rate depreciation in economies with large foreign currency debt, reduced commodity revenue inflows, and borrowing to finance emergency public spending in healthcare.
- East African countries' external public debt, like that of many countries in Africa, has become more market-based and less concessional, with the grant element of new external commitments reduced by almost half over the past two decades. This change has increased rollover risks because reduced foreign currency reserves, high interest expenditures relative to revenues, and limited access to refinancing in international markets exacerbated debt vulnerabilities.
- Better economic governance is needed to stabilize and reduce the public debt burden in East Africa. Essential moves include clearing domestic arrears, improving debt management and transparency, and dealing with debt related to state-owned enterprises and contingent liabilities in some of the region's largest economies. Furthermore, for countries with substantial external refinancing risks, innovative financing instruments like nondebt equity or donor-funded capital projects and risk-sharing tools

must be explored to diversify sources of development finance.

COVID-19 created short-term financing tensions in East Africa, especially in countries with underlying fiscal vulnerabilities. Like most emerging and lower-income developing economies, those in East Africa were affected by the pandemic in 2020 and early 2021. Economic growth fell dramatically relative to pre-COVID projections due to containment measures such as lockdowns and curfews, as well as the natural consequence of reduced external demand—in particular, declining raw materials exports and tourism inflows—when the world economy slowed down. Primary deficits ballooned because of fiscal support in the form of direct cash transfers, equity and loan support, deferment of tax payments for individuals and corporations, and emergency spending on healthcare.

At the same time, exchange rate depreciation pressures increased in most countries in the region, either in official currency markets or on black markets for countries with fixed exchange rates. External sources of financing dried up, with reduced foreign direct investment, lower remittances, and an effective shutdown of international markets for Eurobond issuances for most East African countries, creating fiscal and debt distress risks for fragile states in particular.

This perfect storm of declining growth, deteriorating primary deficits, rising bond yields, and depreciating currencies affected countries in East Africa more than in other African

regions, amid a high existing stock of accumulated public debt and risks of debt distress. This led many East African economies to require emergency external financing from multilateral lenders, as well as short-run debt relief. Of the 13 East African economies, 9 received emergency IMF financing in the form of Rapid Credit Facility or Rapid Financial Instrument disbursements and 6 received immediate grants for debt relief under its Catastrophe Containment and Relief Trust.³ The emergency G20-supported Debt Service Suspension Initiative for official bilateral government loans and multilateral funding also helped close large immediate financing gaps, but longer-term debt restructuring will be needed to ensure debt sustainability.

2.1 DEBT AND FINANCING LANDSCAPE

2.1.1 Slow growth, emergency spending, and exchange rate depreciation worsened debt conditions in East Africa amid the fallout from COVID-19

In 2020 ratios of debt to GDP increased substantially in the region, reaching a weighted average of 73 percent by the end of the year, up from 67 percent in 2019. The distribution of these ratios varied considerably across East Africa (figure 2.1a). Eritrea and Sudan exhibited extremely high debt ratios,

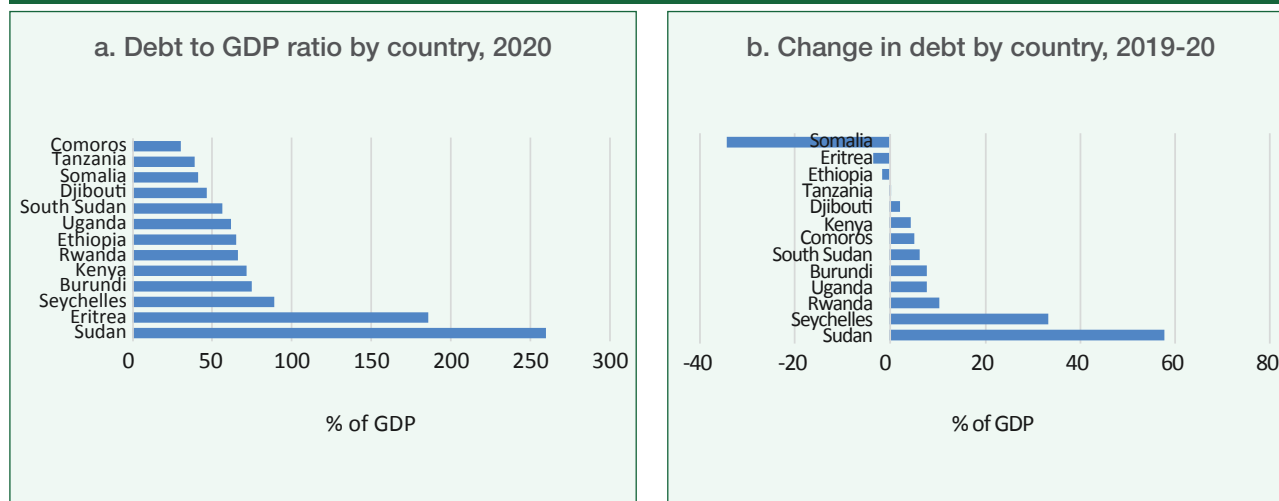
while debt hovered around 50–60 percent of GDP in the largest economies of the region, including Ethiopia, Kenya, and Uganda.

In 2020 ratios of gross government debt to GDP rose sharply for almost all countries in the region (figure 2.1b). The largest increase was in Sudan, followed by Seychelles. Somalia was a major exception, with external debt falling substantially thanks to debt relief from official creditors and the clearance of arrears to multilateral lenders after the country reached its Heavily Indebted Poor Countries (HIPC) decision point in March 2020. Debt also decreased slightly as a percentage of GDP in Ethiopia under the supervision of an IMF-monitored fiscal consolidation program, and in Eritrea due to the clearance of some domestic and external arrears.

Though the increases in debt as a share of GDP were widespread across the region, they reflect distinct dynamics and country-specific situations, depending on government responses to COVID-19 and existing external and domestic vulnerabilities. The rise in these ratios between 2019 and 2020 is broken down into its main components in figure 2.2. Primary deficits increased relative to pre-pandemic forecasts, while adverse macroeconomic conditions lowered GDP growth and exchange rates, pushing public and external debt ratios higher.

³ The first group of countries was Comoros, Djibouti, Ethiopia, Kenya, Rwanda, Seychelles, Somalia, South Sudan, and Uganda. The second was Burundi, Comoros, Djibouti, Ethiopia, Rwanda, and Tanzania.

Figure 2.1: Public debt levels and changes in East Africa by country (Percentage of GDP)



Source: AfDB 2021; IMF 2020f.

In many East African countries, discretionary measures on the spending side, forgone revenues, and low international commodity prices, among others, played a role in the degradation of fiscal positions. Primary deficits were significantly larger than pre-COVID projections, notably in Burundi, Rwanda, Seychelles, and Uganda, where they contributed most to the rise in debt. In Burundi and Seychelles large increases in primary deficits mostly reflect a substantial drop in government receipts, on the back of lower commodity exports and other nontax revenue.

In addition, a substantial share of the rise in these ratios in 2020 in some of the largest East African economies was driven by low or negative real GDP growth. The contribution of real GDP growth to debt reduction was either negative (notably in Burundi, Eritrea, and Seychelles) or positive but significantly below pre-COVID-19 projections (particularly in Ethiopia and Kenya, where growth was positive but 4–5 percentage points lower than pre-COVID projections),

as adverse macroeconomic conditions lowered GDP, pushing debt ratios higher. In Ethiopia services exports in the transportation sector (notably those of Ethiopian Airlines) were hit hard by the pandemic, reducing growth from an annual average of about 9 percent before the pandemic to closer to 6 percent in 2020 and potentially to 2 percent in 2021.⁴

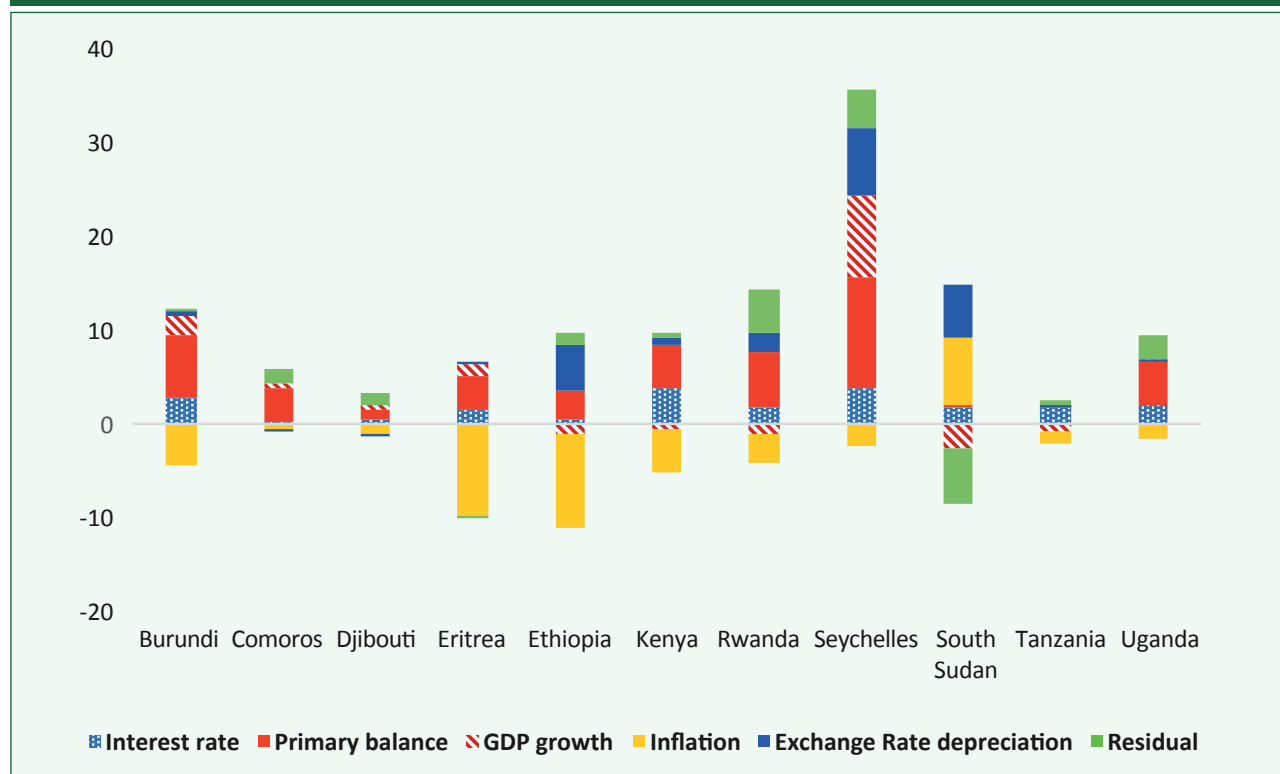
In commodity-exporting economies, lower oil and commodity prices were key drivers of growth shocks in 2020. For example, these adverse terms of trade pushed real GDP growth down to –8.4 percent in Sudan. Exchange rate depreciation increased debt burdens the most in countries with substantial liabilities denominated in foreign currency, such as Ethiopia and Seychelles. That was also the case in South Sudan, where monetization of the deficit led to substantial depreciation of the local currency even before the pandemic. In most East African countries, the role of real interest rates remained subdued due to significant inflation eroding part of the real

⁴ For Ethiopia the 6 percent growth rate is for July 2019–June 2020, and thus largely reflects about one-quarter of COVID-19 effects. The real GDP growth projection of 2 percent in 2021 (July 2020–June 2021) reflects the full impact of COVID-19 on Ethiopia's economy.

cost of debt, international debt service relief, and limited needs for refinancing of market-based debt—with the notable

exception of Kenya, where spending on interest represented close to 4 percent of GDP in 2020.

Figure 2.2: Decomposition of the 2020 change in debt in East Africa by country (Percentage of GDP)



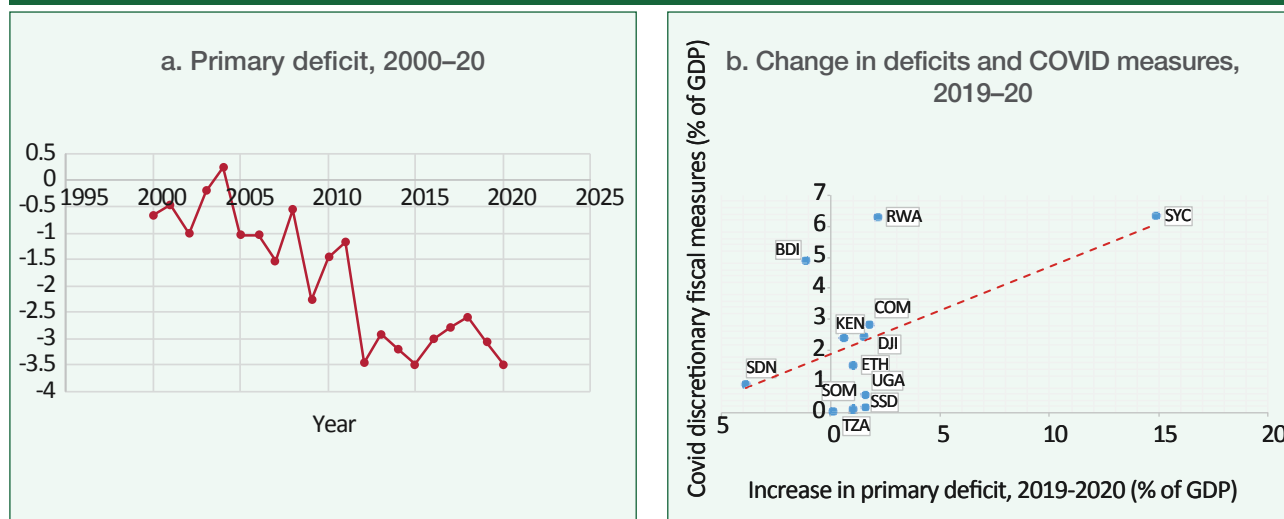
Source: AfDB staff calculations; AfDB 2021; IMF 2020f.

Note: Data are estimates and do not include Somalia and Sudan due to high international debt arrears, which substantially affect debt dynamics. The contribution of exchange rate depreciation uses nominal depreciation against the U.S. dollar as a proxy for overall nominal depreciation, given the predominant share of foreign currency debt denominated in dollars.

The fiscal situation is closely related, with governments in the region having introduced discretionary outlays and revenue measures to tackle the immediate consequences of the pandemic. These steps illustrate the impact of primary deficits on public debt vulnerabilities. The region's weighted average government deficit increased from -3.1 percent of GDP in

2019 to -3.5 percent in 2020, a substantial shock by historical standards (figure 2.3a). Digging deeper, figure 2.3b compares emergency COVID-related measures taken by countries—including both spending and forgone revenue due to deferred tax payments—with changes in primary deficits as a share of GDP between 2019 and 2020.⁵

⁵ The measure of additional COVID-related spending and forgone revenues is taken from the IMF's Policy Tracker as of March 2021. The measure focuses on discretionary above-the-line measures (forgone revenue, emergency spending) disclosed by the authorities and undertaken specifically to respond to the pandemic and might not reflect the full extent of more traditional automatic stabilizers and other forms of support.

Figure 2.3: Primary deficits and COVID-related measures in East Africa (Percentage of GDP)

Source: AfDB 2021; IMF 2020f; IMF Policy Tracker.

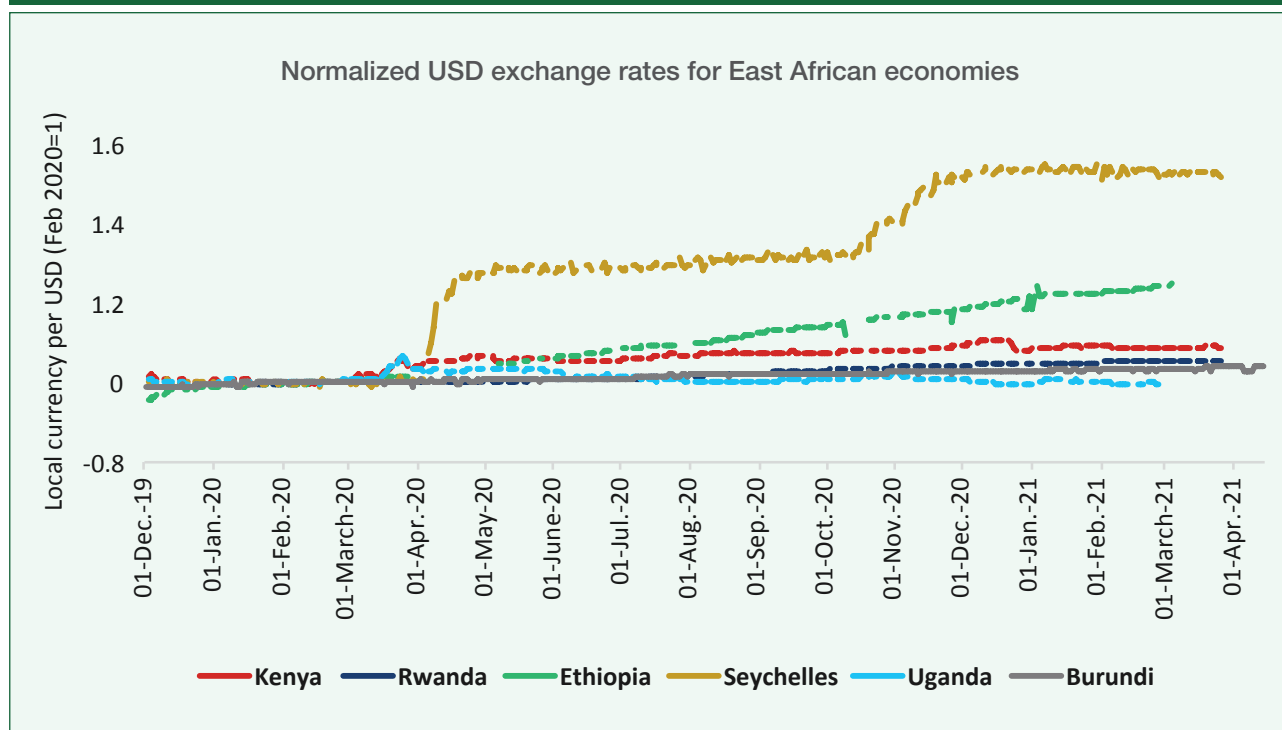
According to the IMF's Policy Tracker, as of March 2021 emergency fiscal measures designed to tackle the immediate health consequences of the pandemic and support affected businesses and households ranged from 0.03 percent of GDP in Tanzania to 6.3 percent in Rwanda and Seychelles. But short-term discretionary measures taken to address urgent COVID-related spending explain only a fraction of the deterioration in government deficits. The main drivers were lower than expected growth and reduced tax and nontax revenues due to lower commodity receipts, especially for commodity exporters. Among countries with large COVID-related measures, Burundi, Rwanda, and Seychelles stand out. Burundi forgave taxes in the hospitality and leisure sectors, while Seychelles launched the Financial Assistance for Job Retention program to subsidize payroll costs for firms with COVID-related disruptions. On the other hand, Ethiopia, South Sudan, and Uganda experienced substantial deterioration in their primary deficits despite limited direct COVID-related fiscal spending. In these countries the larger primary deficits in 2020 were mostly the outcome of reduced nontax revenues from lower oil and other commodity export prices and, in Ethiopia, lower export-related tax revenue due to the reduced activity of Ethiopian Airlines.

2.1.2 Tighter external financing conditions led to exchange rate depreciations and higher bond yields

The deterioration in the debt situation of several East African economies was partly the product of tighter external financing conditions, in the form of the contribution of exchange rate depreciations and interest expenditures (see figure 2.2). At the onset of the pandemic, international markets experienced a "flight to quality." In addition, concerns that unsustainable current account deficits would put downward pressure on foreign reserves in several low-income countries in the region led to sharp depreciations in exchange rates.

The adverse exchange rate dynamics for selected countries between January 2020 and April 2021 are shown in figure 2.4. Given the substantial share of external government and publicly guaranteed debt in these economies, the nominal exchange rate depreciations increased ratios of external debt to GDP and debt service requirements, while making imports more expensive and requiring domestic poverty-alleviating measures to counter inflation in the prices of basic necessities.

Figure 2.4: Exchange rate dynamics in selected East African countries, January 2020–April 2021



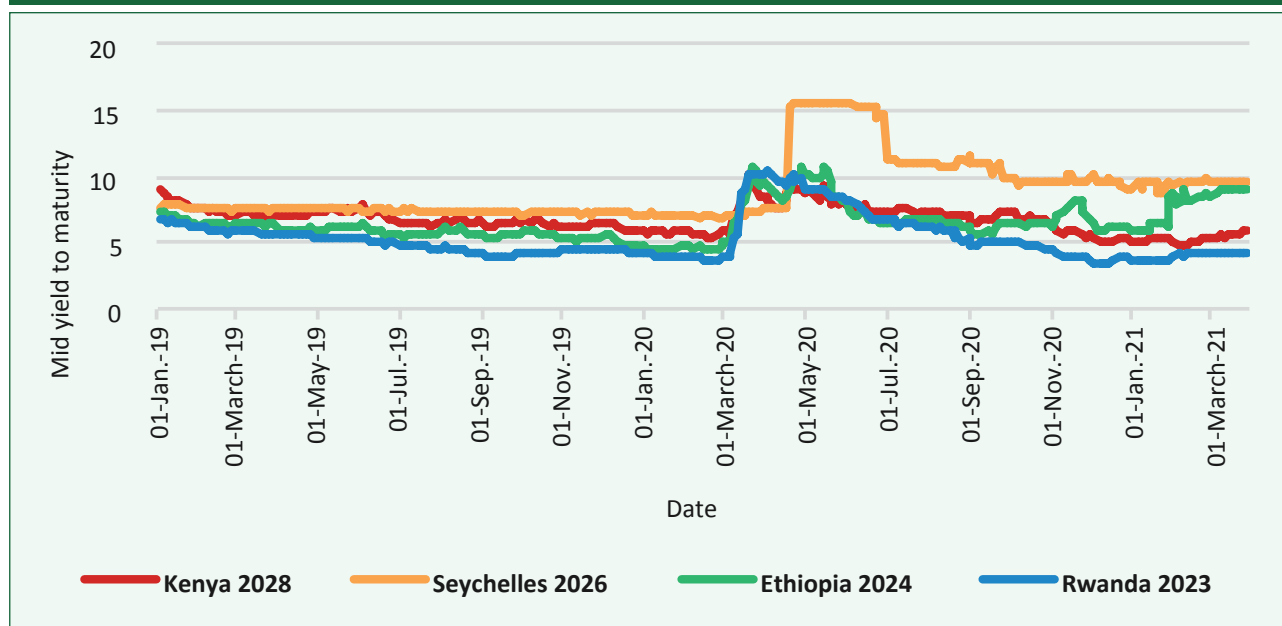
Source: Ethiopia; Central Bank of Seychelles; Bank of Uganda; Morningstar; AfDB staff calculations; IMF 2021b; World Bank 2020a.

Note: To compare recent dynamics using a common starting point more easily, the value of a U.S. dollar in local currency is normalized to 1 as of the end of February 2020, immediately before the start of the COVID-19 shock in financial markets. A higher value indicates a depreciation.

Though exchange rate pressures were only temporary and gradually eased in several countries, such as Uganda, they were more severe and persistent in countries with larger initial external debt burdens and more substantial deteriorations in their current accounts. In Ethiopia, Kenya, Rwanda, and Seychelles exchange rate depreciations exerted steady pressure on external debt repayments and import costs, partly inducing imported inflation—especially for countries with large imports of final consumer goods. Even in some countries with fixed or managed float exchange rates, the need to re-anchor monetary policy and reduce inflationary pressures led to exchange rate devaluations. Sudan, for example, was compelled to devalue its currency by about 85 percent in March 2021.

International financing conditions have continued to tighten for emerging and low-income countries during the COVID-19 pandemic. This tightening has partly reflected pull factors in destination countries, including rising debt service burdens, low export prices for raw materials, and the risk of debt rescheduling measures, which contributed to deteriorations in sovereign credit ratings and risk perceptions. But the tightening also mirrored push drivers, notably increased volatility, and risk aversion among fixed-income investors in advanced economies, as well as the impact of fiscal stimulus in the United States pushing long-term Eurobond yields higher toward the end of 2020 and start of 2021 (figure 2.5).

Figure 2.5: Foreign currency yields for Eurobond issuers in East Africa, January 2019–April 2021



Source: Bloomberg.

Note: The mid-yield to maturity is as of end-March 2021.

In 2020 bond yields rose for the four East African countries with outstanding Eurobonds (Kenya, Ethiopia, Rwanda, Seychelles). During the height of pandemic-induced financial stress in April 2020, most Eurobond yields for East African economies rose in lockstep, followed by a gradual easing—mostly in countries with moderate risk of debt distress, such as Rwanda. In the first quarter of 2021 Ethiopia (whose Eurobond falls due in December 2024) considered participating in the new G20 Common Framework for debt treatment, which goes beyond the Debt Service Suspension Initiative, contributing to spikes in its Eurobond yields. For countries without Eurobonds, tighter external financing conditions effectively meant the temporary shutdown of commercial borrowing.⁶

2.1.3 East Africa's public debt and fiscal deficits were already elevated before the pandemic due to public investments in infrastructure

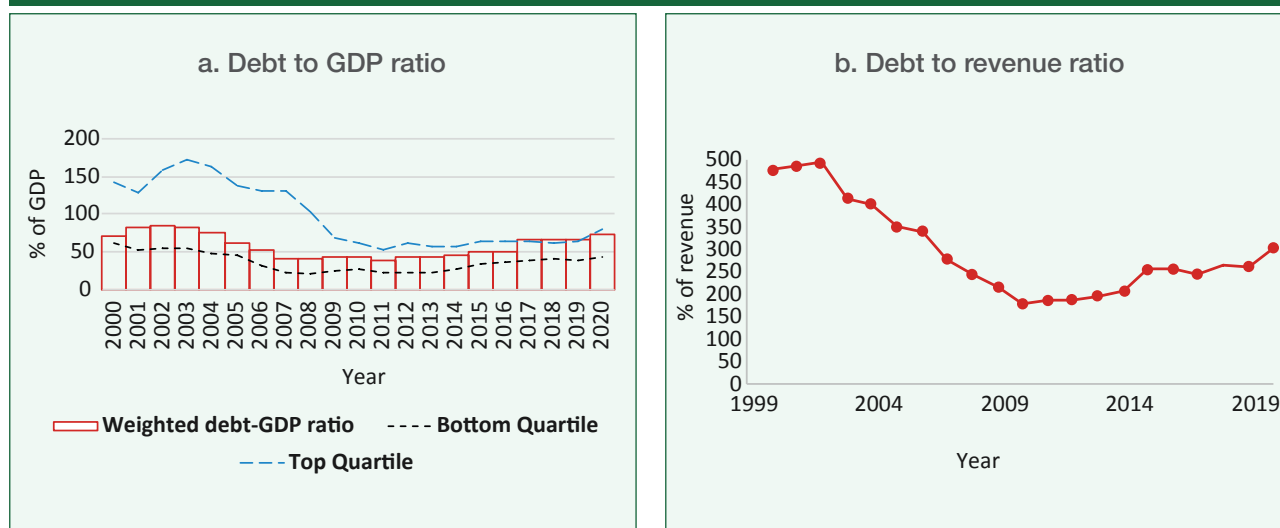
Though adverse macroeconomic and financing conditions associated with COVID-19 and its economic consequences explain much of the short-run rise in debt burdens in East Africa in 2020, debt ratios had been rising for much of the past decade, creating vulnerabilities and exposing countries to substantial refinancing risks. A longer-term perspective on the rise in gross government debt in East Africa over the past two decades is shown in figure 2.6. Ratios of debt to GDP have been rising in East Africa since 2010, with those for both the bottom and top quartiles of countries increasing

⁶ For example, Uganda avoided international commercial debt financing throughout the pandemic, but in March 2021 sought \$200 million in new financing at a seven-year maturity through a syndicated loan led by Societe Generale, according to press reports.

substantially (figure 2.6a). Comparing the median amount of debt to overall government revenue—a measure of governments’ ability to raise resources to service debt in the long run—shows that after a decline in the 2000s,

ratios of debt to revenue increased substantially after 2010 (figure 2.6b). These ratios peaked in 2020 because of sharply declining government revenues due to the pandemic.

Figure 2.6: Public debt ratios in East Africa, 2000–20



Source: AfDB 2021; IMF 2020f.

Note: Weighted average, weighted by USD GDP. Data include Somalia only after 2013.

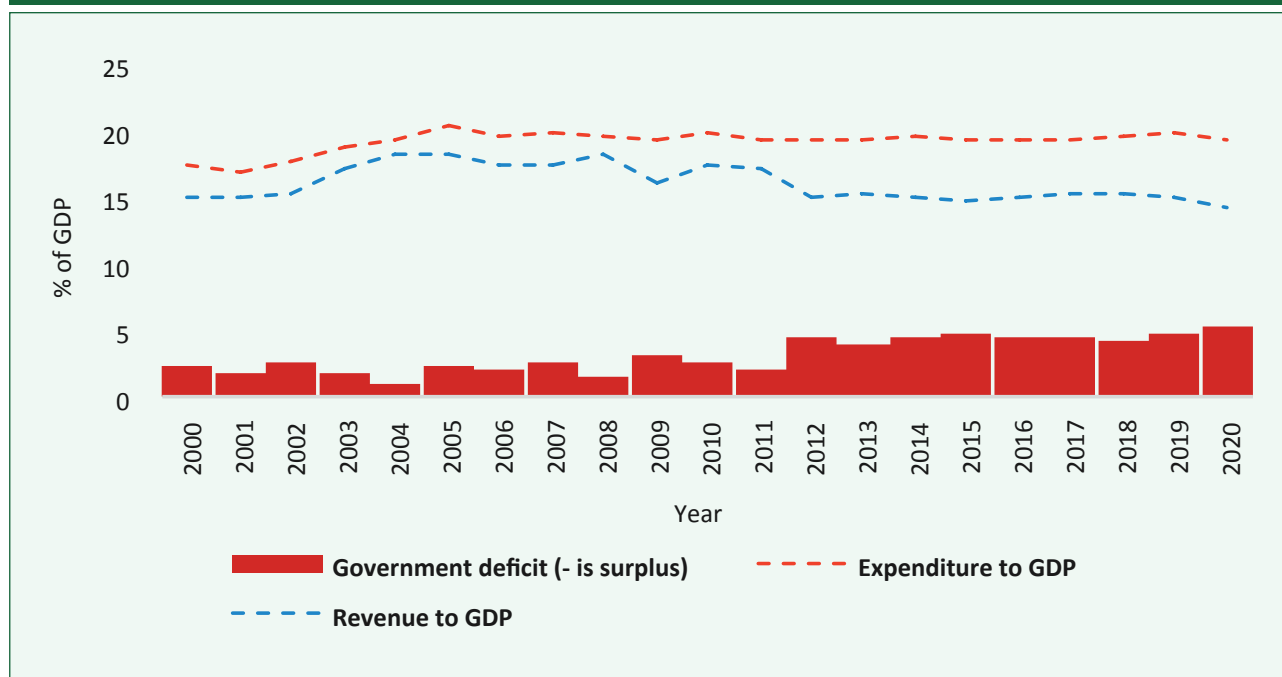
Source: AfDB 2021; IMF 2020f.

Note: Median debt to revenue. Data do not include Somalia.

After a decade of improvement in the 2000s following implementation of the Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI), East Africa’s ratios of debt to GDP rose again after 2011 and gradually worsened. This pickup in public debt was mostly a result of government spending that remained elevated while public revenue declined on the back of lower grant receipts, reduced commodity royalties and nontax inflows, and limited broadening of tax bases (figure 2.7).

Favorable international financing conditions amid historically low interest rates in advanced economies during 2010–19 allowed East African governments to access international commercial lenders, non-Paris Club official creditors, and Eurobonds to finance both current expenditures and long-term investment projects, especially in large economies like Ethiopia, Kenya, and Tanzania (box 2.1).

Figure 2.7: Government revenue, spending, and deficits in East Africa, 2000–20
(Percentage of GDP)



Source: AfDB 2021, IMF 2020f.

Note: Weighted average, weighted by USD GDP. Data include Somalia only after 2013.

Box 2.1: East Africa's debt-investment-growth nexus

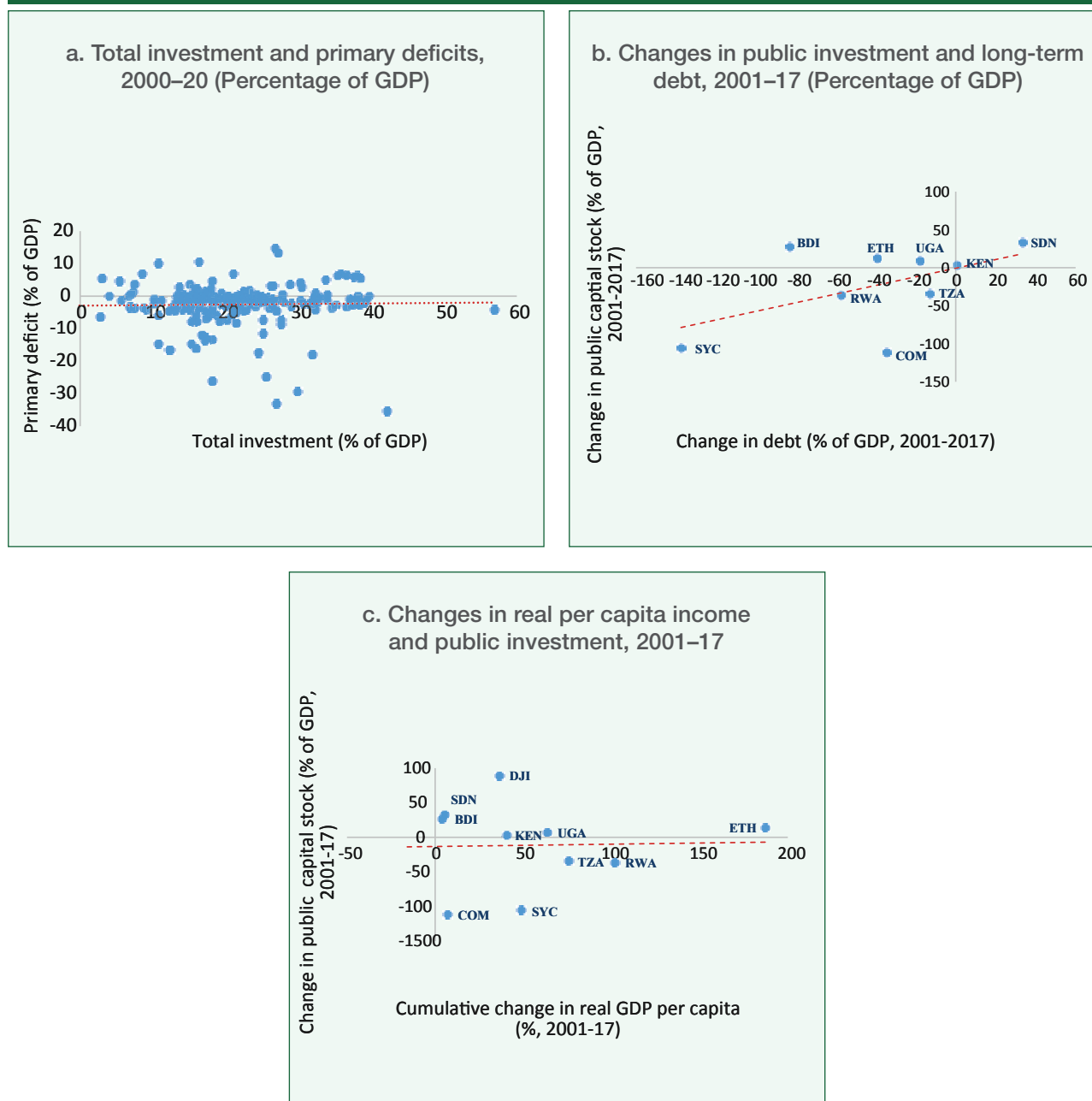
Though rising ratios of debt to GDP may entail refinancing risks and constrain fiscal space, they can also result from increased government capital spending. Such spending can raise prospects for higher living standards by increasing the overall capital stock in an economy, connecting domestic markets to continental and international supply chains, and raising total factor productivity. Theoretical models (Berg and others 2012; Harrison and McMillan 2003) and historical experience in Africa (Morsy, Levy, and Shimeles 2019) suggest that well-targeted “big push” investments in infrastructure can sometimes pay for themselves by inducing future growth and repayment capacity more than the initial debt-financed investment.

Elements suggesting a correlation between debt accumulation, government investment, and growth in East Africa are a key tenet of the IMF-AfDB debt, investment, and growth paradigm. The direct link between higher annual capital formation and public debt is shown in box figure 2.1a. The short-term relationship is relatively weak: while some countries witness high government investment alongside large primary deficits, in most cases high deficits in a given year are driven by growth shocks that trigger unusually low revenues or high current expenditures, limiting the high-frequency correlation.

The longer-term relationship between the accumulation of public capital and debt is shown in box figure 2.1b. Over the medium and long run there appears to be a consistent relationship between the accumulation of external public debt and an increase in the public capital stock, as government borrowing partly funds infrastructure spending. This finding is consistent with empirical evidence about debt-financed investment in several countries in East Africa, including for large infrastructure projects such as the Grand Ethiopian Renaissance Dam, which partly relies on Chinese banks to finance turbines and electrical equipment. Similarly, the Seacom project to develop Africa's first submarine fiber optic cable on Kenya's east coast and the plan to extract methane for electricity generation from Lake Kivu in Rwanda are large investment projects partly funded by the Emerging Africa Infrastructure Fund, in which the AfDB is a participant. Still, the link between external funding and domestic public investment remains imperfect, even over the medium run, suggesting the potential for better public financial management and prioritization of high-impact, debt-funded capital developments.

Moreover, while the debt-investment connection suggests that some of the region's higher debt was used to fund useful capital assets, efficiently turning this additional capital stock into improved capacity to pay and higher living standards requires reinforcing the capital stock–growth nexus in East Africa. The limited apparent connection between long-run growth in GDP per capita and long-run increases in the public capital stock in East Africa, shown in box figure 2.1c, implies substantial room for improving the relationship between capital stock and growth. Though the weak correlation is only suggestive, some of the most significant debt-financed infrastructure projects in Africa have failed to improve growth prospects as much as initially expected, partly due to adverse circumstances (such as military or civil conflict in Ethiopia and South Sudan) and partly to delays in implementation (such as for roads and other transportation infrastructure in Kenya and Rwanda). Raising the growth impact of investment projects requires improving government project management, reducing cost overruns through stricter monitoring of public-private partnerships, and internalizing regional growth spillovers of large infrastructure projects through cooperation institutions in the region.

Box figure 2.1: Capital formation, government debt, and growth in East Africa



Source: AfDB 2021; IMF 2020f.

2.2 CHANGING STRUCTURE AND DRIVERS OF DEBT

Though East Africa has tapped domestic and external commercial markets, most of its public and publicly guaranteed debt is owed to multilateral lenders and official creditors (figure 2.8). Structural trends in the medium-term evolution of the region's debt burdens have been partly halted or concealed by short-term dynamics linked to COVID-19. The composition of debt, its nature, and maturity structure evolved substantially over the past two decades because of global financial and economic forces as well as domestic policy choices.

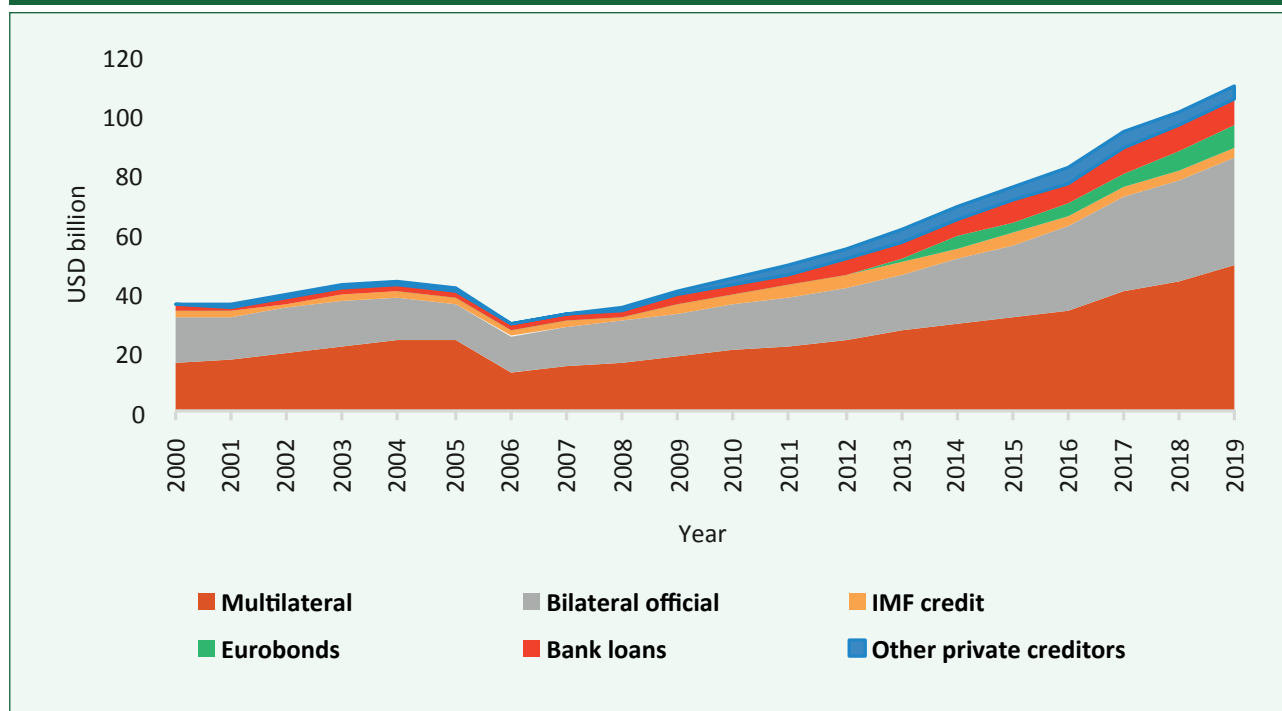
Consistent with trends in the rest of Africa, but at a slower pace, East African countries have increasingly resorted to nontraditional sources of funding. New borrowing was increasingly sourced from commercial lenders, domestic and external, in the form of bonds, bank loans, and collateralized private debt based on the revenue streams of associated infrastructure projects. Before the pandemic, the issuance of international bonds had picked up over the past decade in several countries, notably Ethiopia, Kenya, and Rwanda.

The role of non-Paris Club official or semiofficial creditors—particularly development and state-owned banks in China and India—also increased substantially during 2010–20, especially for countries with tighter geopolitical links to these new partners. Nonetheless, additional borrowing in 2020 to cover the impacts of the pandemic mostly relied on traditional concessional and multilateral sources, leading to a slowdown in the changing structure of external public debt.

2.2.1 The shift toward bondholders, non-Paris Club bilateral lenders, domestic markets, and non-concessional debt has been slower in East Africa than in other parts of Africa

East African economies have traditionally relied on concessional funding from European and U.S. official lenders, and international financial institutions, particularly the African Development Bank, World Bank Group, and IMF. In recent years, however, there has been growth in bank loans, bonded foreign currency debt, and debt owed to other private creditors (see figure 2.8).

Figure 2.8: Public and publicly guaranteed external debt in East Africa by type, 2000–19
(Billions of U.S. dollars)



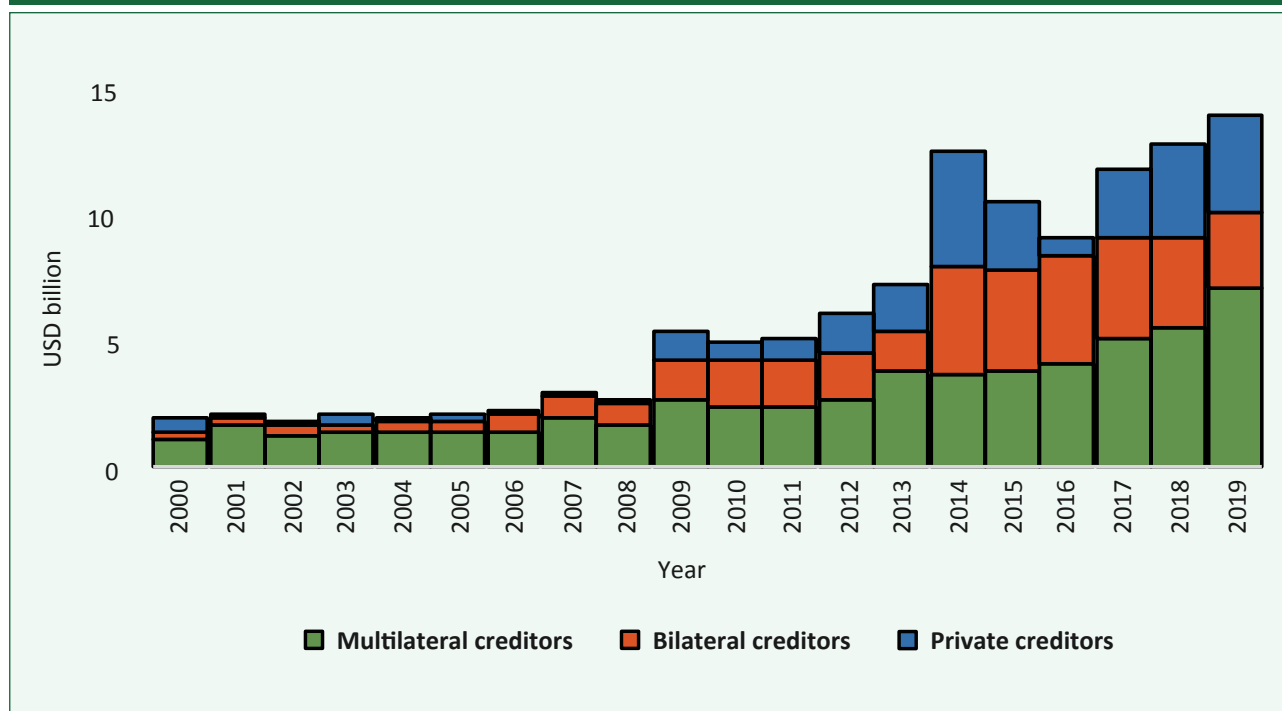
Source: World Bank 2021a.

Note: Data do not include Eritrea, Seychelles, and South Sudan. Data for Sudan do not include penalty interest due on arrears.

These dynamics have evolved since the completion of the Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI), as countries have tried to diversify funding sources and exploit increased fiscal space

to tap domestic and foreign commercial markets. Over the past decade new debt has increasingly been obtained from private and quasi-private creditors, bondholders, and non-Paris Club official lenders (figure 2.9).

Figure 2.9: New debt disbursements in East Africa by source, 2000–19 (Billions of U.S. dollars)



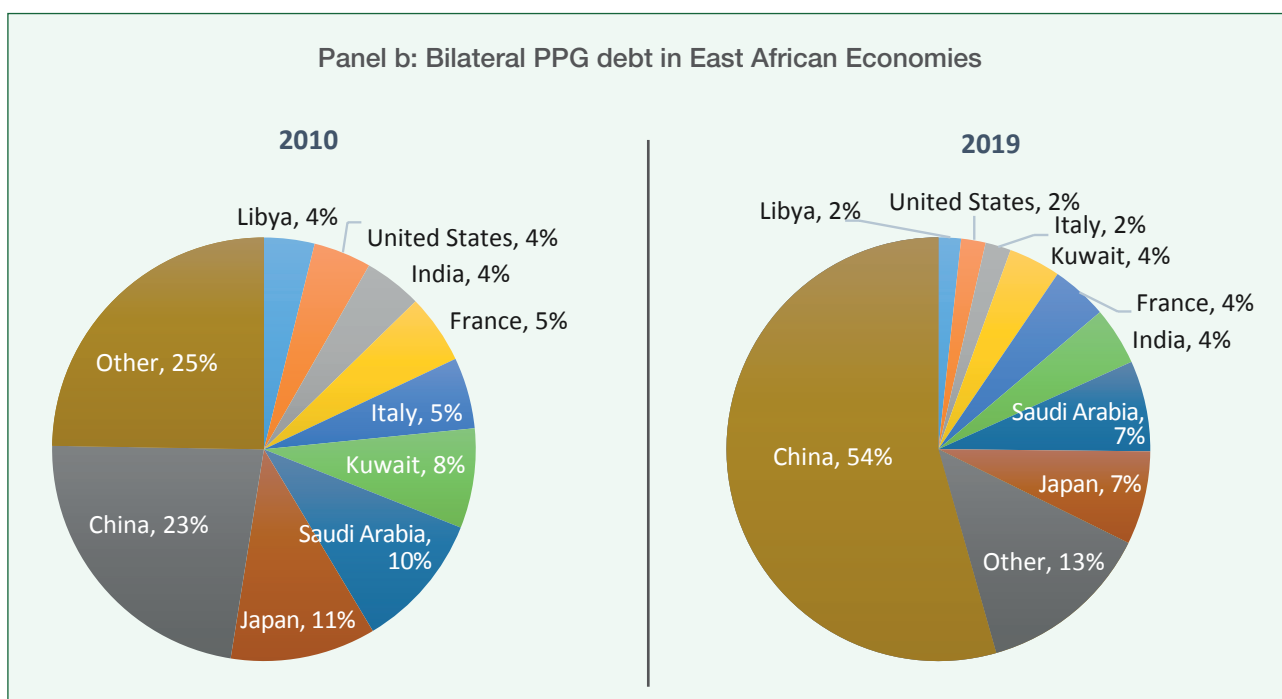
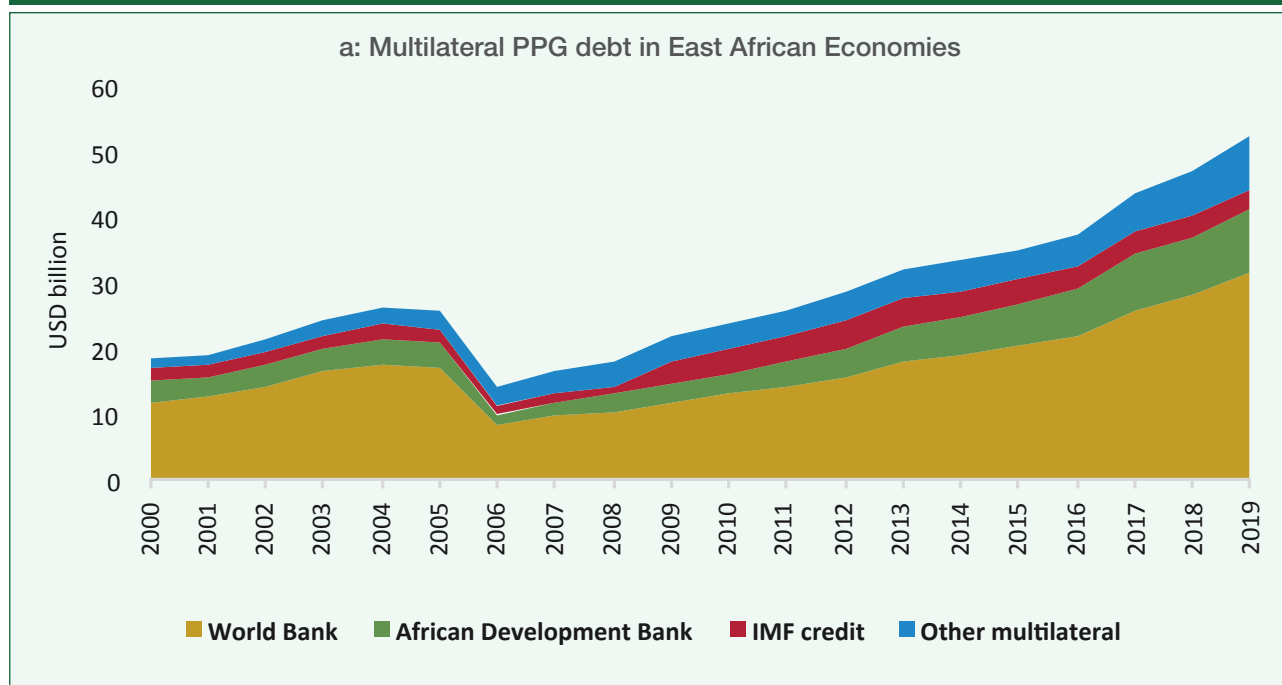
Source: World Bank 2021a.

Note: Data do not include Eritrea, Seychelles, and South Sudan. Data for Sudan do not include penalty interest due on arrears.

A breakdown of debt owed to the region's main multilateral creditors from 2000 to 2019 is shown in figure 2.10a, while figure 2.10b presents a breakdown of debt owed to the top 10 official bilateral creditors (for countries with available data)

for 2010 to 2019. The data show the role of the African Development Bank and World Bank among multilateral creditors, but also the rise of China as an emerging bilateral creditor.

Figure 2.10: Public and publicly guaranteed external debt in East Africa from multilateral and bilateral creditors



Source: Dafe, Essers, and Volz 2018; World Bank 2021a.

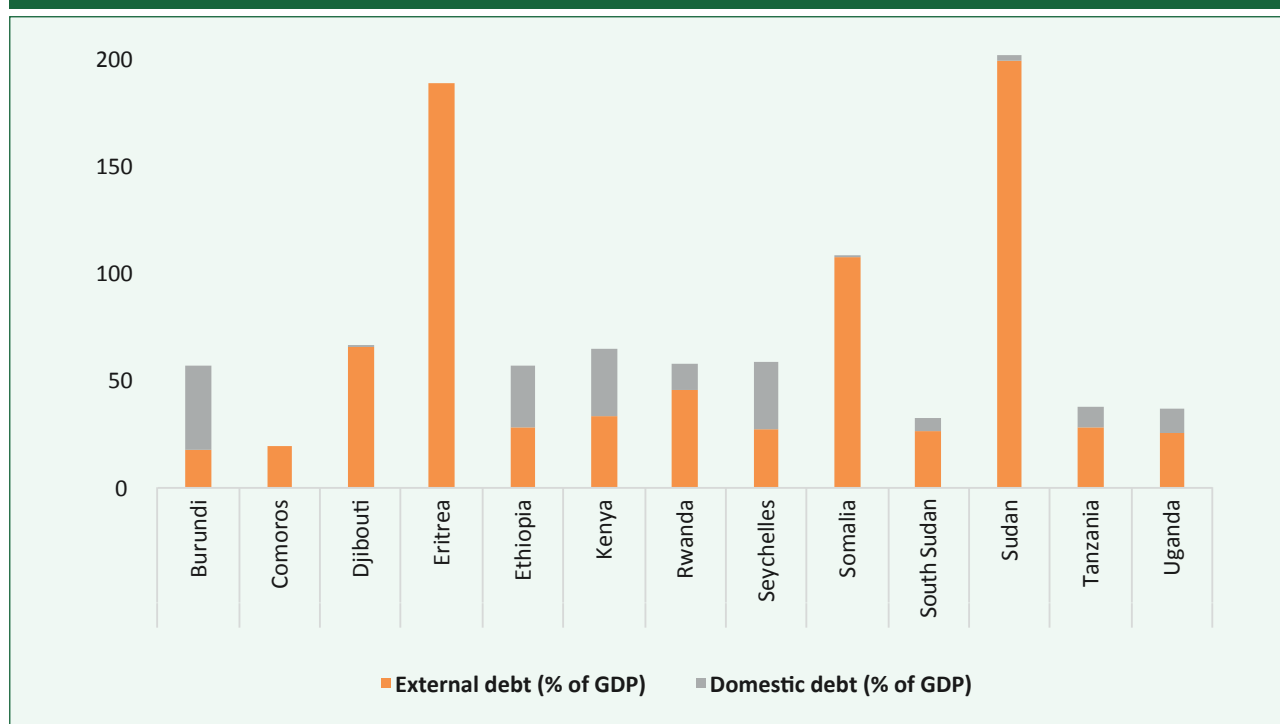
Note: Data do not include Eritrea, Seychelles, and South Sudan. Data for Sudan do not include penalty interest due on arrears.

2.2.2 The increase in domestic debt in East Africa suggests a deepening of absorptive capacity in local currency financial markets

East African economies have traditionally relied on external foreign currency borrowing to fund development initiatives and bridge financing gaps. The limited availability of domestic private savings prevented countries in the region from

tapping domestic currency funding for much of the past three decades. Indeed, domestic private savings remain limited in East Africa, especially in the poorest economies. But as development outcomes have improved, banking systems developed, and life expectancy risen, domestic debt markets have increasingly represented a potential source of local currency funding for governments and other public entities.

Figure 2.11: External and domestic public debt in East Africa by country, 2019 (Percentage of GDP)



Source: World Bank 2021a; IMF World Economic Outlook database and staff estimates; AfDB 2021 and staff estimates.

In 2019 domestic public debt was especially large (above 25 percent of GDP) in Burundi, Ethiopia, Kenya, and Seychelles, reflecting the deeper liquidity of their financial sectors and the presence of substantial domestic savings (figure 2.11). For Ethiopia sizable domestic public debt also partly reflected

financial repression policies subjecting local banks to local currency debt holding requirements, such as the former 27 percent rule.⁷ Similarly, in Burundi ownership of local currency debt instruments is concentrated among domestic banks and the secondary market remains mostly illiquid

⁷ The 27 percent rule, which required private commercial banks to invest an equivalent of 27 percent of loan disbursements in low-yield central bank bonds, was repealed in 2019.

(Essers and others 2016). Intermediate levels of domestic debt are found in Rwanda, Tanzania, and Uganda, where governments have been trying to expand the universe of local currency borrowing instruments. Other countries with limited domestic financial markets, high degrees of fiscal deficit monetization, or substantial domestic and external arrears—including Eritrea, Somalia, South Sudan, and Sudan—are mostly unable to incur domestic public debt.

Domestic bond markets can be expensive funding sources for many East African economies, given persistently high nominal interest rates—although real debt servicing costs remain lower amid elevated inflation. Uganda’s medium- and long-term yields are about 15 percent on government Treasury bonds. Kenya’s 10-year yields hover close to 13 percent, and Tanzania’s at about 12 percent. Despite these substantial debt servicing costs, local currency bond issuance has enabled countries in the region to use more efficient monetary policies, reduce currency mismatches, and raise the maturity profiles of public sector debt. Kenya and Tanzania have issued local currency debt with maturities longer than 15 years, and Uganda has bonds maturing in 2040.

Increasing foreign and domestic nonbank investment in local currency debt markets could help insulate East African economies from global volatility shocks and deepen liquidity for corporate stock and bond markets by reducing novelty premiums and providing benchmark return indexes in domestic financial markets. Foreign investment in local currency bond markets, while subject to higher risk of sudden stops (given its sensitivity to yields and high international mobility) than local ownership, has also stabilized domestic financial markets.

Foreign participation in local currency bond markets has also helped standardize government Treasury bond and Treasury bill auctions (box 2.2), thanks to the presence of the African Development Bank’s African Financial Markets Initiative (AFMI) and the African Domestic Bond Fund (ADBF). In addition, local currency issuance by international institutions can increase liquidity in domestic financial markets, as illustrated by the Rwandan franc-denominated three-year bond with a 9.25 percent coupon rate issued by the World Bank in January 2020. In December 2018 the Dutch development bank FMO provided a five-year, \$32.5 million loan to the Tanzanian corporation ZOLA Electric denominated in Tanzanian shillings.

2.2.3 New private and official players have diversified Africa’s external funding sources—at the cost of limited flexibility in debt resolution

During 2010–20 Eurobond issuances and loans from China to East African countries increased, reflecting a shift and diversification in the composition of the region’s creditor base. These new sources can provide attractive financing opportunities given the absence of policy conditions and the lump-sum cash disbursements associated with such loans. But the lack of policy conditions can also undermine transparency and governance in the use of such financing. Loans from China to East Africa reached more than \$37 billion over 2000–19 (box 2.3). Such loans may imply less flexibility in risk sharing among creditors in cases of debt distress, given the absence of a consistent international legal framework for resolving debt owed to private creditors and non-Paris Club bilateral lenders.

Box 2.2: The recent uptick in bond issuance in East Africa

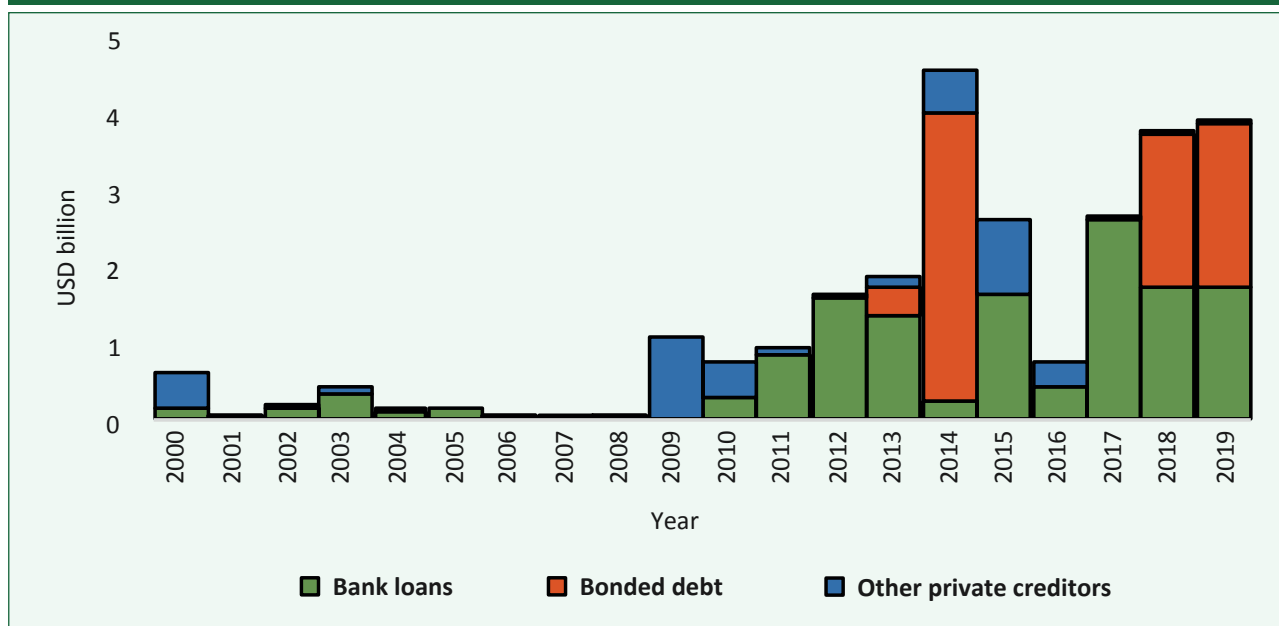
Starting in 2013, low global bond yields and a “reach for yield” among fixed-income investors favored investment in East Africa because countries in the region offered relatively high coupon rates and apparently safe investor ratings. As more East African economies obtained inaugural sovereign ratings, investor appetite for the region’s foreign and local currency-denominated government bonds grew, presenting governments with long-term nonconcessional financing opportunities and full discretion over the use of funds.

Eurobond issuance tends to be associated with pull factors, including oil discoveries (Kenya), energy infrastructure investment (Ethiopia’s Grand Ethiopian Renaissance Dam), or large construction projects (such as stadiums, convention centers, and a new airport in Rwanda). Issuance also coincided with investor appetite for frontier markets in Sub-Saharan Africa and Southeast Asia, in the context of a search for higher yields, high willingness to incur risk, and abundant liquidity. Because yields in advanced economies, notably the United States, are expected to increase somewhat due to the post-COVID economic recovery and investment stimulus plans, international funding conditions might deteriorate and deter future Eurobond issuance by East African economies—especially those undergoing IMF programs or supervision.

Issuances of debt to private creditors in East Africa over 2000–19, by debt type, are shown in box figure 2.2. Eurobond issuances are not as prevalent in East Africa as they are elsewhere in Africa due to the large number of economies in debt distress or at high risk of falling into distress. Still, commercial borrowing in the form of foreign currency-denominated bonds has picked up, with Eurobond issuances concentrated in Ethiopia (which issued \$1 billion in Eurobonds in 2013), Kenya (\$2.75 billion in 2014, \$2.0 billion in 2018, and \$2.1 billion in 2019), Rwanda (\$400 million in 2013), and Seychelles (\$230 million in 2006, later converted to a discount bond). In addition, Tanzania issued a \$600 million, seven-year private placement in 2013. In 2008 Seychelles defaulted on its Eurobond, but other countries have remained current on their foreign currency bonded debt, including Tanzania repaying its private placement at the onset of the COVID-19 pandemic. Still, recent stress involving repayment risks for Ethiopia’s 2024 Eurobond suggests that the inflexibility associated with foreign currency bonded debt repayment schedules may not align well with East Africa’s volatile macroeconomic conditions, risky refinancing options, and limited domestic fiscal space.

Source: Sy 2015.

Box figure 2.2: Public and publicly guaranteed debt issuances to private creditors by East African countries, 2000–19 (Billions of U.S. dollars)



Source: World Bank 2021a.

Note: Data do not include Eritrea, Seychelles, and South Sudan. Data for Sudan do not include penalty interest due on arrears.

Box 2.3: The rise of China's role as a creditor to East Africa

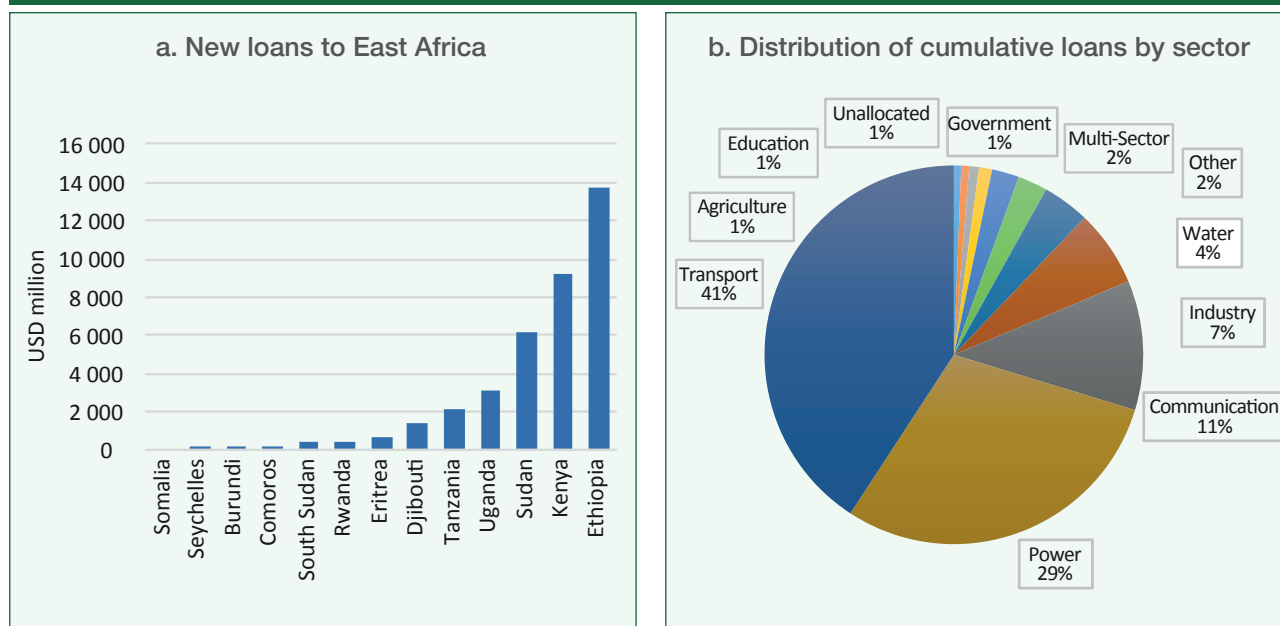
Over the past two decades new international bilateral creditors have played an important role in meeting East Africa's external funding needs. Borrowing tied to infrastructure projects, as well as commercial resource-backed loans to fund the exploration and exploitation of natural resources, became increasingly available from China's multilateral development banks.

During 2000–19 Ethiopia, Kenya, and Sudan were among the top five African borrowers from China. Chinese loans to East Africa countries since 2000 have been concentrated in countries where China has substantial economic or geopolitical interests (box figure 2.3). Chinese loans have fallen since 2014, partly due to local conflicts and stagnating or declining commodity prices in key exporters of raw materials. Though the bulk of Chinese loans to East Africa have targeted the region's largest economies, including Kenya, some smaller countries, notably Djibouti, owe a substantial share of their external debt to Chinese quasi-official or official lenders.

It is of paramount importance to increase the transparency and consolidation into public sector balance sheets of Chinese official and nonofficial lending to East Africa, especially since some estimates suggest that some East African economies have failed to disclose more than half of their debt commitments to China to the World Bank and IMF's debtor reporting system.

Source: Horn, Reinhart, and Trebesch 2020.

Box figure 2.3: China's loans to East Africa by country and sector, 2000–19 (Millions of U.S. dollars)



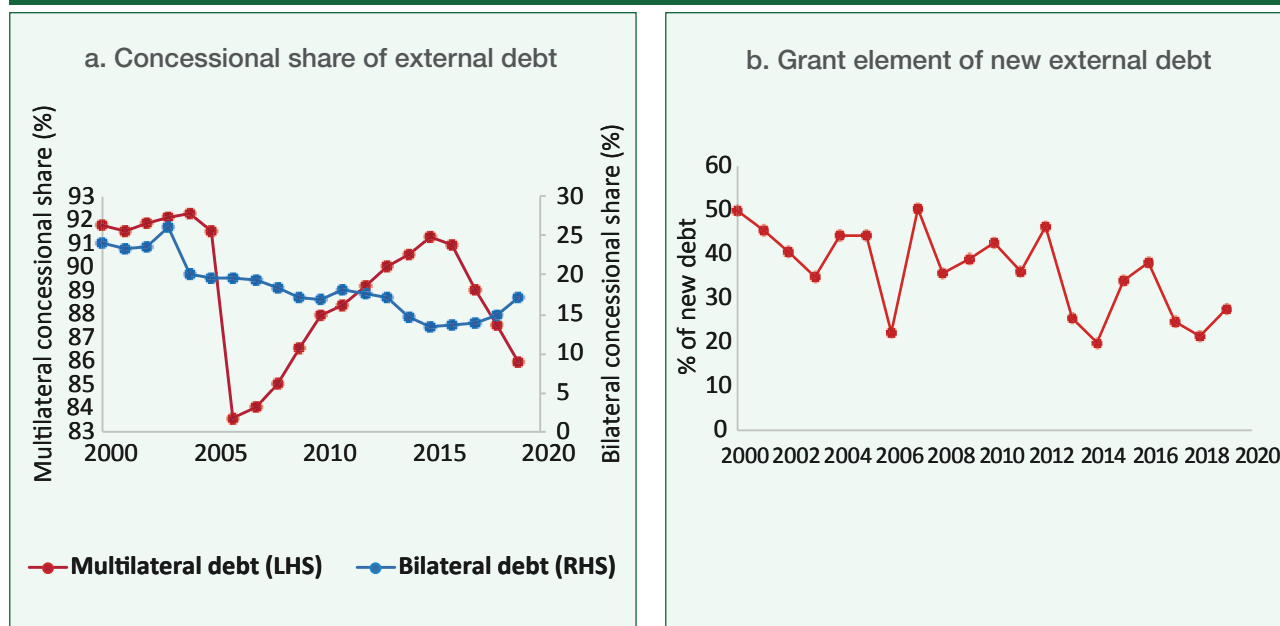
Source: Bräutigam and others 2019.

2.2.4 The maturity and structure of East Africa's debt indicate a structural shift toward less traditional donor-based concessional borrowing

Even though multilateral lending still constitutes the bulk of external public sector financing in East Africa, its terms have become less favorable as development outcomes have improved. The weighted average shares of concessional debt in external debt for the region over 2000–19 are shown in figure 2.12a, separated for debt owed to multilateral

and bilateral official creditors. The downward trend in concessional debt for both types of borrowing reflects better economic prospects in many East African countries, backed by higher living standards and prospects of access to middle-income country status. It also demonstrates the substantially reduced availability of bilateral concessional financing amid reductions in aid budgets by many traditional official lenders: the grant element of new external debt steadily decreased over the period (figure 2.12b).

Figure 2.12: Concessional share of public and publicly guaranteed external debt in East Africa, 2000–19 (Percent)



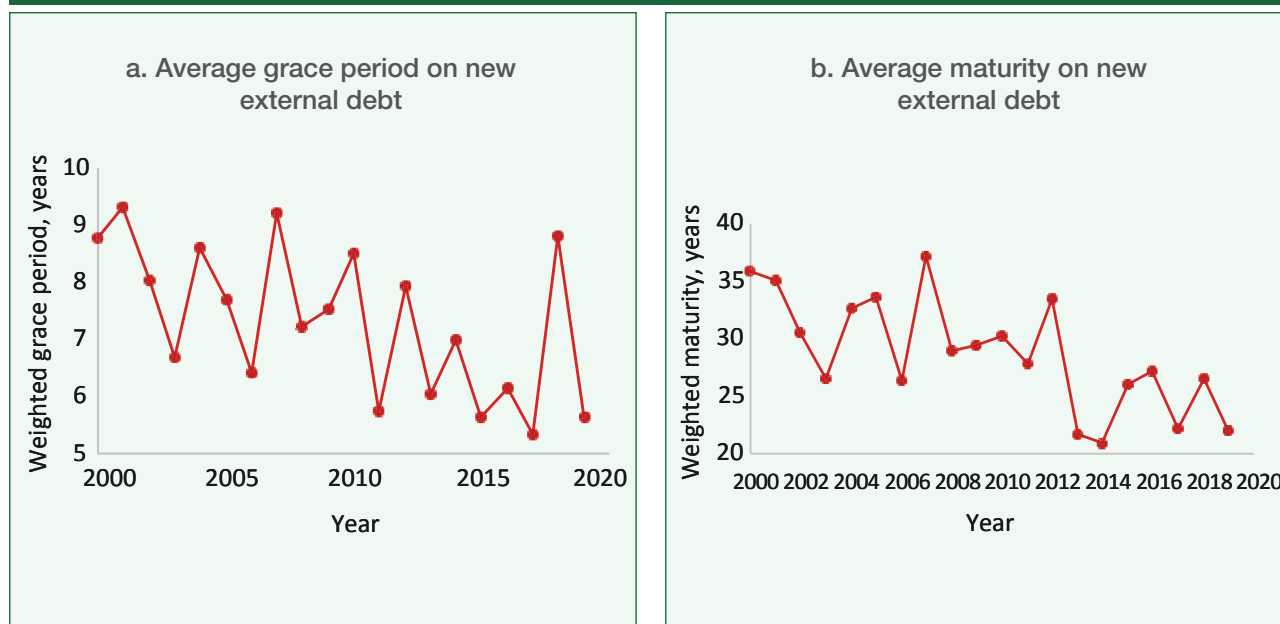
Source: World Bank 2021a.

Note: Data for figure 2.12a are averages weighted by total debt in the category. Data for figure 2.12b are averages weighted by new loan commitments. For both figures, data include Somalia only after 2013.

Similarly, the average grace period on new commitments has shortened for new debt incurred by economies in the region, again suggesting less concessional financing terms from multilateral and bilateral creditors (figure 2.13a). At the same time, increased access to private borrowing led the maturity structure of debt in East Africa to evolve in parallel with the

changing composition of creditors. And despite a long average maturity of more than 20 years, the region shows a steady long-run decline in the maturity of new public and publicly guaranteed debt—potentially raising rollover risks in the short term, especially when combined with shorter grace periods (figure 2.13b).

Figure 2.13: Average grace periods and maturities of public and publicly guaranteed new external debt in East Africa, 2000–19 (Number of years)



Source: World Bank 2021a.

Note: Data are averages weighted by new loan commitments and include Somalia only after 2013.

2.3 EMERGING VULNERABILITIES AND THE OUTLOOK FOR DEBT

2.3.1 Fiscal space has narrowed and repayment constraints are expected to tighten over the next few years, prompting concerns of widespread debt distress

Several East African countries are experiencing substantial risk of debt distress due to declining government revenues, large infrastructure financing needs, domestic or external conflicts, and significant external headwinds in commodity prices and exchange rates.

In 2020, among all regions in Africa, East Africa had the

highest prevalence of countries in external or public debt distress (Eritrea, Somalia, Sudan) or at high risk of it (Burundi, Djibouti, Ethiopia, Kenya, South Sudan; table 2.1). Debt distress risk has also evolved unfavorably in the region since 2013, with some countries that were at low risk of debt distress in 2013—such as Ethiopia and Kenya—at high risk in 2020. This deterioration partly reflects the direct impacts of COVID-19, which led many countries to breach high-risk debt service coverage ratios, largely due to reduced exports and rising debt service. In addition, import costs rose due to exchange rate depreciations. Moreover, countries' ability to pay down debt fell over the past decade because rising debt service obligations and interest payments were not met with commensurate increases in government revenue and GDP growth.

Table 2.1: Debt sustainability ratings for low-income countries in East Africa, 2013 and 2020

	2020				
		Low	Moderate	High	Distress
2013	Unrated				Somalia
	Low	Tanzania	Uganda	Ethiopia Kenya	
	Moderate		Rwanda	South Sudan	
	High		Comoros	Burundi Djibouti	Eritrea Sudan

Source: IMF Debt Sustainability Analysis, various years.

Similarly, credit rating agencies have downgraded several East African economies due to deterioration in external funding conditions, reflecting reduced willingness to lend and retrenchment by investors in advanced economies, as well as the impacts of COVID-19. Ratings from Fitch for East African sovereigns from 2018–21 exhibit a series of down-

grades—including for Ethiopia, which financial market institutions consider to be at greatest risk of debt default (table 2.2). Seychelles experienced two downgrades in 2020 as reduced foreign currency inflows and a widening fiscal deficit (including contingent liabilities associated with state-owned enterprises) suggested a higher likelihood of debt distress.

Table 2.2: Credit ratings for selected East African countries, 2020–21

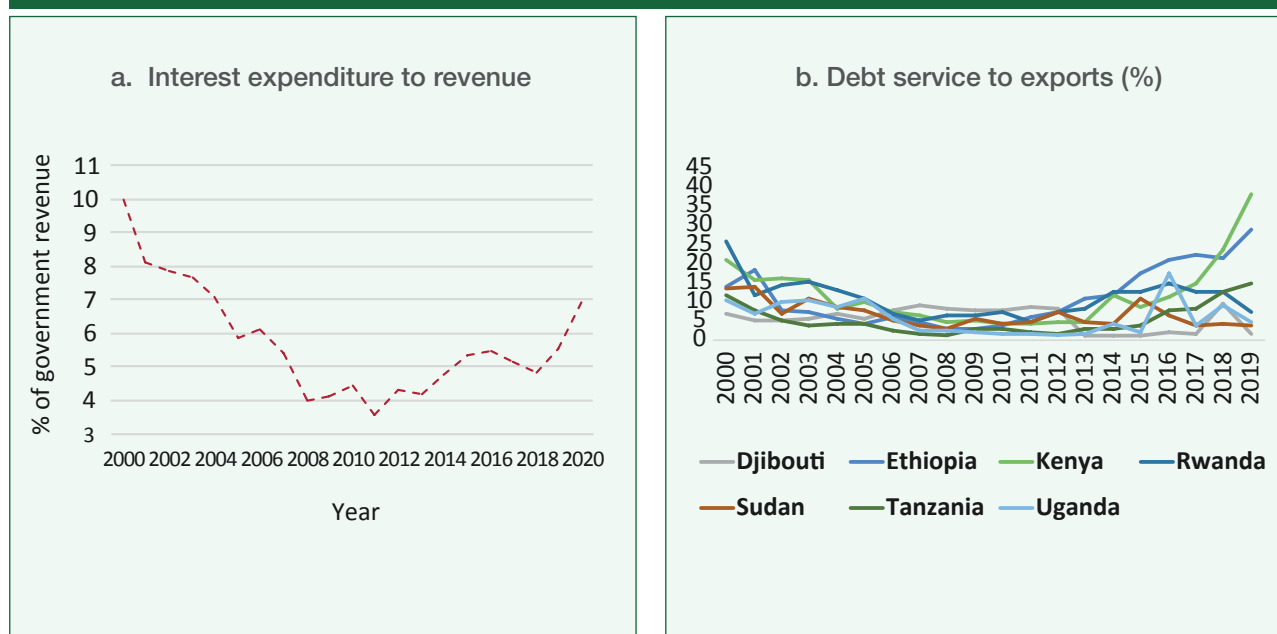
Country	Rating	Last rating action	Date of last action	Rating outlook
Ethiopia	CCC	Downgrade	09-Feb-2021	-
Kenya	B+	Affirmed	26-Mar-2021	Negative
Rwanda	B+	Affirmed	25-Aug-2020	Stable
Uganda	B+	Affirmed	24-Jun-2020	Negative
Seychelles	B	Downgrade	18-Dec-2020	Stable

Source: Fitch Ratings.

Fiscal capacity in East Africa has been stretched over the past decade because interest expenditures have accounted for a steadily rising share of government spending (figure 2.14a). Most of the rising burden of interest payments reflects a composition effect, as debt shifted away from multilateral and bilateral concessional sources toward more commercial domestic and foreign ones. Interest servicing can put substantial strain on government budgets and crowd out the funding of development initiatives and basic public services.

Moreover, interest rates on new external public and publicly guaranteed debt increased throughout the period, burdening East African countries with substantial external debt servicing costs in foreign currency and exacerbating exchange rate vulnerabilities. Debt service relative to exports has been rising in most large East African economies since 2011, following a decline in the 2000s, raising liquidity concerns (figure 2.14b).

Figure 2.14: Interest spending and debt service in East Africa (Percent)



Source: World Bank 2021a; IMF World Economic Outlook database; AfDB 2021 and staff estimates.

Note: Median value. Data include Somalia only after 2013.

2.3.2 Suspension of short-term debt service has provided breathing space, but several East African countries will likely require debt restructuring and relief

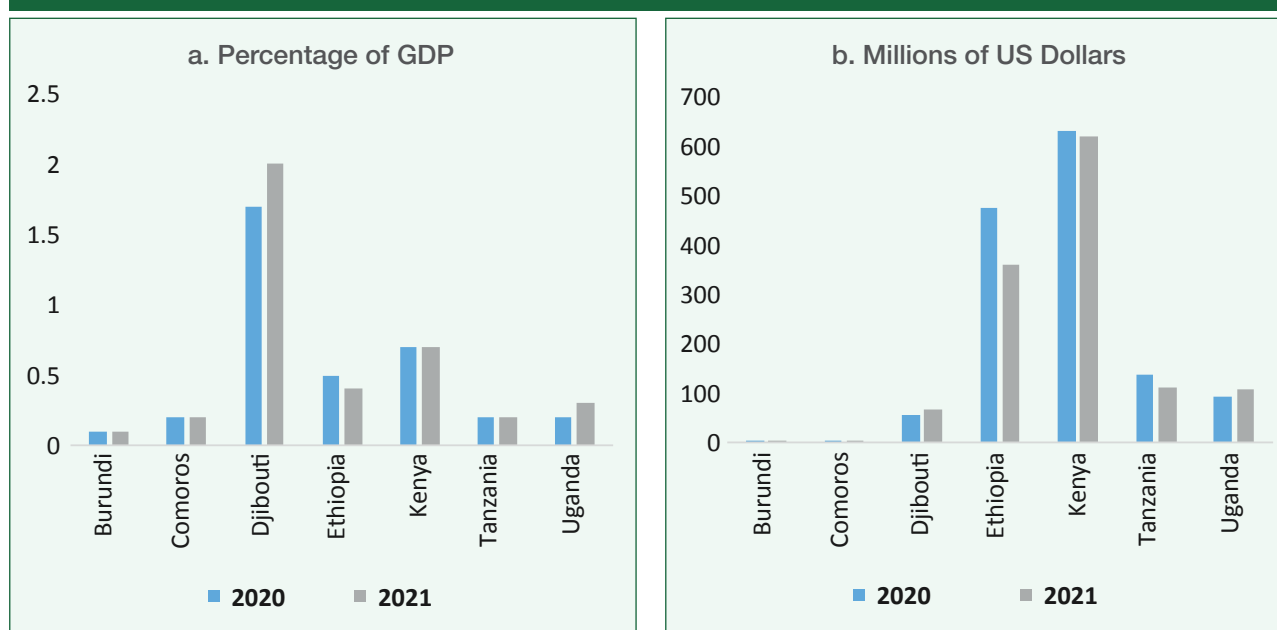
Several bilateral and multilateral initiatives have provided temporary debt service relief to East African economies, including the G20-sponsored Debt Service Suspension Initiative (DSSI) and the IMF's Catastrophe Containment and Relief

Trust (CCRT). The DSSI suspended principal and interest repayments owed to official bilateral creditors for eligible countries from May 2020 to June 2021, representing overall potential debt relief of nearly \$3 billion for East African countries (figure 2.15). The CCRT provided grants to fund principal repayments to multilateral lenders for the region's most affected economies. Steps taken by China under the Forum on China-Africa Cooperation also provided some reprieve to East African economies with large zero-interest loans coming due in 2020.

Temporary debt relief helped countries allocate funding to address the COVID-19 pandemic. But the extension of maturities and preservation of the net present value of existing external debt servicing requirements under the DSSI will increase refinancing needs after 2022. This will add to medium-term rollover risks for highly indebted East African countries such as Djibouti and Ethiopia. Thus debt restructuring will likely be needed to

address potential liquidity and solvency constraints, extend existing maturities, and expand fiscal space for pro-poor and growth-enhancing public spending. Ethiopia's intention to seek relief under the G20 Common Framework for Debt Treatments beyond the DSSI is a sign of the rising need for more structural medium- to long-term liability management for East African economies amid rising rollover risks.

Figure 2.15: Potential debt relief savings for East African countries under the Debt Service Suspension Initiative, 2020–21



Source: World Bank 2021a; DSSI data; AfDB staff estimates.

2.3.3 The debt maturity profiles of East African countries suggest high potential for substantial rollover risks in the coming years

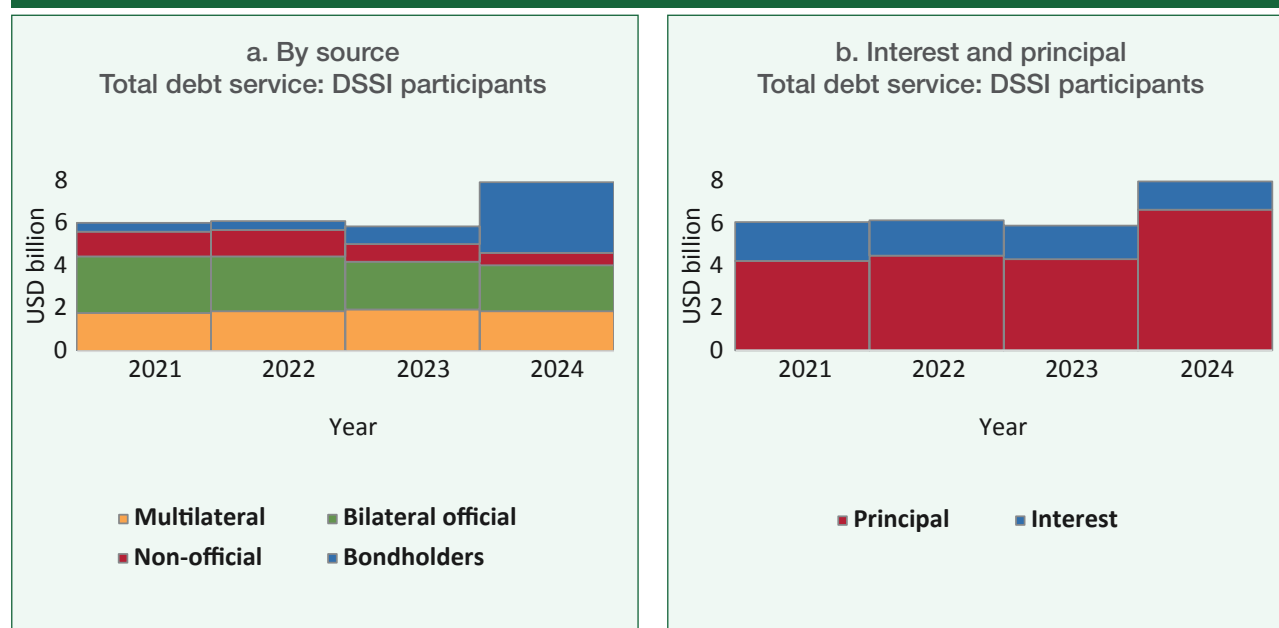
Debt vulnerabilities are also evident in East Africa's large external refinancing needs over 2021–24, especially for the region's most vulnerable countries. The projected external debt servicing needs of the public sector, before the application of the DSSI for eligible countries, are shown in figure 2.16.

Substantial refinancing needs are expected, especially as large external bond repayments denominated in foreign currency come due in Ethiopia, Kenya, and Rwanda during 2022–24. In addition, public sector debt owed to official and multilateral lenders is due in 2021–22 in Burundi and Djibouti. Moreover, because the DSSI merely pushed back repayment obligations over the next five years, without affecting their net present value, pre-measures of future refinancing needs should be interpreted as lower-bound estimates of funding

gaps for DSSI beneficiaries in East Africa. Though growth is expected to pick up in 2021–22, partly easing the debt burden for the region's countries thanks to increased government

and export revenue, the interest rate growth differential remains positive in several countries, contributing to an increase in debt burdens.

Figure 2.16: Projected external debt servicing needs for East African participants in the Debt Service Suspension Initiative, 2021–24 (Billions of U.S. dollars)



Source: World Bank 2021a; DSSI data; AfDB staff estimates.

Note: Data are calculated before the application of the DSSI and net present value–neutral rescheduling of 2020–21 maturities and may not include all debt service. Data cover Burundi, Comoros, Djibouti, Ethiopia, Kenya, Rwanda, Somalia, Tanzania, and Uganda.

2.3.4 Debt owed by state-owned enterprises can create large contingent liabilities

Over the past decade the contingent liabilities associated with the quasi-fiscal deficits of state-owned enterprises (SOEs) have been a major source of debt vulnerabilities in East Africa. In Sub-Saharan Africa a huge share of public sector balance sheets—up to 20 percent of GDP on average—could arise from the liabilities of SOEs. Non-debt liabilities including accounts payable, pensions, and other financial commitments can also be substantial: in Tanzania they could represent about 15 percent of GDP (Harris and others 2020). Though central government fiscal support for SOEs aims to target

systematically relevant entities and ensure a level playing field between SOEs and private competitors, such support often lacks transparency and clear prioritization, leading to high recurring fiscal costs without improvements in enterprise governance.

In East Africa these contingent liabilities are created by the debt distress of SOEs including utilities, airlines, and banks. Such liabilities can represent enormous immediate fiscal needs and trigger protracted debt resolution negotiations. For example, Air Seychelles has yet to repay its \$70 million debt to Etihad Airways, and the government might be required to assume it—in addition to the company's contingent liabilities

of about 5 percent of GDP that the government covered in 2012. Oil-related advances in South Sudan and the resolution of the state-owned postal bank in Comoros are other examples of contingent liabilities that could amount to more than 2 percent of GDP. Fiscally relevant support to SOEs in the region is often concentrated in a few entities. In Kenya 10 entities account for 95 percent of all losses made by public corporations. In Uganda the recapitalization needs of the Bank of Uganda and Uganda Development Bank represented a fiscal cost of nearly 1 percent of GDP.

Few East African countries provide complete, aggregated reporting on their SOEs, preventing data collection and fostering concerns about potential contingent liabilities, which in turn raise borrowing costs. Improving the oversight of smaller SOEs, consolidating the supervision of large ones under domestic sovereign wealth funds, and privatizing nonpriority businesses owned by governments for legacy reasons could improve the management of contingent liabilities and limit downside risks for central governments.

2.3.5 Despite the risks associated with a race to seniority, rising collateralization can improve risk sharing with creditors

Collateralization has increased in new commitments by bilateral lenders in East Africa—especially in project finance, where secured loans are often backed by physical assets or future revenue streams. Collateralization can improve risk sharing with creditors, especially when it takes the form of pledged flows of future revenues generated by underlying investments. In Ethiopia and Kenya collateralized debt associated with pledged future revenues has been used to fund major railway projects and utility investments.

Collateralized debt allows for partial equity-like exposure of external investors, guarantees risk sharing in case of underperformance, ensures the involvement of creditors in the successful completion of infrastructure and construction

projects, and typically does not involve foreign currency or maturity mismatches between revenue streams and debt servicing requirements. Collateralized loans can also involve public-private partnerships, as in the case of cooperatives in Comoros receiving funding for clove harvesting from the International Trade Centre and the United Nations Development Programme to facilitate access to global value chains.

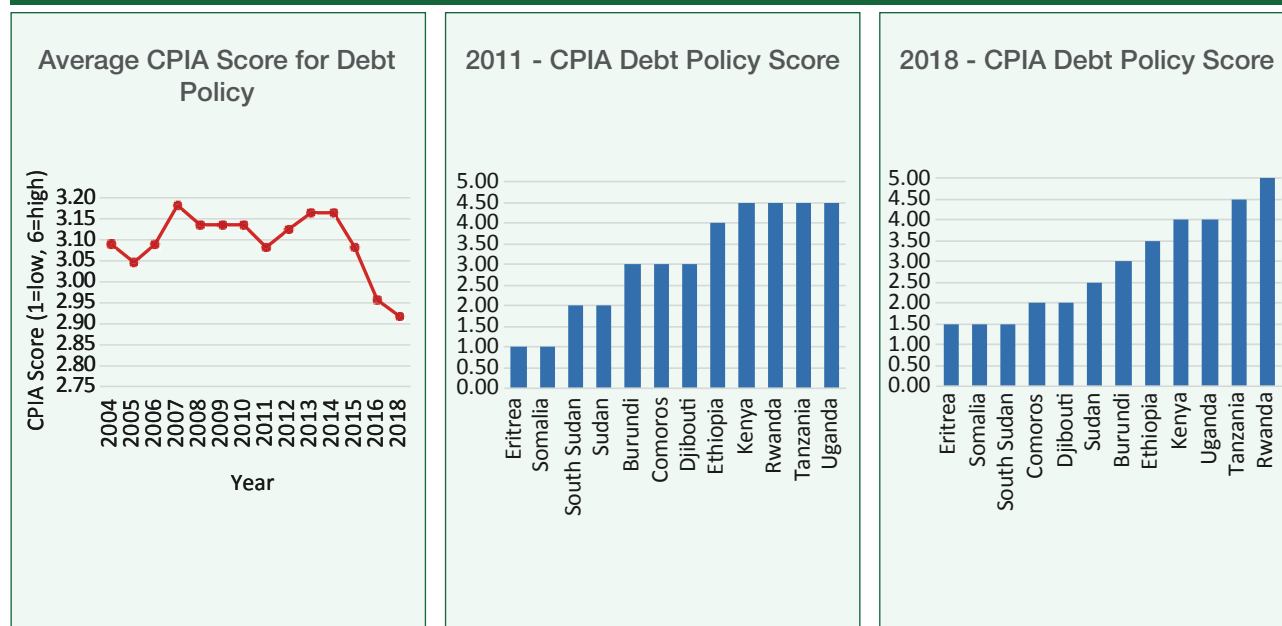
However, collateralization could lead to a “race to seniority” as creditors of countries in debt distress attempt to secure their liens on pledged assets to avoid being part of aggregate settlements and debt resolution initiatives. So, improving the quality and standardization of negative pledge clauses in bonded debt, legally limiting collateralization potential to the direct flows of revenues associated with projects, and ameliorating the transparency and consolidation of collateralization clauses across public sector liability commitments are of paramount importance to avoiding a race to seniority in East Africa.

2.4 CONSOLIDATING DEBT SUSTAINABILITY: THE NEXUS BETWEEN STRUCTURAL REFORMS, GOVERNANCE, AND GROWTH

2.4.1 Improving the governance of public sector balance sheets is crucial to long-term sustainability and market access

The African Development Bank’s Country Policy and Institutional Assessment (CPIA) scores for debt policy over 2004–18 are shown in figure 2.17 for most East African countries. Though debt management quality improved in Eritrea, Somalia, Sudan, and Rwanda between 2011 and 2018, it mostly deteriorated or stagnated elsewhere, notably in the region’s largest economies (Ethiopia, Kenya, Uganda). CPIA debt scores are lower in East Africa than among peer Sub-Saharan countries, especially in poorer and debt-distressed countries (Eritrea, Somalia, Sudan).

Figure 2.17: Country Policy and Institutional Assessment scores for debt policy in East Africa



Source: AfDB Country Policy and Institutional Assessment database 2020.

Improving debt governance in East Africa will require actions related to transparency, reporting, oversight, and early warning signals of unsustainable debt dynamics. Centralizing debt data and management activities in an independent office could provide a comprehensive view of each country's contractual debt obligations. It would also enable countries to better manage their debt by improving currency matching with future export and foreign direct investment inflows (hence reducing exposure to foreign exchange risk) and duration matching with the timing of debt-financed investments. Debt management could be accompanied by an early warning system that alerts countries of slippages in debt levels or dynamics at the national and subnational levels.

Though some East African countries have established dedicated debt management units—notably Ethiopia, Rwanda, and Tanzania—some lack the human and financial resources needed to ensure achievement of their mandates. Debt management would be improved by integrating cash and debt management into single units responsible for

monitoring treasuries' general accounts, ensuring the timely reporting of liabilities by subnational governments, and using state-of-the-art auctioning, management, reporting, and risk assessment software.

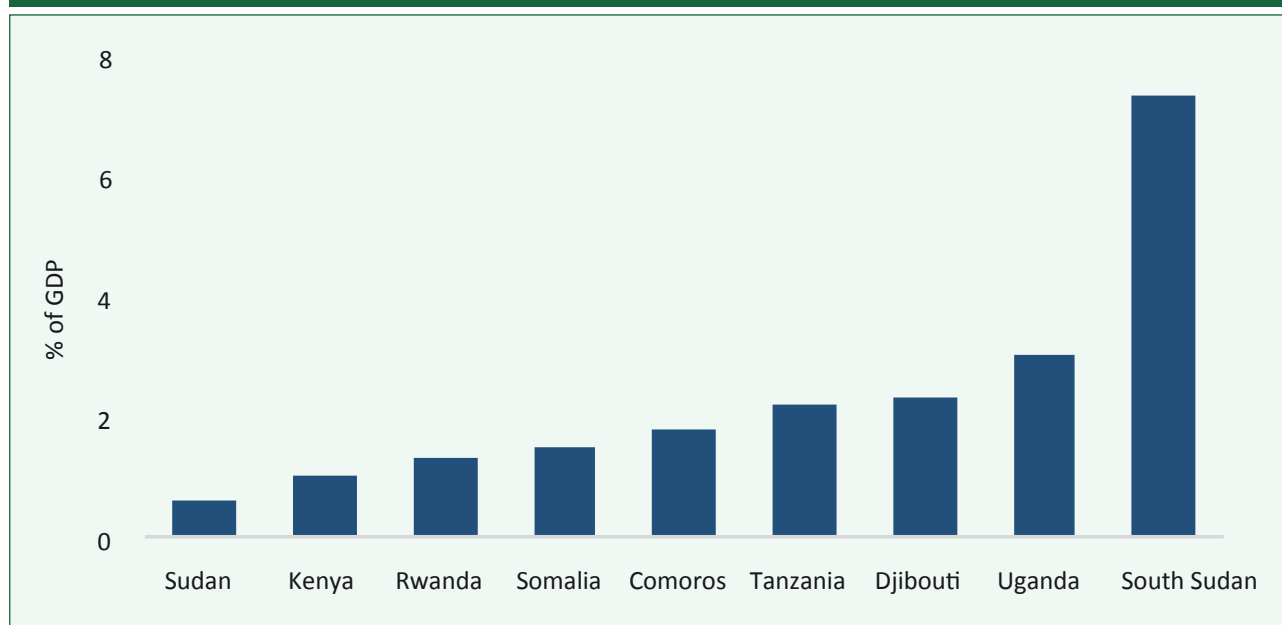
Domestic arrears can complicate debt management. In 2018 East African countries had large domestic arrears, a situation that only worsened after 2020 due to COVID-related delays in payments to civil servants and the fulfillment of contractual obligations.

Domestic arrears are especially large in South Sudan, Uganda, and Djibouti (figure 2.18). But they also account for a considerable share of public debt in larger economies—including Tanzania, where the repayment of arrears on domestic expenditures and VAT refunds is a critical part of the conditionality associated with emergency financing obtained from multilateral lenders. In many of the region's countries the domestic arrears of SOEs have become government debt burdens due to poor monitoring and moral hazard inducing

excessive risk taking by SOEs. Examples include commodity price risks for exporters of raw materials (such as Sudan) and

quasi-fiscal subsidies to electricity and water consumers in countries with high poverty (such as Ethiopia).

Figure 2.18: Domestic fiscal arrears in selected East African countries, 2018 (Percentage of GDP)



Source: Beers, Jones, and Walsh 2020.

2.4.2 Better transparency and coverage are required to build creditor confidence, limit hidden liabilities, and regain access to international funding markets

Improving debt transparency in East Africa is essential to regain investor confidence and limit the spillover risks of debt restructuring. Recent downgrades in country credit ratings (see table 2.2) were motivated by the need for better data collection on the debt commitments of subnational and corporate SOEs. Increased debt transparency could lower

borrowing costs for low-income and emerging economies (Kemoe and Zhan 2018). Model laws on budget execution and transparency, such as Uganda's Public Finance Management Act of 2015,⁸ could be expanded and provided as a repository of best practices for economies in the region with weaker governance of budget processes and debt transparency. Several countries in the region have implemented reforms to enhance debt transparency, including Ethiopia, Somalia, South Sudan, and Sudan. Measures have included expanding publication of detailed quarterly and annual debt

⁸ The act sought to align government incentives with chapter 9 of the Ugandan constitution and included principles such as long-term sustainability of public finances, optimal resource allocation based on national goals, prudent custody of government resources and investments, and accountability in the use of public funds (Mills 2019).

statistics (Ethiopia) and reconciling debt data (Somalia, South Sudan, Sudan). Debt reconciliation formed the basis for Somalia's progress toward its HIPC decision point in March 2020 and Sudan's in June 2021.

Debt reconciliation could be conducted more often in East African countries, with technical assistance from multilateral lenders, to reduce the legal and financial risks associated with hidden liabilities, provide investors with a complete picture of countries' external debt commitments, and contribute to the diversification of the investor base.

2.4.3 Curbing illicit financial flows is crucial to reducing international currency outflows

Illicit financial outflows have been a drain on foreign exchange reserves in East Africa for several decades and continue to put downward pressure on foreign currency liquidity for several countries with weak public financial management. Such outflows can also erode the tax base, limit capital accumulation, and undermine the rule of law. In the region illicit financial flows are often related to money sheltering in tax havens or trade of extracted raw materials. Outflows of illegal capital flight in the form of trade-related contraband—especially exported commodities, tax evasion and sheltering, and direct products of criminal activities—could cost low-income African countries nearly 4 percent of GDP a year (Global Financial Integrity 2020).

Capital flight represents more than 5 percent of GDP in many East African countries including Burundi, Comoros, Djibouti, Ethiopia, Rwanda, Seychelles, and Uganda (UNCTAD 2020a). Some have been at the core of illicit financial flows—notably countries affected by domestic and external conflicts where tax enforcement can be lacking due to limited administrative capacity and legitimacy. Countries with higher commodity dependency are also more likely to exhibit trade-related corruption, transfer pricing manipulation and broader international corporate income tax evasion, and other forms of illicit cash outflows. Discrepancies in international trade data between importer-based and exporter-based reporting appear to be large for commodity trade flows, suggesting illicit financial outflows in diamonds, gold, and other precious metals. This is the case in countries such as Burundi, Tanzania, and Uganda, where intermediaries serve as conduits for illegal international trade flows (UNCTAD 2020a).

Potential ways to improve reporting of international financial flows in East Africa and reduce government tax gaps related to illicit outflows include promoting financial transparency, increasing the number of bilateral treaties involving automatic cross-border exchange of information between tax authorities, and establishing continentwide registries of beneficial ownership. Coordinating the drafting of bilateral tax and investment treaties among East African economies is also essential to avoid a race to the bottom in secrecy provisions and transfer pricing conditions offered to multinational corporations.

CHAPTER 3

POLICY PRIORITIES TO RECOVER FROM COVID-19

This chapter proposes priority policies and reforms needed to get East African economies back on the path of strong growth and social inclusion. The goal of the proposed strategies is to build economic resilience in the long term while preserving livelihoods in the short term and maintaining debt sustainability in the medium term. The strategies are categorized into three groups:

- Short-term policies that respond to the immediate impacts of the pandemic on livelihoods.
- Medium-term policies that stimulate post-pandemic economic recovery and create conditions for more durable growth over 2021–24.
- Long-term policy reforms that strengthen countries' resilience and build capacity to tackle poverty and fragility, creating opportunities to move out of fragility for fragile and post conflict countries and transition to high-income status for middle-income countries.

3.1 SHORT-TERM POLICIES

3.1.1 Gradually withdraw economic stimulus packages to cement gains already achieved

In 2020 several East African governments instituted fiscal and monetary policy measures to cushion their economies from the impacts of COVID-19 (table 3.1). Tanzania cut the minimum reserve requirement from 7 to 6 percent and the Central Bank discount rate from 7 to 5 percent to support growth and the private sector. Kenya instituted fiscal and monetary stimulus measures including a reduction in the

Central Bank rate from 8.25 percent to 7.0 percent. Ethiopia accelerated processing of value-added tax (VAT) refunds and expanded tax exemptions on products that mitigate the spread and effects of the pandemic. In addition, the National Bank of Ethiopia provided liquidity to commercial banks—15 billion birr (\$456 million) to private banks and 33 billion birr (\$1 billion) to the Commercial Bank of Ethiopia—to enable them to provide debt relief and additional credit to the private sector.

Similarly, the National Bank of Rwanda cut its reserve ratio from 5 to 4 percent and provided 50 billion francs (\$50 million) to private banks facing liquidity challenges to borrow for short periods including overnight, 3, 6, and 12 months. Seychelles dropped its monetary policy rate by 1 percentage point and introduced a credit facility of \$50 million to help commercial banks.

Though the stimulus packages supported resilience in East Africa by keeping many private firms in business, they also shrank fiscal space by reducing tax revenues—a tradeoff that will be inevitable in the short to medium term to support economic recovery. Taxing already depressed private firms would undermine their survival, negatively affecting tax collections in the long term. Countries with small private sectors and vulnerable domestic resource bases (like South Sudan) should not focus on quick ways of boosting domestic revenues through aggressive tax measures to expand the fiscal space. Instead, they should keep economic stimulus packages in place for a bit longer than countries with more mature, diversified private sectors (like Kenya).

Table 3.1: Economic stimulus packages introduced in East Africa in response to COVID-19, 2020

Country	Monetary policy	Fiscal policy
Burundi		Established a national contingency plan equivalent to 0.9 percent of GDP for six months and increased reserves for oil and food.
Comoros	Central Bank reduced its reserve requirement to 10 percent, restructured commercial loans, and froze interest rates.	Granted a delay in tax payments for formal businesses and cut import taxes by 30 percent on essential items such as food and medicine.
Djibouti	Granted a delay in tax payments for formal businesses and cut import taxes by 30 percent on essential items such as food and medicine.	\$5.5 million allocated for healthcare supplies and deadline for submitting tax reports extended by 15 days.
Eritrea		
Ethiopia	Provided \$456 million to private banks and \$1 billion to the Commercial Bank.	Implemented sectoral coordination links to mitigate pandemic effects at a cost of 1.6 percent of GDP.
Kenya	Reduced the Central Bank rate from 8.25 to 7.0 percent.	Increased healthcare spending by 0.4 percent of GDP and provided economic stimulus of 0.5 percent of GDP.
Rwanda	National Bank lowered its reserve ratio from 5 to 4 percent and provided \$50 million to private banks.	Implemented economic recovery plan estimated to cost 4.4 percent of GDP.
Seychelles	Monetary policy rate cut by 1 percentage point and Central Bank credit facility of 500 million rupees created for private banks to help affected businesses.	Provided wage grants equivalent to 5.1 percent of GDP to affected firms for three months. Increased healthcare spending by 0.5 percent of GDP, spending on vulnerable groups by 0.25 percent of GDP, and froze hiring of nonessential workers.
Somali	Central Bank provided \$2.9 million to commercial banks for lending to affected firms.	Introduced partial tax exemption on basic food imports and full exemption on medical supplies. Government spending on health and other social services increased \$12.1 million.
South Sudan	Reduced lending rate from 13 to 10 percent and cash reserve ratio from 15 to 10 percent. Banks allowed to negotiate and vary loan terms.	Government spending on healthcare increased by \$8 million.
Sudan	Imposed three-month moratorium on loan repayments.	Allocated \$912 million for spending on healthcare, vulnerable households, and salary increases.
Tanzania	Cut minimum reserve requirement from 7 to 6 percent and discount rate from 7 to 5 percent.	Expedited payment of arrears to small and medium-size enterprises and introduced value-added tax and custom exemptions for imported health supplies.
Uganda	Bank of Uganda waived limitations on credit restructuring facilities. Lending rate cut from 8 to 7 percent. Mobile banks asked to lower transaction fees.	Provided supplemental budget spending of 1.3 percent of GDP for healthcare, security, and vulnerable groups. Expedited payment of government arrears, deferred tax payments for affected people and firms, exempted taxes on medical supplies, and supported provision of essential services (water and electricity) and distribution of food.

Source: IMF 2020a, 2021.

In addition, countries can take different approaches to supporting the private sector, with more incentives going to small and medium-size enterprises (SMEs). Furthermore, countries more reliant on donor financing of development projects (like Burundi and Eritrea) should try to strengthen their domestic resource bases over the long term, while using more concessional loans and grants in the short term to reduce the long-term pressure of debt service.

To cement the gains achieved with the stimulus packages, the measures should be withdrawn gradually. The first phase of withdrawal for each country could be implemented when signs of economic recovery are evident in high-frequency economic data including tourist arrivals, home sales, consumer spending, and payroll and employment data. Withdrawal of the measures should give businesses that benefited from tax deferrals an opportunity to spread the accumulated tax arrears, if any, to avoid plunging the businesses into a liquidity crisis. To that end, countries should adopt flexible regulations to accommodate carryforwards and write-offs of tax liabilities for businesses facing challenges.

Furthermore, phased withdrawal of the measures can also be implanted at the sector level, with sectors deemed to be super-spreaders of the pandemic remaining under partial containment while the rest are opened. In Kenya containment measures were partially relaxed in June 2020 to help open the economy but retained on the hospitality industry. Targeted support including tax deferrals and access to funding at below-market interest rates can then be extended to sectors remaining under containment to ensure that businesses do not choke under dried liquidity.

With the already weakened fiscal positions of East African countries, financing of the phased withdrawal of the economic stimulus packages is bound to be a constraint. To avoid further fiscal deterioration, recovery strategies should be part of ongoing fiscal consolidation programs, focusing on rationalization of nonpriority spending to restore debt and fiscal sustainability. The authorities should also seek international support through grants and concessional loans and avoid more expensive commercial debt.

3.1.2 Roll out mass vaccinations to build herd immunity and accelerate the return to normal

Faster recovery in East Africa will depend on how quickly large portions of the population can develop immunity against the virus through vaccinations. Several countries have already begun vaccinating their populations, starting with the most vulnerable groups including doctors and nurses, police officers, teachers, and the elderly. But uptake of vaccines by targeted groups has been low due to concerns about their safety and side effects. In April 2021 South Sudan announced plans to destroy about 70,000 doses of the AstraZeneca vaccine that had expired earlier in the month.

The authorities should take bold steps to procure more doses of the vaccines and encourage people to take them. These efforts should involve public education and awareness campaigns to debunk the conspiracies surrounding the vaccines. In addition, East African policymakers must support greater coordination among countries in the fight against COVID-19 and in the provision of financial support to mitigate the effects of the pandemic and support the rollout of vaccinations. Countries like Tanzania that have not yet approved the use of the vaccines should consider authorizing, procuring, and starting vaccinations.

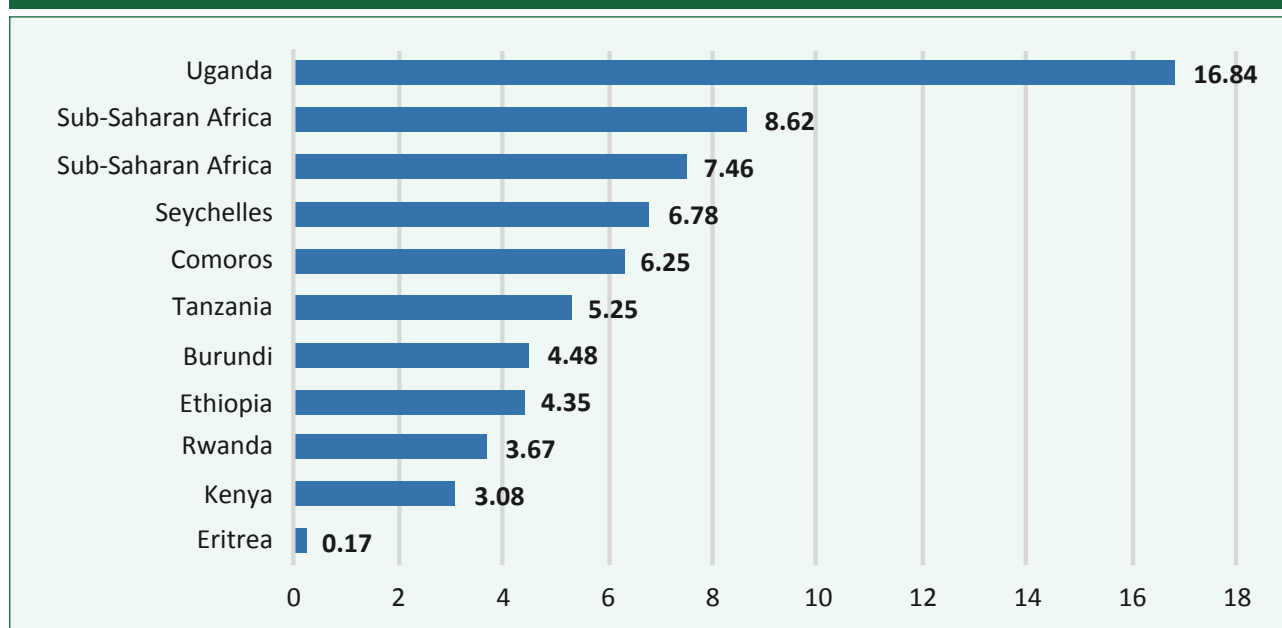
3.1.3 Rationalize and increase the efficiency of spending to expand fiscal space

Though the development needs of many East African countries remain enormous, the resources available to meet those needs have declined due to COVID-19. To maintain reasonable fiscal space, countries must reprioritize recurrent spending and reschedule nonpriority development projects. Several countries in the region, such as Tanzania, have reallocated budgets for travel, meetings, workshops, and public holiday celebrations to support the recovery—including by providing much-needed support to vulnerable populations. With travel limited by COVID-19 containment measures, countries can also reallocate travel budgets to strengthen healthcare infrastructure.

At the same time, making public spending more efficient will help improve the development impacts of available resources. Public investment efficiency, captured by incremental capital output ratio (ICORs) and measured by total investments as a percentage of GDP divided by

GDP growth, is low in some East African countries (like Uganda) relative to the Sub-Saharan average (figure 3.1). But most East African countries have higher investment efficiency (lower ICORs) than the Sub-Saharan average.

Figure 3.1: Average investment efficiency in selected East African countries, Sub-Saharan Africa, and emerging markets and developing countries, 2015–19 (Percent)



Source: African Development Bank statistics.

Measures to make public spending more efficient should primarily entail reducing resource leakages through corruption and misuse of public resources. Building strong and independent accountability institutions will help in countries like South Sudan, which ranked 179 of 180 countries on Transparency International's 2019 Corruption Perceptions Index. SOEs are another area where countries can increase spending efficiency. Sudan has 450 SOEs engaged in financial, commercial, and noncommercial activities. Most incur losses and receive state subsidies, adding to the central government's growing fiscal burden. Many East African SOEs have weak governance structures, and no system is in place to track and monitor their performance. In early 2021, allegations of

misuse of funds intended for COVID relief by the Kenya Medical Supplies Agency led to investigations by parliamentary committee on health, and call for strengthening of transparency, accountability and financial management in SOEs by the development partners and other stakeholders.

3.1.4 Scale up public health preparedness to mitigate effects of pandemics

Containing further waves of the pandemic and avoiding harsh lockdowns will require beefing up health systems in almost all of East Africa. As in many developing countries, preparedness for a large-scale pandemic attack remains

weak in many East African countries. Multiple border entry points, some of which are not staffed, mean that the risk from the coronavirus comes from both airport and land arrivals. Thus, tighter border controls are needed, particularly for illegal crossings.

Several East African countries do not have adequate isolation centers or ventilators for patients infected with COVID-19. Moreover, the number of health workers dedicated to COVID-19 treatment is still low in many countries in the region, while the supply of personal protective equipment is inadequate. More resources should be directed toward strengthening health infrastructure and human resource capacity to curb further spread of the virus. In addition, public awareness campaigns should promote adherence to public health protocols for containing the virus. Countries can encourage employers, as Kenya did, to allow workers to work more from home if their physical presence in offices is not a must, and religious ceremonies (including church services) can be celebrated online to avoid gathering too many people in one place. Governments can also encourage their private sectors to develop and use more online transactions for services including online and mobile payment systems and courier services.

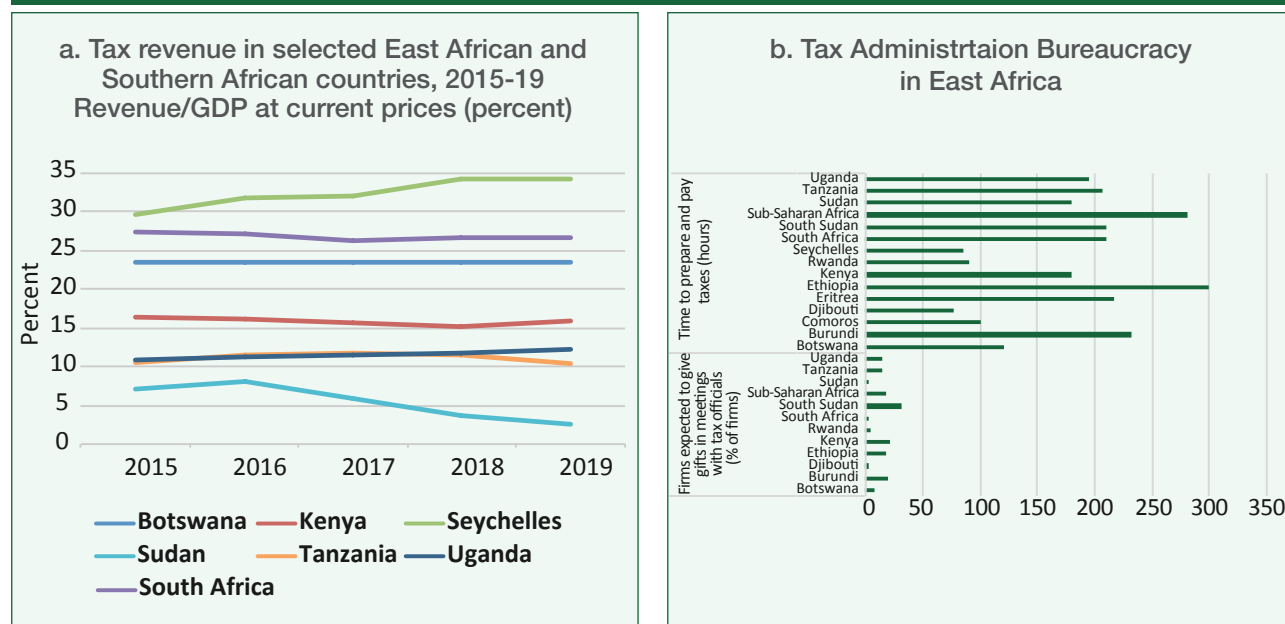
In addition, rapid testing and contact tracing can aid in early identification and isolation of cases. Tanzania introduced a community-based contact tracing system in Dar-es-Salaam to help the government identify people with signs of infection

and trace their contacts, which helped contain the spread of the virus. Rwanda adopted innovative ways to combat the spread of the virus including disseminating public information through drones, using robots for screening and inpatient care, and delivering official communications through a national WhatsApp number to combat misinformation. Decentralizing testing to private health facilities helped Kenya increase the number of people knowing their status once they suspected they were infected. Ethiopia's government established toll-free call centers that operate 24 hours a day at the national and subnational levels under the COVID-19 Emergency Response Project. It also introduced a risk communication and community engagement strategy that includes a recording at the beginning of all phone calls with information on how to prevent the coronavirus, what its symptoms are, and a number to call if care is needed.

3.1.5 Boost domestic revenues through more efficient tax administration

The adverse impacts of COVID-19 on domestic revenues has significantly widened fiscal deficits in East Africa, from 5.1 percent of GDP in 2019 to 5.6 percent of GDP in 2020, with fragile and less diversified countries hit hardest. To restore fiscal stability, accelerating domestic resource mobilization remains a priority in the region. Domestic tax collections remain low in many East African countries, and between 2015 and 2019 fell in Sudan and Tanzania and stagnated in other countries of the region (figure 3.2a).

Figure 3.2: Tax revenues and administrative bureaucracy in East Africa



Source: African Development Bank statistics.

Tax collection efforts are low in the region (except Seychelles) relative to Southern African peers Botswana and South Africa. Though low tax effort does not necessarily imply the need to raise taxes, it signals the potential for increasing tax revenues by making tax administration more efficient and broadening the tax base. In many East African countries tax administration is riddled by rent seeking (figure 3.2b), which induces inefficiencies that lead to sluggish revenue mobilization. The shares of firms expected to give gifts in meetings with tax officials are high in East Africa—at 30.6 percent in South Sudan, 20.9 percent in Kenya, and 20.0 percent in Burundi—compared with the Sub-Saharan average of 17.6 percent, 8.4 percent in Botswana, and 3.1 percent in South Africa.

Furthermore, while some East African countries have made impressive improvements in the time required to prepare and pay taxes, others still perform dismally relative to Botswana and South Africa. In Ethiopia it takes about 300 hours to prepare and pay taxes, compared with 76 hours in Djibouti,

85 hours in Seychelles, 120 in Botswana, and 210 in South Africa (see figure 3.2b). In the short term, implementing measures to broaden the tax base and reducing inefficient tax expenditures could help build fiscal space. Efforts should be channeled to take advantage of underused tax bases, including on immovable property. Efforts should also expand the use of technology in collecting taxes and in broadening the tax base by looping in small taxpayers, from whom the cost of collecting taxes is high when physical tax administration and monitoring are used. East Africa could also boost corporate tax revenues by enhancing transparency, which would enable tax authorities to prioritize and conduct tax audits of multinational corporations with local subsidiaries. Finally, countries in the region should advocate for a unitary tax approach, where countries work with their global partners to develop policies along these lines.

Measures to boost domestic savings could also supplement revenue for financing development. Some East African countries' financial sectors are still repressed, discouraging

savings. Financial sector reforms, including interest rate and exchange rate liberalization, could improve financial sector intermediation and support increased savings mobilization.

To further enhance savings in East Africa, countries should improve access to banking for broader swaths of their populations to provide households with safe, readily accessible saving instruments. There is also a need to widen domestic participation in treasury bill and bond markets and to help domestic financial institutions secure more stable inflows of household deposits. The region has seen significant uptake in the use of mobile phones for money transfers relative to bank accounts. Though the share of households with a bank account has been rising in some East African countries in recent years and the use of mobile banking (such as Kenya's M-PESA mobile money system) has broadened considerably, their uptake remains far below levels in peer economies. Finally, efforts should be made to deepen local currency debt markets and mobilize private savings; this will require improving access for unbanked and underbanked households, potentially using nudges inspired by the literature on behavioral economics.

3.1.6 Expand fiscal space through debt restructuring, debt rescheduling, and debt service suspension

Many East African countries have increased their debt to bridge the financing gap caused by COVID-induced weak revenue performance. But this debt has significantly increased debt vulnerabilities in many countries. Some, like Kenya, have moved from moderate to high risk of debt distress. Part of the short-term solution lies in debt restructuring, debt rescheduling, and debt service suspension. Kenya has already secured deals with Paris Club members and other creditors to defer debt service payments of \$600 million, including \$378 million to China, for the first half of 2021.

Successful debt restructuring will require the participation of private bondholders. Private creditors can be encouraged to accept haircuts—mutual reductions in the value of bonds payable to them. The main challenge with haircuts on private

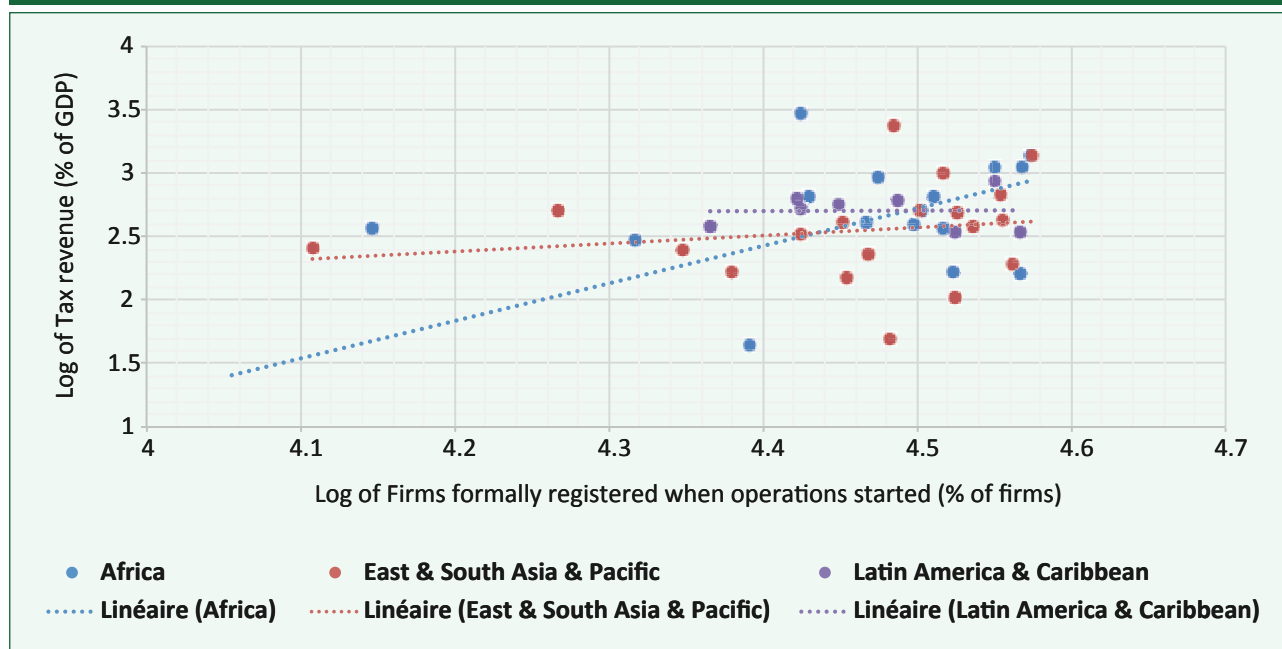
bonds is that investors are unlikely to accept losses. But if bonds are issued under local laws, governments can retroactively introduce collective action clauses in the bond terms to bind bondholders to haircut deals favorable to the government. Greece used that strategy to force a 50 percent haircut on its bondholders in 2011. Similarly, Ukraine negotiated a 20 percent haircut with its private bondholders in 2015, a deal that was accepted by all the bondholders except the Russian Federation. Still, haircuts should be the last option that East African countries pursue when in serious debt distress.

Another option available to East African countries with elevated risks of debt distress is buying time by extending debt maturities. Countries can negotiate with sovereign and non-sovereign bondholders to extend the maturities of their debt obligations, giving them more time to reorganize their public finances. The reprofiling of debt may include changes in interest and principal repayments, but the time that the debt falls due is delayed. Two disadvantages of debt maturity extensions are that markets will see them as defaults and that debt obligations are passed on to future governments and generations.

3.1.7 Enhance the business environment to build a dynamic private sector and increase tax revenues, including from informal cross-border traders

East Africa has the potential to boost private investment to help its countries tap the benefits of formality, such as ease of access to credit. Governments should put more effort into identifying firms that could broaden their tax bases in, say, agriculture. This would also ensure that informal businesses are registered and have access to formal credit facilities as they become more productive and can extend social protection to workers. Increased firm formality is associated with increased tax revenues in Africa and East Africa in particular (figure 3.3). Furthermore, a 1 percent increase in firm formality increases tax revenues by a higher percentage in Africa than in East and South Asia and the Pacific as well as in Latin America and the Caribbean.

Figure 3.3: Average firm informality and government tax revenue in Africa, East and South Asia and the Pacific, and Latin America and the Caribbean, 2015–19



Source: African Development Bank statistics.

Note: Due to limited data, only Ethiopia, Kenya, Rwanda, and Tanzania are included in the Africa sample.

Measures aimed at reducing informality should not increase the operations costs of informal enterprises to drive them out of business. Measures to incentivize informal firms to formalize include cutting the costs of registering new businesses, encouraging the creation and growth of productive formal firms to induce informal firms to formalize, and better enforcing labor regulations in the formal sector to attract workers.

Particular attention should be paid to the challenges facing informal cross-border traders. An estimated 30–40 percent of Africa's regional trade is informal, and cross-border traders are four times more likely to be operating outside the formal economy (UNCTAD 2020b). Informal cross-border trade can help deepen regional integration, create jobs, and raise incomes. Many informal border traders are women and young people for whom trade is their main source of income.

But informal border traders face myriad challenges including harassment by border control officials, lack of knowledge of border procedures, lack of access to credit, and limited

entrepreneurial skills. Many informal cross-border traders use illegal paths to cross borders, exposing them to risks such as rape, harassment, heavy fines and bribes, and confiscation of their merchandise by border control officers. Helping informal cross-border traders become formal will require training to help them understand trade rules and traders' rights and obligations, as well as equip them with entrepreneurial skills. Efforts to mitigate the challenges facing cross-border traders in East Africa should also facilitate trade by harmonizing regulations to ease the movement of goods across borders. And, to expedite movements between countries, the region's countries should implement coordinated transport guidelines that include COVID-related requirements.

3.1.8 Diversify sources of development financing, including by deepening financial markets

Several East African countries heavily rely on public financing of development projects and rarely tap into the diverse array of private sector financing sources. Governments can use

several innovative nonsovereign financing mechanisms to bridge the public financing gap. These include public-private partnerships and securitization of infrastructure assets through deeper capital markets. The African Development Bank has been at the fore in helping deepen Africa's capital markets, launching the African Bond Index to increase investments in domestic currency bonds and supporting the integration of capital markets to ease cross-listing across stock exchanges. The continent also has pools of financial resources that can be tapped for development through securitization of remittances and private equity. Disclosed capital invested through private equity deals reached \$0.8 billion in 2017, after peaking at \$1.8 billion in 2014. Strong capital markets can act as catalysts in attracting such capital.

To stabilize government sources of funding, tax collection also remains a policy priority. East African countries could diversify their revenue sources by introducing broadly based personal income taxes and enhancing value-added and corporate taxes to tap into informal sector revenue. In addition, the growing shift to ecommerce presents an opportunity to increase tax revenue through digital trade among the region's countries. The East African customs union and improved trade facilitation framework could accelerate the adoption of ecommerce to broaden domestic and international trade in goods and services. Moreover, using a digital framework for revenue mobilization reduces cost overruns, increases efficiency in public procurement, and rationalizes spending—freeing up resources for development. Kenya has been at the fore of such efforts, with the Kenya Revenue Authority having introduced iTax for online filing for pay-as-you earn income taxes; the system has become mandatory for all sectors. This framework has stabilized revenue sources, increased compliance, and reduced informal activity.

3.1.9 Foster economic activities through appropriate monetary policies

Strong monetary policies can supplement fiscal policies in building resilience and supporting economic recovery in East Africa. During the pandemic, most countries in the region implemented accommodative monetary policies to support

economic activity. Countries with low inflation are expected to continue with this stance. Countries with high inflation, including South Sudan and Sudan, are better off with tight monetary policies. In early 2020 South Sudan, where inflation was estimated at 124.9 percent in 2020 and 82.4 percent in 2019, announced an increased cash reserve ratio to control inflation. But policy inertia prevented its implementation due to its negative impact on credit to the private sector. Sudan, on the other hand, implemented tight monetary policy to curb rising inflation, which stood at 31.1 percent in 2020. Other countries experiencing significant supply shocks and consequent rising inflation are also expected to implement tight monetary policies.

3.2 MEDIUM-TERM POLICIES

3.2.1 Improve public financial management including public investment management

The broader issue of strengthening public financial management remains at the core of streamlining public spending in many developing countries, including those in East Africa. One of the main concerns about public financial management in these countries is the lack of proper investment planning. In some countries, especially where governance challenges abound, public investment decisions, particularly on big projects, are still based on political considerations rather than economic and financial viability. Fortunately, many East African countries have recently recorded strong improvements in their economic governance indicators. Tanzania's score on overall governance rose from 57.7 (out of 100) in 2016 to 58.5 in 2017 2018 (Mo Ibrahim Foundation 2018). Rwanda's score improved from 64.1 in 2016 to 64.3 in 2018, higher than Africa's overall score of 49.7 in 2016 and 49.9 in 2018.

Challenges to public financial managements include weak budget credibility, which leads to mismatches between approved budgets and spending outturns, misuse of public finances, inadequate enforcement of procurement and financial regulations, inadequate financial allocations to development, and accumulation of arrears due to delays in processing VAT refunds. Countering these challenges will require concerted

efforts—including from development partners—to frame and financially support reforms of public financial management.

3.2.2 Strengthen debt management and institutional capacities

East African countries should work closely with development partners and other stakeholders to strengthen their capacities to manage public debt. These efforts should include developing capacity to devise contingency plans for refinancing external and domestic debt. Focus should also be put on increasing transparency, a key element of sound public debt management. Transparency can be attained by strengthening oversight institutions with the ability to detect and advise on mitigation measures if public debt is increasing. Kenya's parliamentary budget office and auditor general's office offer oversight on public spending. Both entities provide information to the public on spending by government agencies, thus showing transparency in resource use.

Transparency helps policymakers make informed borrowing decisions and enables creditors and rating agencies to assess sovereign creditworthiness and, thus, appropriately price debt instruments. It also keeps citizens informed about how governments spend public money. But most oversight institutions in East Africa have inadequate capacity to carry out their mandates. In the medium term, it should be a priority to build the capacity of oversight organizations such as parliamentary budget offices to mitigate loss of public

funds and enhance debt management. Furthermore, project monitoring and evaluation should be strengthened to ensure that projects financed using debt are completed on time and with quality to bring prompt returns to countries. To support these efforts, systems for monitoring and auditing contingent guarantees to state-owned enterprises (SOEs) should be put in place to ensure that resources are used for intended purposes.

Relatedly, East African countries should limit overreliance on volatile funding channels that undermine the smooth implementation of planned projects. In addition, countries will have to use innovative refinancing strategies to crowd in alternative sources of finance such as revenue-backed instruments, public-private partnerships, risk sharing instruments, and diaspora remittances.

3.2.3 Promote innovative financing including public-private partnerships

Sustainable growth will require that the private sector play a more active role in financing development in East Africa. Many countries in the region have not fully embraced the private sector as a partner in development; instead, they have tended to look at it as an inhibitor of development. Public-private partnerships can provide viable vehicles through which large-scale, capital-intensive development projects can be implemented without increasing the risk of debt distress.

Box 3.1: COVID's effects on small and medium-size enterprises in Africa

COVID-19 has had disastrous effects on Africa's small and medium-size enterprises, with huge negative spillovers to employment and incomes. The World Bank's Business Pulse Survey, undertaken between June and August 2020, targeted small and medium-size enterprises in the continent's 47 countries and found that 62 percent had experienced a fall in demand, cashflow, access to credit, and availability of inputs. Nine of ten enterprises had seen sales decline, and one in five workers had lost their jobs. To stay afloat, small and medium-size enterprises have resorted to labor adjustment measures including reduced working hours and wages. Moreover, the pandemic's effects fell disproportionately on women: more firms with more than 40 percent female employees closed relative to those with more male employees. The survey also found that the manufacturing sector experienced larger reductions in cashflow and access to credit.

Kenya's experience offers insights on the innovative approaches that firms have devised in response to the pandemic. Many small and medium-size enterprises increased their use of digital and online technology, with 49 percent increasing their use of digital platforms, 13 percent investing in digital technology, and 18 percent repackaging their products to cope with government-imposed lockdowns.

Source: World Bank 2021; AfDB staff..

Several such initiatives already exist in Africa—some supported by the African Development Bank—to pool private financing of large development projects. The Africa50 Fund is a commercially oriented initiative founded by the Bank and designed to mobilize private finance for selected transformative projects in Africa and deploy innovative instruments for delivery to scale. The fund has become a major player in driving infrastructure investments on the continent, mobilizing more than \$850 million for investments in Egypt, Kenya, Nigeria, and Senegal, among others. Positioning the private sector as the main source of domestic resources requires tackling poor infrastructure and weak regulatory frameworks for public-private partnerships, among other bureaucratic bottlenecks.

3.2.4 Increase resilience to global supply chain shocks

East African countries remain exposed to external shocks,

so there is a need to build mechanisms to absorb them. This is evidenced by the high concentration of regional exports, which makes them vulnerable to external shocks, and the effects may be amplified during a global crisis. Thus growing regional integration efforts geared toward improving intra-African trade will improve regions' ability to mitigate external shocks. The continued weaknesses of the economies of developed countries, especially during COVID-19, have caused significant uncertainty in developing countries including those in East Africa. To cushion themselves against global shocks, East Africa's exports should be oriented toward other emerging markets, including those covered by the African Continental Free Trade Area (AfCFTA). Increasing domestic demand through innovation will also be crucial to building a resilient regional economy that boosts domestic investment opportunities. This will also help foster sector-specific resilience and support countries dependent on natural resources.

3.2.5 Support technological innovations to raise efficiency and productivity

The containment measures put in place to mitigate the spread of COVID-19 showed that adopting information and communications technology has great potential for sustaining and even improving productivity in ways not embraced before the pandemic. Many organizations, including schools, began delivering services online to ensure continued operations—though in some cases, at a reduced scale. The adoption of technology helped many firms, particularly small and medium-size enterprises, avoid closing altogether. A 2021 World Bank survey found that increased use of digital platforms to deliver products helped many small and medium-size enterprises in Kenya navigate through a period of the pandemic when restrictions were placed on travel and in-person meetings (box 3.1). Governments must build on such momentum to create business-friendly regulations and, if possible, provide subsidies for information and communications technology, particularly to small and medium-size enterprises.

Several innovations and new technologies can accelerate service delivery and raise productivity. East Africa leads the

continent in some of these, including mobile phone-based transactions. The growing mobile money ecosystem offers new savings and investment opportunities to governments, businesses, and individuals. Kenya is a leader in mobile payments (through MPESA), and in 2017 went beyond other countries by launching a government bond sold exclusively through mobile money (M-Akiba). Using their mobilephones, millions of East Africans that never had access to credit can now generate transaction histories, borrow money, and repay loans. New technologies have also been deployed with amazing success in monitoring weather patterns for agriculture and in microinsurance, among other areas.

3.2.6 Develop skills for the long term, targeting both demand and supply

East African countries generally suffer from a severe mismatch between the skills of young workers and those demanded by employers. Many workers in the region take jobs for which they are underqualified (figure 3.4). Tanzania leads, with 88.5 percent of workers holding jobs for which they are underqualified, followed by Comoros and Uganda. Rwanda has a lower prevalence of underqualification, at 36.9 percent.

Figure 3.4: Prevalence of underqualification and overqualification for employment in selected East African countries, various years (Percent)



Source: ILO 2021.

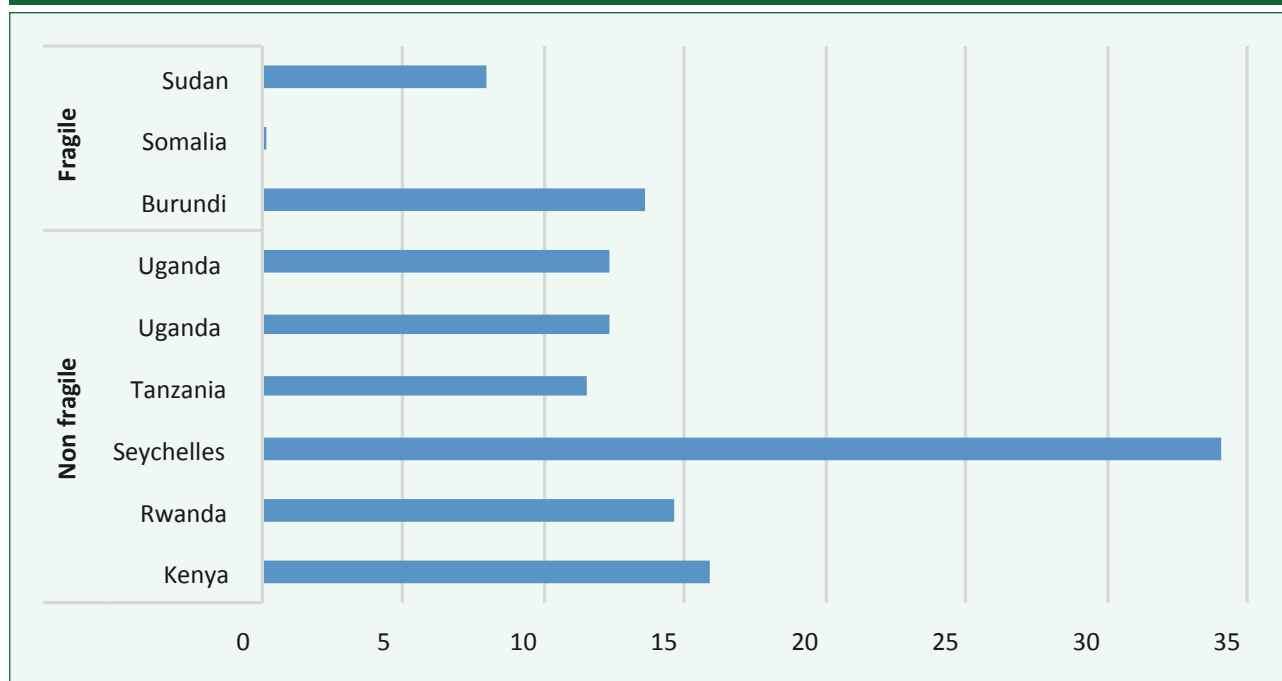
Several policies could boost skills in the region, targeting both their supply and the demand for them. On the supply side, the private sector should be represented in the governance of tertiary educational institutions to ensure market-driven skills development, with private sector interests reflected in the design and implementation of curriculums. In addition, building partnerships with the private sector would increase the supply of modern skills development institutions offering up-to-date, market-relevant skills. Incentives like tax holidays should be designed to encourage the private sector to provide training opportunities. Middle-income East African countries such as Comoros, Kenya, Seychelles, and Tanzania could benefit from privatizing higher education to share the burden for financing skills development. The government's role would be ensuring quality control and developing regulations to avoid private sector exploitation of the public. Poor and fragile countries like Burundi and South Sudan would continue to rely more on public financing of skills development to ensure that larger shares of their populations have access to such opportunities at affordable fees.

In countries like Comoros, Tanzania, and Uganda, where most workers hold jobs for which they are underqualified, governments could provide incentives for informal firms to invest in skills development for their employees. Such incentives could include tax relief for skills development expenses. For public sector employees, governments could support further training—through grants, vouchers, subsidies, and scholarships—while guaranteeing that jobs will be available when workers complete their studies.

3.2.7 Strengthen fragile countries

East Africa is home to a few countries classified as fragile, with active civil strife or recent conflict. For example, Somalia continues to face significant threats from Al-Shabaab militants, compromising its political stability. Except in Burundi, tax compliance rates and revenues are lower in the region's fragile countries than in nonfragile ones. Lower taxes translate into narrower fiscal space for development projects.

**Figure 3.5: Tax revenues in selected fragile and nonfragile East African countries, 2019
(Percentage of GDP)**



Source: African Development Bank statistics.

Conflict is a major disincentive to private investment and driver of sluggish growth. Thus measures aimed at reconciliation among warring groups in fragile countries should be prioritized. The measures should address the key drivers of instability including ethnic divisions, power struggles, weak state capacity, rent seeking, corruption and lack of accountability, and inequity in the distribution of benefits accruing from natural resource exploitation including oil (as in South Sudan).

To address fragility and boost investor confident in East Africa, there is need consolidate peace, security, and stability. Ongoing reforms to strengthen political governance and institutions in the region need to be sustained and reinforced to ensure an enabling environment for social inclusion, voice and accountability, and peace, security, and stability. COVID-19 presents unique challenges to fragile states. At the global level, extreme poverty is estimated to have increased in 2020 for the first time in more than two decades. But the situation in fragile states is expected to have become even worse.

The pandemic will increase extreme poverty by an estimated 60 million people globally, with about 43 percent of them in fragile states. Moreover, the lockdowns in response to COVID-19 have precipitated an education emergency. This effect is especially dramatic in fragile states, where 384.5 million children were out of school in 2020 at both the basic and tertiary levels. This trend is expected to be similar in East Africa. The situation is expected to worsen as the share of children out of school in fragile states is estimated to have increased from 22 percent in 2019 to 34 percent in 2020, compared with the global average of 9 percent and 20 percent. For East Africa as a whole, it is expected that rate of children out of school will be similar to the global average as countries reopen schools. Going forward, fragile states should try to adopt a coordinated approach with both the private sector and development partners to increase education opportunities as a source of employment creation and poverty reduction.

3.3 LONG-TERM POLICIES

3.3.1 Build infrastructure for the long term

Long-term sustainable growth requires reliable “hard” infrastructure (transport, energy, water supply and sanitation) as well as soft infrastructure (information and communications technology). Many East African countries still lag their regional peers, particularly Southern Africa, on infrastructure development. In 2020 East African countries’ infrastructure scores on the Global Competitiveness Index were lower than regional peers, with Tanzania at 44.9 (out of 100), Uganda at 47.9, Rwanda at 52.0, and Kenya at 53.6—compared with 68.1 in South Africa. The region’s lower scores are mainly due to a huge gap in infrastructure financing.

To narrow this gap, many East African countries including Ethiopia, Kenya, Rwanda, and Tanzania have recently ramped up investments in infrastructure. As the quantity of infrastructure increases, countries must ensure that it is of quality and sustainable—socially, economically, and environmentally. For example, clean energy should be emphasized to support countries’ efforts to reduce their carbon footprints.

3.3.2 Develop industrial clusters to accelerate structural transformation

Despite some evidence of structural transformation in most East African countries, several structural challenges are holding back its pace. These include widespread poverty inequality, large infrastructure deficits, low labor quality, and declining industrial competitiveness. In Kenya considerable investments in human and physical capital have not been complemented by structural change, as evidenced by the high share of agriculture in GDP (35 percent) and total employment (60 percent).

In addition, the movement of labor is not guided by differences in labor productivity. Workers are moving from agriculture to services rather than to industry even though labor productivity in industry is twice that in services. This shift

suggests that workers are not necessarily attracted to the most productive sector, but are driven out of agriculture by deteriorating productivity. In Tanzania medium- and high-tech exports as a percentage of manufactured exports—a proxy for the degree of complexity of a country’s production processes—fell from a high of 20.2 percent in 2000 to 6.5 percent in 2017. Indeed, between 2014 and 2019 the reallocation of labor into the industrial sector stagnated in all East African countries.

Advancing the transition from low value-added production to higher value-added activities will mitigate vulnerabilities to domestic and external shocks. To accelerate East Africa’s structural transformation to industrial development, emphasis should be placed on fostering industrial clusters, filling infrastructure and skills gaps, and addressing limited access to finance. Ethiopia’s experience with developing industrial clusters offers lessons for other East African countries. The Local Economic Development (LED) program supported the rollout of the country’s first guidelines for industrial cluster development to make micro and small enterprises more competitive and lay the foundations for industrial development across the country. Ethiopia’s efforts show that accelerating the development of industrial clusters requires making regulatory bodies more efficient; ensuring sufficient funding for infrastructure development; promoting links between industrial clusters, parks, local labor markets, and local companies; and supporting technical and vocational education and training (TVET) for industries targeted by industrial park development strategies by aligning curriculums of universities and TVET institutions with private firms’ labor needs.

3.3.3 Promote economic diversification

Most East African countries’ exports are highly concentrated. Some of the region’s countries that were most severely affected by COVID-19 are those that are least economically diverse, like Seychelles. Building resilience in such countries will require diversifying the economy and export base. Low economic diversification increases exposure to external shocks, undermining prospects for long-term economic growth.

Export competitiveness in the region is also low, limiting the potential to exploit trade opportunities. But the current revitalization of East African countries' export strategies and implementation of the Africa Continental Free Trade Area (AfCFTA) agreement will help make the region's exports more competitive. To achieve the benefits of economic diversification, countries will have to pursue both product diversification (shifting domestic outputs across sectors and industries, resulting in structural transformation) and trade diversification (diversifying exports and imports, market destinations, and improving the quality of domestically produced outputs).

3.3.4 Harness regional integration to promote intra-regional trade

Trade within East Africa is plagued by trade disputes between countries, most of whom are members of the East African Community. Several countries' ratings on the Africa Regional Integration Index (ARII) are lower than the African average. Deepening regional integration and economic cooperation could increase intraregional trade, diversify export products and markets, consolidate regional peace, and reduce vulnerability to fluctuations in international commodity prices.

Though the African Continental Free Trade Area (AfCFTA) agreement could expand regional export markets for East African countries, only six—Djibouti, Ethiopia, Kenya, Rwanda, Somalia, and Uganda—have ratified it (though as of July 2021 Somalia had not yet deposited its instruments of ratification with the African Union). Six other countries in the region—Burundi, Comoros, Seychelles, South Sudan, Sudan, and Tanzania—have signed but not ratified the agreement. Eritrea has not even signed it.

Countries that have not ratified the agreement may be worried that opening their borders to trade may expose nascent domestic industries to stiff external competition and kill domestic firms. Thus countries need to be assured of the long-term benefits of the AfCFTA and build the physical infrastructure required to make domestic firms more competitive. Low-cost energy and good transport networks (roads, rail,

ports, air) will lower the operating costs of domestic firms and increase the competitiveness of their exports. In addition, awareness campaigns in these countries should be enhanced and cost-benefit analyses conducted to allay fears of net losses from implementation of the AfCFTA agreement.

3.3.5 Promote more inclusive growth

Despite being among the fastest-growing regions in Africa, East Africa exhibits high poverty and inequality. In South Sudan poverty remains high, rising from 66 percent in 2015 to 88 percent in 2019, partly because of the recent civil conflict. The International Food Policy Research Institute estimates that poverty increased by 13.9 percentage points in 2020 due to COVID-19 and climate change shocks. Similarly, the World Bank's 2018 Somalia High Frequency Survey ranks the country as having the third highest poverty incidence (67 percent) in East Africa and seventh highest in Sub-Saharan Africa. Poverty is exacerbated by insecurity, weak institutions, and natural disasters. Somalia's high population growth rate, about 2.9 percent a year, also poses significant challenges to reducing poverty. In Sudan poverty increased to from 46.5 in 2009 to 55.4 percent in 2020 due to rising inflation and job losses resulting from COVID-19.

Sudan's low labor force participation for women in all age groups (48 percent for women compared with 73 percent for men) underscores gender inequalities in access to economic activities and is a major cause of poverty. In Kenya poverty fell from 36 percent in 2015/16 to 28 percent in 2019, but COVID-19 pushed nearly 2 million people below the poverty line—causing the poverty headcount index to rise to 41 percent in 2020. Tanzania's 2017/18 Household Budget Survey reported that poverty declined from 28.2 percent in 2011/12 to 26.4 percent in 2017/18, which was a reduction of just 6.4 percentage points compared with 18.0 percentage points between 2007/08 and 2011/12. Inequality, as measured by the Gini coefficient, rose from 0.34 in 2011/12 to 0.38 in 2017/18, indicating limited progress toward a more inclusive society.

Building resilience will require increasing inclusivity in the region through measures such as targeted employment quotas, social safety nets targeting women, young people,

and the poor, and affirmative actions to ensure access to public procurement opportunities for marginalized groups.

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