May 24, 2011

Rwanda's Private Sector and the EAC: Harnessing the EAC for Growth

Executive Summary

- Because Rwanda's domestic market is small, developing its private sector into a dynamic source of growth can occur through the progressive expansion of trade.
- Rwanda's trade to GDP ratio remains low, and thus exports will need to grow significantly to develop the export industry into a new source of growth. Rwanda's National Export Strategy and Industrial Policy present a portfolio of policies and projects to expand Rwanda's global market share.
- To realize this strategic vision, Rwanda has to use the EAC not only as a self-contained regional market but also as a springboard to more effectively reaching the fast-growing markets of Asia and the rest of the world. This means using the EAC to link into regional and global production chains, to take advantage of its geographic position as a hub, and to develop new sources of comparative advantage in services exports. This entails intensive work to take the EAC to the next level: from tariff harmonization to "deep integration", through removing NTBs, reducing infrastructure costs (energy and transport), increasing services integration, and allowing access to intermediate inputs and consumer goods at world prices.

Widening Markets to Develop the Private Sector

Small markets like Rwanda tend to produce small firms, and helping small firms to become large firms requires making use of international markets. Trade has allowed the Netherlands to become home to world-wide giants such as Philips and Royal Dutch Shell, and Switzerland to give birth to Nestle and Brown Boveri. Trade allows firms to reap productivity gains through economies of scale, scope, and specialization – and it is this productivity growth that, together with investment in capital and upgrading of labour, leads to rising incomes. The EAC provides an opportunity for the Rwandan private sector to reach a wider market – within the five member countries and, through deeper integration with them, to global markets.

Rwanda and Burundi acceded to the EAC on 18th June 2007, and became full members of the community on 1st July 2007. The implementation of the basic EAC Customs Union was finalized when Uganda and Tanzania removed their remaining tariffs on goods originating in Kenya on January 1st, 2010. On November 20th 2009, Rwanda and the other EAC member states signed the EAC Common Market

Protocol, which came into force on July 1st, 2010. This is envisaged to cover, among other things, trade in services and the free movement of persons. Negotiations to establish the EAC Monetary Union are ongoing.

The EAC is a market of over 130 million people, with annual per capita growth of almost 4 percent over the past 6 years[1]. Moreover, rapid growth in both incomes and population provide a dynamic foundation for future growth. But this promise has to be kept in perspective, as the combined GDP of the EAC is still small – US$73.8bn in 2009[2], less than the size of Vietnam. Second, the countries of the region produce many of the same goods, and so opportunities for trade growth in goods are more limited than for less similar, more complementary economies[3]. Finally, in the last five years, and especially since the global financial crisis, the fastest growing sources of import demand in the world have been countries in Asia. In 2010, Asia constituted roughly half of the growth in world imports.

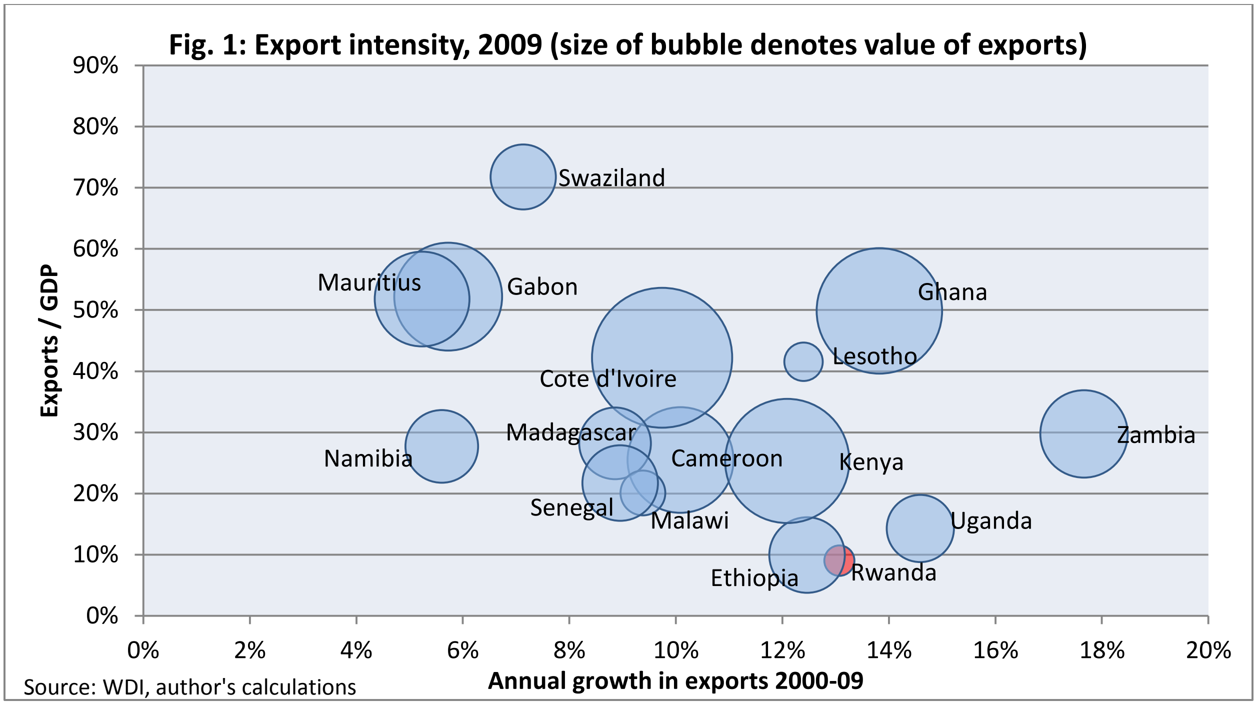
These facts combine to suggest that a strategy that seeks to use the EAC not only as a self-contained regional market but also as a springboard to more effectively reaching the fast-growing markets of Asia and the rest of the world. This means using the EAC to link into global production chains, to take advantage of its geographic position as a hub, and developing services exports. This suggests an agenda of "deep integration" – wherein Rwanda seeks to use the EAC to reduce its transport costs, reduce non-tariff obstacles to trade, improve the efficiency of its input services, and to adjust policies in ways that offset the disadvantage of high input costs associated with being landlocked.

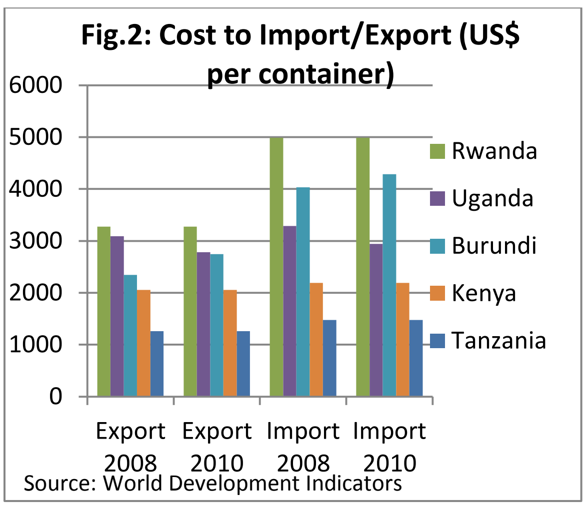
Rwanda's aspirations and objectives

While the nominal value of Rwanda's exports has grown impressively over the past decade, Rwanda's export to GDP ratio remains low (10% in 2010, compared to 11% in 2005[4]), even compared to other landlocked African countries (see Figure 1 below). To develop exports as a new driver of growth, Rwanda's National Export Strategy and National Industrial Policy were approved by Cabinet in April 2011. These documents outline a growth strategy for Rwanda's export and industrial sectors centred on high-value exports to international markets and efficient import substitution. The National Industrial Strategy recognizes that Rwanda's integration into global (and regional) value chains will be determined by its ability to access inputs at world prices, whether produced domestically or internationally. In the short term (while transport and electricity costs remain high - see Figure 2), export growth will be driven by products that require minimal imported inputs and energy such as coffee, tea and horticulture.

Apart from infrastructure costs, these documents recognize that technical and managerial skills gaps remain acute, and the cost and limited availability of land remains a constraint. Government programmes to address these issues will take effect in the medium- to long-term.

[1] IMF Regional Economic Outlook – Africa, Spring 2011
[2] World Development Indicators, 2009 data
[3] Said differently, countries with different endowments of capital, labour, technology and resources, and which have different products and costs structures, have greater opportunity to realize gains from trade. See Schiff and Winters (2002), among others, for a comprehensive review of this phenomenon.
[44] NISR, GDP Annual Estimates 2010, author's calculations





Integration in goods markets

As a member of the COMESA FTA, Rwanda had removed tariffs on goods originating from EAC members (except for Tanzania, which is not a member of COMESA) before acceding to the EAC. On July 1st 2009, Rwanda removed tariffs on goods originating from Tanzania, and adopted the EAC Common External Tariff (CET), with limited exceptions. The implementation of the basic EAC Customs Union was finalized when Uganda and Tanzania removed their remaining tariffs on goods originating in Kenya on January 1st, 2010. On November 20th 2009, Rwanda and the other EAC member states signed the EAC Common Market Protocol, which came into force on July 1st, 2010. By 2010, then, the first important steps toward free trade within the region were accomplished as member states eliminated tariffs on goods originating within the region, and adopted, albeit with some exemptions, a common external tariff.

The Common External Tariff and Goods Trade

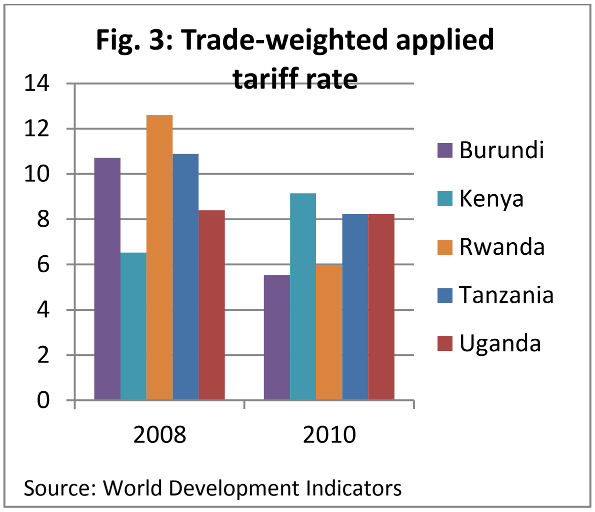
Joining the EAC for Rwanda implied a reduction in average external tariffs – but an increase on selected items and consequently a substantial change in the structure of protection. The average trade weighted tariff fell by more than half between 2008 and 2010 (Figure 3).

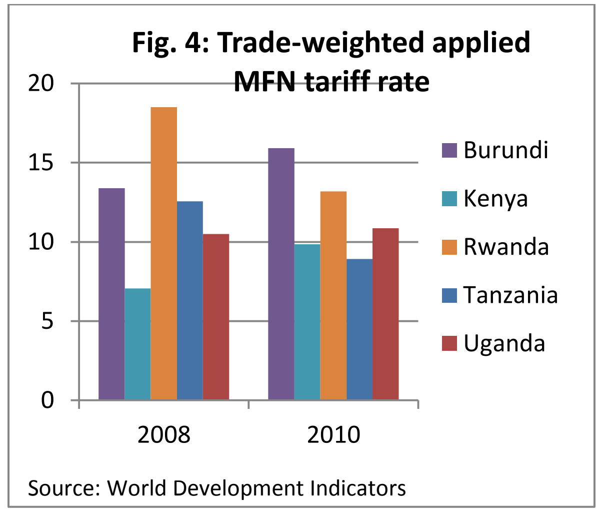
Adopting the EAC common external tariff with its list of sensitive items (SI) to be accorded tariff protection greater than 25 percent[5] served to increase tariffs on goods equal to about 22 percent of its import portfolio in 2006[6]. For Rwanda, the adoption of the CET thus risks trade diversion (replacing low cost imports from outside the EAC with high-cost imports made with the EAC imports), higher prices on imported intermediate goods and consumer goods, and the development of ultimately inefficient regional industries, most of which would be located in the larger member countries[7]. A range of exemptions are currently available to Rwandan producers to mitigate the effect of high tariffs on imported inputs for production. However, these do not offset the penalties for higher costs of selected consumer goods, may not be factored into investment decisions by firms what have not yet entered into production, and will likely not be available in the medium-term. Given that high transport costs put Rwanda at a significant disadvantage in global and regional markets, the addition of a border tariff to these costs increases the cost penalties facing Rwandan producers

While Rwanda's weighted tariff on goods originating outside of the EAC fell from 9.7% to 5.6% between 2008 and 2010[8], the weighted average of Rwanda's MFN tariff (ie. non-preferential tariff) is still higher than that of Kenya, Tanzania, and Uganda (Figure 4)[9].

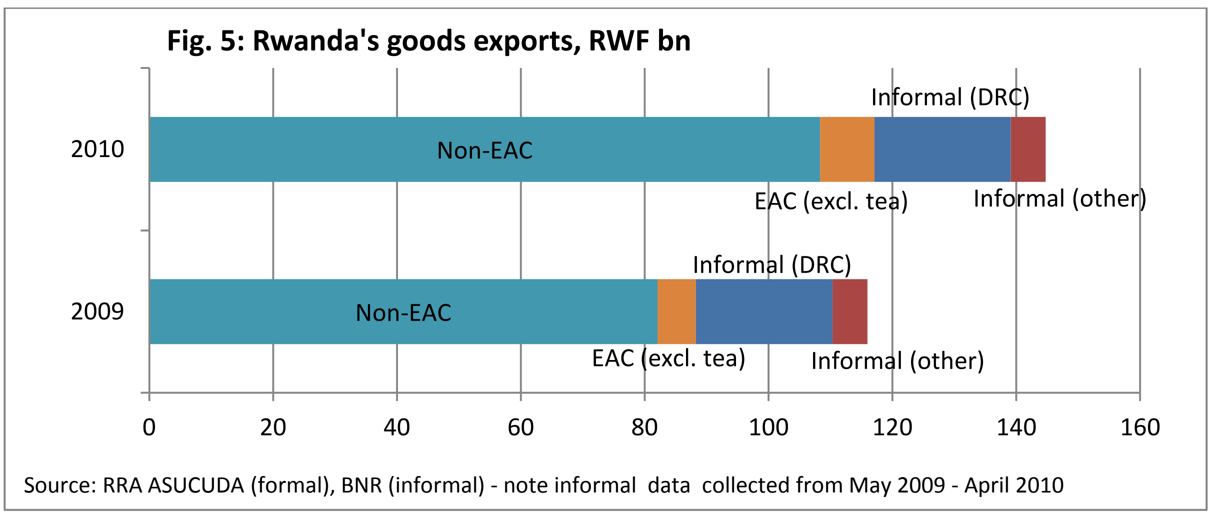
[5] The SI list is comprised of 57 products that carry a tariff rate greater than 25%, the upper band of the CET. It includes sugar, milk, wheat flour, some fabrics, crown corks, cigarettes, chemicals and batteries.
[6] Carrere and De Melo (2007)
[7] Carrere and De Melo (2007) using a CGE model calculated that Rwanda would suffer static losses of national income as it would be forced to pay a higher cost on imported inputs and consumer goods and lose tariff revenues from previously imported products; Kenya and the other members would gain because import-substituted production was located in these larger economies.
[8] RRA ASYCUDA data
[9] The trade weighted tariff rate is the average of effectively applied rates weighted by the product import shares corresponding to each partner country. The trade weighted MFN tariff rate is the average of most favored nation rates weighted by the product import shares corresponding to each partner country, ie. if Rwanda only imported products from outside the region, they would pay more for imports than Uganda, Kenya and Tanzania.

While Rwanda's tariff rates have decreased… **…Rwanda still pays more for non-EAC imports**





The EAC accounts for a small component of Rwanda's trade…and EAC member exports have been driven by trade with other regions (Figure 6)



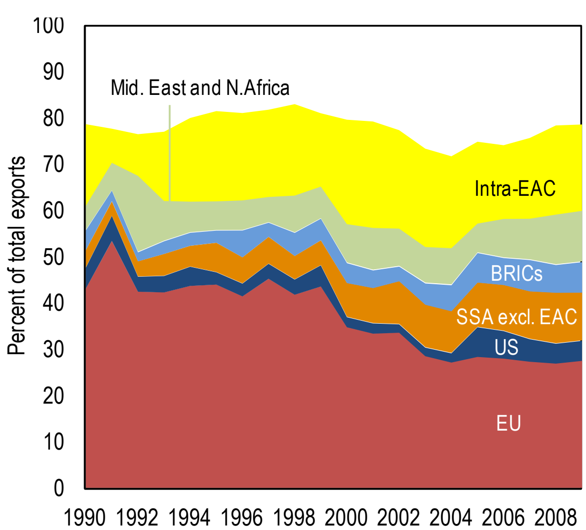


Fig. 6: EAC Member Exports by Destination

Source: IMF Direction of Trade Statistics, from Spring 2011 Regional Economic Outlook

Trade performance so far remains largely unchanged

Because tariff changes have a short history (less than one year of implementation), accession to the EAC has not been accompanied by significant change in trade patterns for Rwanda or other EAC countries (Figures 5 and 6 above). Exports of goods and services remain a small component of GDP for EAC countries, and intra-regional trade remains a small component of the region's exports, increasing from US$1bn in 2005 to US$1.58bn in 2009[10] (Figure 6). Rwanda exports twice as much to external markets as it does to the EAC, and when tea exports are classified as non-EAC trade, Rwanda's exports to the EAC were 6% of total exports in 2008, and 7.4% in 2010[11] (Figure 5), and included hides and skins, beans and cement.

Pre-accession analysis suggested that Rwandan exporters were poised to target the regional market with fruit juice and yoghurts, also citing the potential of beer and cigarettes in the region[12]. While some exportation has taken place (see Table 1 below), the limited success of these products has anecdotally been attributed to barriers posed by standards agencies and other regulatory barriers – these issues should be followed up with the relevant producers in Rwanda.

Table 1: Selected Exports to EAC (RWF)

Product	2008	2009	2010
Beer	-	2,123,316	3,225,187
Fruit juice	278,570	-	61,323,295
Cigarettes	-	9,096,264	-

Rwanda as trading hub: Hidden trade with DRC

Rwanda's trade with the DRC has become as important as trade within the EAC. While re-exports account for a large portion of formal exports to the DRC (itself a demonstration of Rwanda's potential as a distribution hub), informal exports are largely comprised of livestock and other agricultural products. Comparing informal trade data from the BNR Informal Cross-Border Trade Survey to RRA ASYCUDA data, we can deduce that informal exports to the DRC are three to four times the size of formal trade to the EAC, and at least twice the size of total (formal and informal) trade with the EAC (Figure 5 above). Also, there is anecdotal evidence of the emergence of regional production chains, such as Rwanda processing cassava from DRC. This suggests that Rwanda's trade complementarity with DRC may be much higher than with EAC member states.

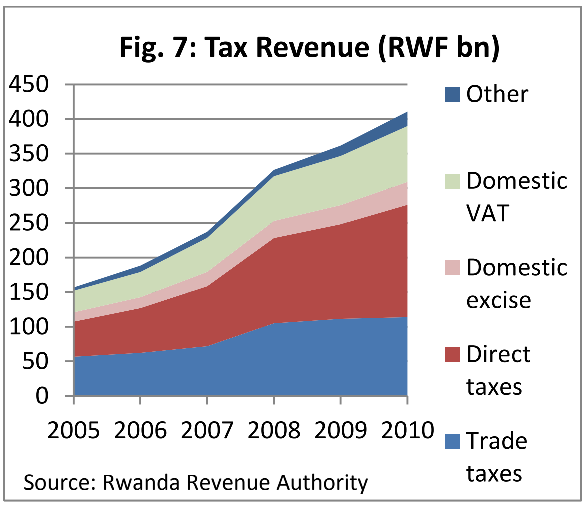
[10] Import (CIF) figures from TradeMap/COMTRADE data
[11] RRA ASYCUDA data
[12] Imani (2006) Support to Rwanda's Accession to the East African Community

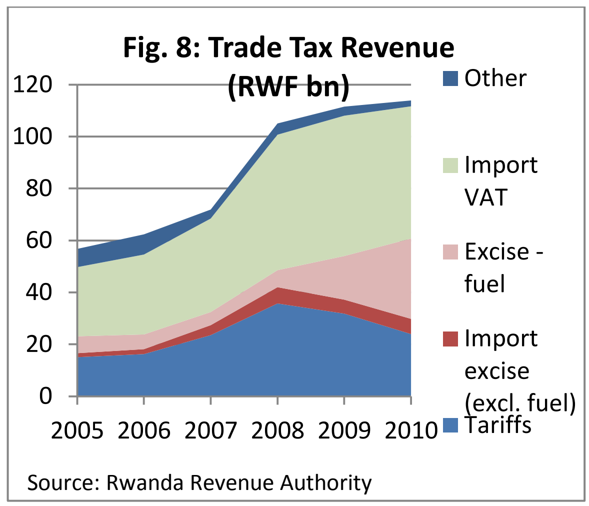
However, as with exporters attempting to penetrate EAC markets, evidence suggests that non-tariff barriers are preventing Rwandan exporters from reaching their full potential in the DRC market. Forthcoming work from the World Bank illustrates that the effect of crossing the Rwanda-DRC border on relative prices is equivalent to pushing the two markets and additional 1549km, or 35 hours, apart.

Fiscal Implications

Total taxes collected on trade have doubled in the last five years – from RWF 49.7bn to 111.7bn, despite joining the EAC. The most important source of trade taxes remains import VAT. Losses associated with tariff reductions were small because tariffs as a share of total trade tax collections were small at the outset (Figures 7 and 8), and the actual tariff reductions affected only a small portion of trade. Tariff revenue decreases (largely due to the reduction of tariff duty on fuel from 30% to 0% under the CET) have been replaced with excise revenues from fuel.

Tax revenue growth has been driven by direct taxes … and excise on fuel has replaced tariff losses





Additionally, Rwanda received 22.6 million Euros (not shown in Figure 7) in compensation for tax revenue losses for the 2009/2010 fiscal year from the COMESA Adjustment Facility (funded largely by the EU), though will not be able to access this facility again.

Toward a Strategy of Deep Integration

This analysis suggests that integration in goods markets has paid limited dividends so far, and its potential is restricted by the similarity of the trading economies within the EAC. However, the EAC can become a vehicle for more rapid private sector growth by strategic use of the EAC to reach global markets and leverage Rwanda's position as a regional hub. Doing so implies using the EAC to *reduce non-tariff barriers* to goods trade, *reduce transportation costs* to reach global markets through investment, and *expand services trade*.

Aggressive action on NTBs

Non-tariff barriers, including lack of harmonized standards and regulations, and delays and informal payments along the Northern and Central Corridors, have so far prevented the region from achieving the full benefits of the customs union. The 2010 MINICOM/PSF Non-Tariff Barrier report highlights that the number of weighbridges in Tanzania have increased from five in 2008 to eight in 2010, informal payments along the Northern Corridor continue to account for over US$800 per truck, and a number of costly un-harmonized regulations remain along both routes. Carrere and de Melo (2007) estimate that Kenyan, Ugandan and Tanzanian NTBs levied on certain product categories have the same impact as tariffs of upwards of 60%.

Lowering trade costs through investment

Improving regional infrastructure projects in the EAC is critical for Rwanda – reduced transport and energy costs are needed to improve productivity, attract investment in new productive sectors, and compete in international markets. Encouraging national public investment, attracting private investors, and directing donors to these projects will require demonstrated coordination between EAC members.

Transport is an illustrative example. Table 2-10 from the Corridor Diagnostics Strategy (CDS) of the Northern and Central Corridors (below) illustrates the almost US$5,000 price difference between Nairobi and Kigali for heavy container imports.

Table 2-10

Northern Corridor Performance for Imports by Cargo Type and Destination, 2010 (via road)

Destination	Distance km.	Price (US$)				Time (hours)			Reliability Indicator (%)		
		Containers		Bulk		Containers	Bulk		Containers	Bulk	
		Light	Heavy	Dry	Liquid	Light/ Heavy	Dry	Liquid	Light/ Heavy	Dry	Liquid
Nairobi	480	1,396	1,895	1,530	1,365	396	181	145	158	377	359
Kampala	1,180	2,099	3,448	3,511	3,316	323	276	240	194	262	217
Kigali	1,661	3,901	6,595	6,658	6,463	376	329	293	167	220	178
Bujumbura	1,903	4,950	8,448	8,511	8,316	411	364	328	153	200	160
Nimule	1,526	5,383	7,697	7,760	7,565	381	334	274	165	217	190
Kasindi	1,623	4,825	9,635	9,698	9,503	372	325	289	168	223	180
Goma	1,811	4,822	8,137	8,200	8,005	537	490	454	131	162	135
Port Node*											
Mombasa - Domestic		315	315	330	165	217	170	134	287	400	386
Mombasa - Transit		297	297	360	165	217	170	134	287	424	386

Note: Port values are included in the totals shown for each destination.

Source: Nathan Associates

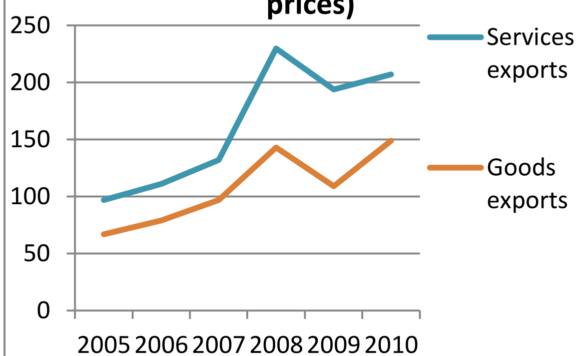
The CDS Draft Action Plan was discussed by EAC technical experts in Dar es Salaam in March 2011 and highlights 27 priority EAC infrastructure projects, 22 of which may be suitable for national or regional PPPs. They include the injection of U$100 million into the Tanzania Railways system (TRL) and the construction of an efficient road/rail transfer terminal at Isaka to serve the Rwandan market[13]. These projects, if undertaken by the region, are estimated to reduce transport costs by 28 percent, resulting in annual transport cost savings of US$1.9 billion.

Services Trade

Between 2005 and 2009, Rwanda's services exports grew 50% faster than goods exports - 14.9% annually compared to 10.2% for goods (Figure 9). Services exports are almost double goods exports. The National Export Strategy foresees greater tourism exports – in part to be realized through the development of Lake Kivu as a premium destination. More aggressive efforts to link tourism in Rwanda to tour operator packages coming into the EAC might pay dividends.

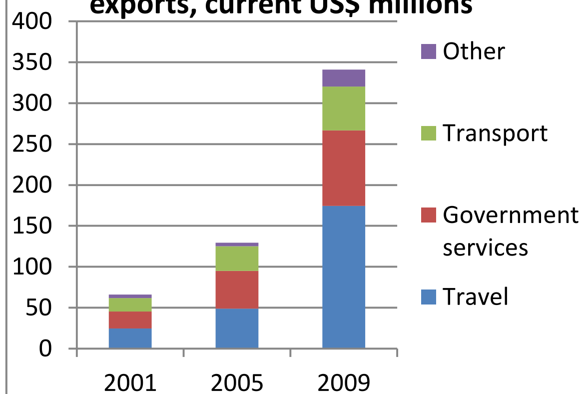
Service exports have also grown in transport services. The construction of the Bugesera airport will pave the way for further air transport exports.

Fig. 9: Rwanda's goods and services exports, RWF bn (current prices)



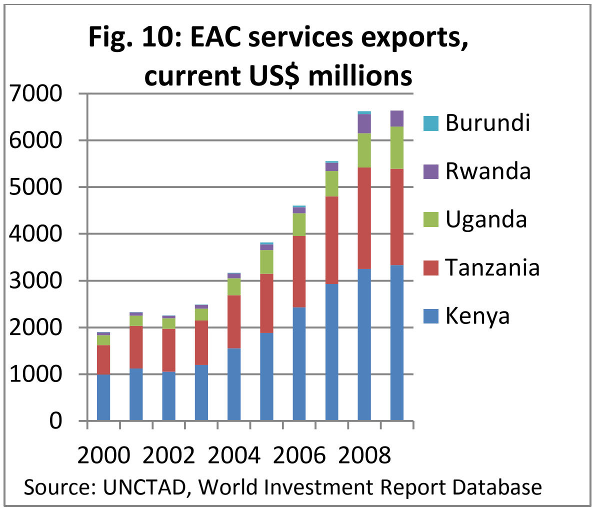
Source: NISR GDP National Accounts 2011

Fig. 10: Rwanda's services exports, current US$ millions



Source: UNCTAD, World Investment Report Database

[13] Goods would travel via rail between Dar es Salaam and Isaka (900 km) and then via road between Isaka and Kigali (460 km).



Perhaps the highest potential arena for new gains from deep integration in the EAC is unifying markets in backbone services. This requires detailed efforts to harmonize and foment cross-border competition, particularly in transport, telecommunications, energy, and selected financial services. For example, Rwanda could benefit from the creation of the East African Power Pool.

Integrating the market for professional services is also important for both exports and imports. Rwanda is developing the capacity to produce well-trained professionals who could export their services. Moreover, Rwanda's firms need skilled professionals, particularly managers and technicians, to help propel productivity growth. First steps have been taken with respect to mutual recognition agreements (MRAs) for professional services, however much work remains in this area.

Specific Recommendations

This agenda for using deep integration within the EAC to propel private sector growth points to specific actions – some of which are already underway:

- **Reducing non-tariff barriers to regional trade –** This includes unofficial payments and other inefficiencies that increase the time and cost of transporting goods to and from Rwanda, restrictions related to standards and challenges associated with the application of rules of origin. Strong cooperation between EAC members is required to develop what will be seen as a single market in the eyes of potential international investors. Continued close liason with current and potential exporters in Rwanda will identify priority barriers for removal.

- **Developing a Rwandan position on the CET –** As a small and landlocked member of the EAC, Rwanda should develop its own negotiating position on the CET based upon a serious quantitative analysis. It seems that the CET, particularly the Sensitive Items (SI) list, may disadvantage Rwandan producers and consumers[14].

- **Create an action plan to deepen trade with the DRC –** A first component would be to continue collecting information on informal trade. A second element would be to explore ways to make border crossings more transparent and accessible to both formal and informal traders as a way of reducing transaction costs and increasing trade.

- **Developing multi-country infrastructure projects –** The infrastructure deficit that increases production and transport costs can be mitigated through coordinated investments in infrastructure. For example, Corridor Development Strategy (CDS) projects will lead to new access to international markets for EAC exports.

- **Increased attention on services trade, including professional services –** Efficient backbone services (telecommunications, financial, transport, energy services) are critical to GDP and export growth, and thus the liberalization of services must be undertaken carefully. Fostering competition in markets (including the labour market) with adequate regulatory frameworks will allow this to occur.

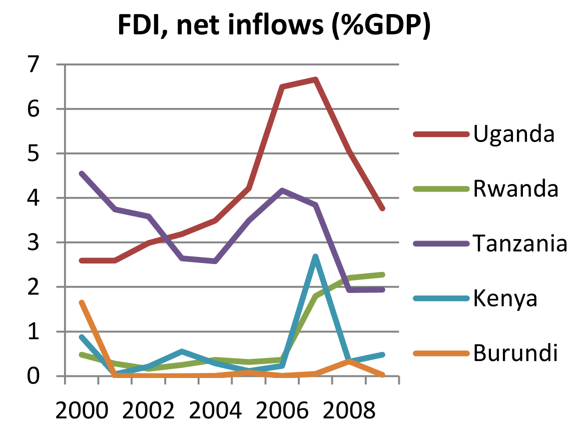
- **Continued dialogue with Rwanda's private sector to identify priority areas for deep integration –** As Rwandan companies test their products in regional and international markets, feedback is critical to determine how the region can work together to facilitate each other's goods and services exports. This will be a priority action of the new Industrial Development and Export Diversification Council (IDEC), that will draw upon private sector feedback through the Public Private Dialogue (PPD).

- **Further analysis** – Firm-level data and production data should be utilized to analyze changes in the size of firms, competitiveness of industries, and domestic production over the past 5 to 10 years. Additionally, the role of the EAC in attracting investment to the region and Rwanda should be explored in depth.

[14] Pre-accession analysis estimated that the average household would have to increase expenditure by 8% to maintain their purchases because of high CET rates on particular products.

Annex: Capital Flows

The IMF's Regional Economic Outlook (Spring 2011) highlights that the EAC has not yet caught up to other regions in terms of attracting capital flows. While FDI flows to the EAC increased from US$590 million in 2000 to US$1.7 billion in 2009, FDI flows to the EAC remain at 2.5% of GDP, compared to 4.3% for Sub-Saharan Africa.



Source: World Development Indicators