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Islamic Finance:

New Opportunities for Driving Development Agenda

Contributors:
- Benson Kiriga
- Bernadette M. Wanjala
- Adan Guyo Shibia
- Christopher Onyango
- Helen Hoka
- Victor Mose
- Humphrey Njogu
- James Gachanja

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Kenya Institute for Public Policy Research and Analysis (KIPPRA)
Bishops Garden Towers,
Bishops Road
P.O. Box 56445-00200,
Nairobi, Kenya
Tel: +254 20 4936000
+254 20 4936000 / 2719933/4
Fax: +254 202719951
Cell: +254 736 712724
+254 724 256078
Email: monitor@kippra.or.ke
Website: www.kippra.org
Twitter: @kipprakenya

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MISSION

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

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ISSUE 9

Editorial

Dr Rose Ngugi
Executive Director, KIPPRA

Welcome to the April-June 2017 edition of KIPPRA Policy Monitor. The lead articles in this edition cover recent Kenya economic developments and prospects with a detailed focus on inflation dynamics given the prevailing drought conditions. The edition also looks at Islamic finance as an alternative source of financing the development agenda, minimization of costs in public infrastructure investments and the opportunities to lower transaction costs to boost intra-regional trade. There are highlights on key domestic and global policy news during the period, key ongoing KIPPRA research projects, as well as KIPPRA news and events.

The recent data released by Kenya National Bureau of Statistics indicates that the economy grew by 4.7% in the first quarter of 2017, a slightly lower growth rate compared to 5.3% in the first quarter in 2016. Growth in the second quarter of 2017 may be slower due to prolonged drought, and slow uptake of domestic credit. Further, should the invasion of army worms destroy a significant proportion of grain crops, overall inflation could be affected because of higher food prices. On the upside, the launch of the 480km Standard Gauge Railway (SGR) on 31st May 2017 marked a significant milestone in transport infrastructure development. The railway is expected to contribute towards improving the investment climate and therefore boosting economic activity. With the General elections in Kenya slated for 8 August 2017, the presentation of the 2017/18 Budget Statement was brought forward to end-March to allow for timely approval of the Appropriations Bill. The budget proposes to reduce fiscal deficit (inclusive of grants) gradually from 9% in 2016/17 to about 6% in 2017/18, 5% in 2018/19 and 4% by 2019/20, in line with the EAC convergence criteria. This demonstrates the commitment by the government to continue with prudent macroeconomic management.

> "...we highlights the launch of M-Akiba, which is a special retail bond, aimed at promoting culture of saving while also contributing to infrastructure financing."

Islamic finance is increasingly expanding the range of financial instruments to finance development while also enhancing financial inclusion. Therefore, this edition reviews the key *shari'ah* products in the Kenyan market, and the ongoing efforts to strengthen their institutional structures including the establishment of Islamic Finance Project Management Office by the National Treasury. In addition, this edition highlights the launch of M-Akiba, which is a special retail bond aimed at promoting a culture of saving while also contributing to infrastructure financing. Further, insights are provided on how to minimize the costs of public infrastructure investments through consideration of social and environmental costs and other costs such as those arising from project financing and land speculation. Consideration of these costs form an integral part of the initial project assessment.

This edition also highlights the prospects of lowering transaction costs through trade facilitation to promote intra-regional trade. Despite regional integration initiatives in the continent, intra-African trade remains relatively low given the high trade costs, especially the cost of compliance associated with collection and processing of information and charges for trade-related services, and indirect costs resulting from administrative processes and inventory charges. It is the government's objective to enhance growth in trade by deepening economic integration especially at regional level.

Recent Kenya Economic Performance and Growth Prospects

By Benson Kiriga

Recent economic performance

The Kenyan economy has remained resilient in the last few years. It grew by 4.7% in the first quarter of 2017, a slightly lower growth rate compared to 5.3% in the first quarter in 2016. In addition to the continued prudence in macroeconomic management, the key sectors that contributed to this growth were accommodation and restaurants (15.8%), Information and Communication (11.4%), Transport and Storage (9.9%), Mining and Quarrying (9.7%), Real Estate (9.6%) and Construction (8.4%). The agriculture sector contracted by 1.1% mainly due to persistent drought conditions in the quarter caused by failure of the short rains for 2016 and delay in the expected long rains for 2017. The second, third and fourth quarters of 2016 saw revisions of economic growth rates to 6.2%, 5.7% and 6.1%, respectively, which has resulted to an annual growth rate of 5.8% for 2016.

Comparing Kenya's economic performance in 2016 with other EAC countries, only Tanzania had a higher growth rate of 6.6% than Kenya. The average growth rate of Sub-Saharan Africa was 1.4%, which was much lower than that of the EAC countries in 2016. It was also lower than the world economic growth rate at 3.1%.

The cumulative national revenue collection, including appropriation in aid, for July 2016 to March 2017 totaled Ksh 984.6 billion (12.8% of GDP), which was slightly lower than the target of Ksh 1,050.5 billion (13.7% of GDP). This was mainly due to shortfalls in Income Tax, Appropriation in Aid collection, Investment Income and IDF fee. The total cumulative expenditure and net lending inclusive of transfers to county governments for the same period amounted to Ksh 1,492.0 billion against a target of Ksh 1,526.8 billion attributed to low absorption levels in wages and salaries by the national government. As a result, the overall fiscal balance, on a commitment basis (excluding grants), amounted to a deficit of Ksh 507.4 billion (6.6% of GDP), which was slightly higher than the expected deficit of Ksh 476.3 billion (6.2% of GDP). Total gross domestic debt stock increased by 18.1% from Ksh 1,646.7 billion as at end of March 2016 to Ksh 1,945.0 billion as of March 2017, while total external debt stock, including the International Sovereign Bond, stood at Ksh 2,101.4 billion (27.4% of GDP).

The current account deficit more than doubled in the first quarter of 2017 to Ksh 123.2 billion from Ksh 43.4 billion in the first quarter of 2016. This was mainly due to merchandise trade, which registered a deficit of Ksh 259.6 billion, an increase of 67.3% from a deficit of Ksh 155.2 billion in the corresponding quarter of 2016. The exports declined by 2.3% to Ksh 152.0 billion while imports increased by 32.4% to Ksh 411.6 billion in the first quarter of 2017. The exports declined due to reduced exports to EAC (Ksh 2,207 million) and to COMESA region (Ksh 2,580 million) and also notable decline in key principal exports such as medicinal and pharmaceutical products by 31%, horticulture 44.6% and cement 2.5%. On the other hand, imports increased due to increased import value of petroleum products, industrial machinery and automatic data processing machines and telecommunication equipment. However, trade in services posted a surplus of Ksh 50.9 billion in the same quarter compared to a surplus of Ksh 38.1 billion in the corresponding

Growth in real Gross Domestic Product (%)

Country	2014	2015	2016	2017*	2018*	2019*
Burundi	4.5	(4.0)	(1.0)	0.0	0.1	0.4
Kenya	5.3	5.6	6.0	5.3	5.8	6.2
Rwanda	7.6	8.9	5.9	6.1	6.8	7.3
South Sudan	2.9	(0.2)	(13.8)	(3.5)	(1.1)	3.9
Tanzania	7.0	7.0	6.6	6.8	6.9	6.7
Uganda	5.2	5.0	4.7	5.0	5.8	6.2
Sub-Saharan Africa	5.1	3.4	1.4	2.6	3.5	3.6
World	3.5	3.4	3.1	3.5	3.6	3.7

Source: International Monetary Fund, World Economic Outlook Database, April 2017

** projections*

quarter of 2016. This is attributed to increased travel inflows following improved tourism arrivals in the quarter under review. Diaspora remittances also increased by 5.5% to Ksh 45.1 billion as compared Ksh 42.8 billion in the first quarter of 2016.

Growth forecast

The short-term economic performance looks promising, with inflation expected to ease, and the Kenya shilling exchange rate having remaining stable for the better part of 2017. The nominal first quarter GDP at Ksh 1,948,094 million was the highest when compared to all the preceding quarters, thereby giving a stable base for the second quarter. Interest rates have stabilized with the capping introduced in late 2016, and this is expected to support investments despite some hiccups on credit availability.

However, the poor rains during the long rains in 2017 will have an effect on agricultural output, which is the mainstay of Kenya's economy, The upcoming general elections in August 2017 could also lead to investors adopting a wait and see attitude, thus impacting on private investments, uptake of domestic credit, and could raise security concerns. The external risks include the unpredictable policy dynamics in the USA and other trading partners, the commodity price slump, low performance of exports, and poor performance in international tourism leading to low arrivals.

The projections below show that economic growth in 2017 will be dismally different from 2016 at 5.9%. In the medium term, the growth rate is expected to reach 6.2% by 2019. Increased government investment is expected to support the expected economic growth rate. Thus, the envisaged long term growth of 10% in Vision 2030 may not be achieved in the medium term.

Going forward, maintaining macroeconomic stability remains critical in supporting strong economic growth. In addition, policy interventions to support growth in exports, and a boost in private investments are imperative for a sustained strong inclusive growth to be maintained.

Economic growth prospects 2017 -2019

	2014	2015	2016	2017	2018	2019
GDP growth rate	5.4	5.7	5.8	5.9	6.0	6.2
Inflation rate	6.9	6.6	6.3	9.5	6.8	5.2
Private consumption (% change)	6.5	2.5	7.2	7.1	6.4	6.2
Government consumption (% change)	1.7	13.0	7.0	5.1	5.5	5.8
Private investments (% change)	2.5	6.1	-11.5	1.3	3.9	4.5
Government investments (% change)	50.3	2.0	-9.1	4.8	6.7	6.2
Exports goods and services (% change)	5.8	6.2	0.6	3.0	3.2	4.8
Imports goods and services (% change)	10.4	1.2	-4.7	3.3	4.3	4.5
Current account balance/GDP	-9.8	-6.8	-5.1	-4.1	-3.6	-3.2
Fiscal deficit/GDP	-5.4	-6.0	-5.4	-5.5	-5.3	-5.2
Public expenditure/GDP	26.6	26.1	25.2	26.4	25.7	25.3
Interest rate	8.9	10.8	8.5	8.6	8.8	8.8
Exchange rate (Ksh per dollar)	87.9	98.2	101.5	103.4	103.4	103.4

Source: KIPPRA Treasury Macro Model (KTMM)

Inflation Dynamics, Food Prices and Policy Responses

By Bernadette Wanjala

Kenya's monthly inflation was on an upward trend since June 2016, increasing from 5.8% in June 2016 to 6.4% in December 2016, and accelerating to 11.7% in May 2017 before declining to 9.2% in June 2017. This has kept the level of overall inflation above the government inflation band of 2.5-7.5% since February 2017.

The surge in inflation was mainly driven by food inflation as shown in the chart below. This was attributed to unfavourable weather conditions characterized by drought and lower than expected rains during the long rainy season. The food and non-alcoholic beverages inflation index increased consistently from 1.0% in September 2016 to 1.7% in January 2017, 3.1% in February 2017, 3.18% in March 2017 and 3.6% in April 2017. In May 2017, the high inflation was also sustained by increased restaurant and hotels inflation index. The non-food non-fuel inflation remained stable below 5%, suggesting that demand pressures and pass-through effects of high food prices were muted. The decline in overall inflation in June 2017 was mainly attributed to a significant decline in inflation index for food and non-alcoholic beverages, which declined by 2.7% between May and June 2017.

The recent high food inflation was largely occasioned by an increase in prices of such food items as sugar, maize grain, fresh packeted milk, onions and fresh unpacketed milk. The slowing rate of inflation in June 2017 is, however, attributed to reductions in prices of Irish potatoes, fresh packeted milk, kales, and cabbages following the onset of the long rains. We can thus deduce that prices of staple foods have a larger effect on inflation as compared to the non-staples.

Similar surges in inflation were experienced during the 2011 drought where, for instance, the year-on-year inflation gained double digit, increasing from 5.4% in January 2011 to 12.1% in April 2011, 15.5% in July 2011, 17.3% in September 2011 and 19.7% in November 2011, before declining to 18.9% in December 2011 and 18.3% in January 2012. It was not until July 2012 that a single digit inflation was realized. The surge in inflation then was also attributed to an increase in the prices of staple foods, such as maize flour, maize grain, sugar and rice.

Comparatively, in the EAC region, Uganda has also experienced an increase in inflation, with headline inflation increasing from 6.8% in April 2017 to 7.2% in May 2017, against a target of 5%. The increase was largely driven by a sharp increase in food prices and higher energy prices. Tanzania experienced slight increases in inflation from 5.2% in January 2017 to 6.4% in March 2017, before declining to 6.1% in May 2017 and 5.4% in June 2017. The slight increase in inflation was attributed to an increase in food prices.

Food inflation is critical because food has a weight of 36% in the consumer price index and contributes a monthly average of over 40% to overall inflation in Kenya. There is thus a direct impact of an increase in food prices on the overall inflation. Indirectly, food prices can be transmitted by further reinforcing price and wage pressures and inflation expectations.

The policy response to address inflation depends on whether food inflation has an indirect effect on overall inflation. So far, only the direct impact of food prices seems to have a significant contribution to increase in inflation. As such, the Monetary Policy Committee of Central Bank of Kenya has maintained the policy stance with no adjustment in the policy rate with no threat of demand driven inflation. To ease food inflation, the government has increased the imports of maize, while also subsidizing maize millers and fixing retail prices.

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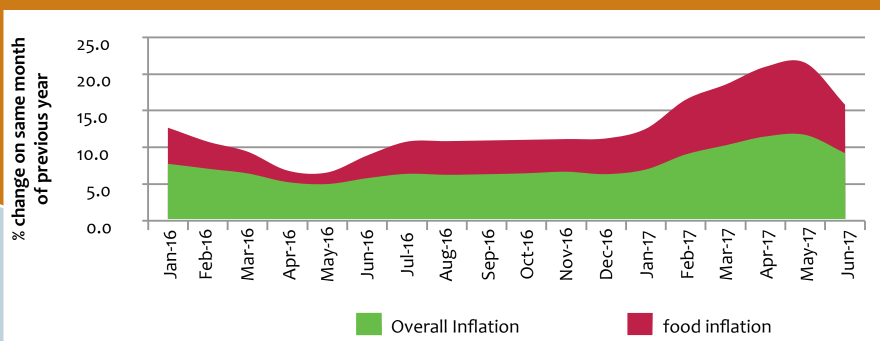
Kenya Inflation Rates (January 2016 – June 2017)



Source: Kenya National Bureau of Statistics, Leading Economic Indicators and CPI & Rates of Inflation Releases

Islamic Finance: New Opportunities for Driving Development Agenda

By Adan Shibia

Globally, Islamic finance has in the recent years recorded spectacular growth with total assets estimated at over US$ 1.9 trillion. The Islamic Financial Services Industry Stability Report 2017, published by the Islamic Financial Services Board (IFSB) based in Malaysia, shows the composition of these assets as: Islamic banking 79%, *sukuk* (Islamic bonds) 17%, Islamic funds 3%, and *takaful* contributions (Islamic insurance) 1%. Middle East and North Africa jointly account for 30% of the global Islamic finance assets. The Sub-Saharan Africa accounts for 1.7% of total Islamic finance assets.

The Vision 2030 envisages positioning Kenya as a regional financial hub. Thus, broadening financial instruments by tapping into the burgeoning opportunity presented by Islamic finance is worth considering. Islamic finance in Kenya is at a nascent stage, but it is fast growing, and large by the Eastern Africa (excluding Sudan) regional standards. The licensing of the Dubai Islamic Bank in April 2017 brought to three the fully fledged Islamic banks in Kenya. The Gulf African Bank and the First Community Bank were licensed in 2007 and 2008, respectively. Eleven other conventional banks operate Islamic finance windows through a branch or a dedicated unit. The scope of Islamic finance in Kenya has also gone beyond banking to include one *takaful* company, one *takaful* broker for general *takaful* products, one *retakaful* company, two investment funds, one investment company, and two SACCOs. The government has also demonstrated commitment to enhance supportive infrastructure for the development of Islamic finance.

Islamic finance differs from the conventional finance as its principles are rooted in the *shari'ah* law, which is the Islamic Divine Law deduced from the Quran (the Islamic holy book) and *Sunnah* (The sayings and the practices of Prophet Muhammad), as well as the consensus (*ijmāʿ*) and analogy (*qiyās*) by Islamic scholars. The Quran and the *Sunnah* are the primary sources of the *shari'ah* as they form the basis for the consensus and analogy by Islamic scholars on emerging issues. The *shari'ah* prohibits charging or receiving interest, products with excessive uncertainty, and financing of prohibited activities such as gambling, alcohol and pork. Since the prohibition of interest charges eliminates conventional debt system, the provider of financial capital shares in the business risks in return for the profits and losses. With risks sharing encouraged, Islamic finance then is largely an asset-based transaction where the ownership and trading of a physical product is a vital element. The sanctity of contracts and the preservation of property rights are vital and, therefore, full disclosure of the information is a key requirement to allow the parties to the contract/exchange accurate assessments of risks and rewards. The principles of Islamic finance are thus broadly classified as partnerships and exchange contracts. Centralized *shari'ah* supervisory boards set up

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Given the significant contribution of food inflation to overall inflation, there is need to comprehensively address the supply side constraints, especially of staple foods by enhancing production and also creating adequate buffer stock to be used during drought. There is also need to diversify the food basket with, for example, drought-resistant food products to cope with weather shocks. Furthermore, enhanced monitoring and timely response to early warnings will ensure that necessary imports are made in good time as exports are also restricted. In addition, it is important that the existing social safety nets are reviewed to ensure they are better targeted to protect the most vulnerable groups, since they are the most hit by food inflation.

'... Eleven other banks operate Islamic finance windows – where conventional banks offer Islamic finance activities through a branch or a dedicated unit'

by regulatory authorities, as is the case in Malaysia. These are vital in assessing *shari'ah* compliance, standardizing the rulings and reducing compliance costs. In Kenya, individual financial institutions establish their own *shari'ah* supervisory committee or board to regularly review and appraise the products, and issue pronouncements on *shari'ah* compliance.

The growth of Islamic finance globally is both policy and commercially driven. On the policy side, financial inclusion agenda, and diversification of financial capital through sovereign and corporate *sukuk* are some of the key factors. On the commercial front, high demand for *shari'ah* compliant products by financially excluded Muslim populations coupled with emergence of *shari'ah* standards issuing institutions such as IFSB, and the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) serve as an opportunity for tapping into this market by financial institutions. Islamic financial products are also embraced in non-Muslim majority countries. The UK, Singapore and Hong Kong have already undertaken policy reforms to facilitate *sukuk.* The Government of Hong Kong issued US$ 1 billion *sukuk* in 2017, having made other *sukuk* issuances in 2014 and 2015.

Policy and institutional reforms in Kenya to support Islamic finance date back to 2008 when the Banking Act was amended through the Finance Act of 2008 to recognize banking institutions offering Islamic financial products. The Islamic Finance Project Management Office (PMO) was established in December 2015 to work with the Financial Services Regulatory Forum (FSRF) in developing a policy framework for the Islamic finance industry. The forum is composed of the Central Bank of Kenya, Insurance Regulatory Authority, Capital Markets Authority, Retirement Benefits Authority, and SACCO Societies Regulatory Authority. Further, the Insurance Act was amended in 2016 to incorporate definition of *takaful* business and empower the Cabinet Secretary for National Treasury to make Regulations for licensing and regulations of *Takaful* businesses.

The recent Finance Act 2017 made amendments to the Co-operative Societies Act and the SACCO Societies Act to facilitate *shari'ah* compliant products and enhance financial deepening. It also amended the Public Finance Management Act to recognize *sukuk* as one of the national government securities. The Cabinet Secretary for the National Treasury is now empowered to make regulations for raising money through *sukuk,* both locally and internationally, specifying the purpose for which the money is raised. Other amendments relate to the Income Tax Act, VAT Act and the Stamp Duty Act to provide for equitable tax treatment of Islamic financial products with the conventional financial products. Other developments include empowering the Cabinet Secretary for National Treasury to make Regulations under the SACCO Societies Act to facilitate the licensing and supervision of *Shari'ah* compliant cooperative societies carrying out deposit-taking businesses.

Going forward, there is need to consider engaging *shari'ah* advisors on *sukuk* structuring and documentation and setting up of a special purpose vehicle to support the issuance. Unlike conventional bonds (debt instrument), *sukuk* represents ownership of *shari'ah*-compliant assets which form the basis for returns. The specificity of the assets is therefore an important step in issuance of *sukuk*. Low public awareness and misconceptions is perhaps foremost constraint to the deepening of Islamic finance. Skills deficit may further constrain growth of Islamic finance industry. In addition, establishment of a National *Shari'ah* Supervisory Board is vital for enhanced governance and standardization of the products across the financial institutions. The other area that requires improvement include guidance on Islamic contracts and regulatory supervision that is anchored on *shari'ah* compliance with respect to co-mingling of funds, deposit insurance and the reporting standards.

Minimization of Costs in Public Infrastructure Investments

By Helen Hoka, Victor Mose, James Gachanja and Humphrey Njogu

Efficient and effective infrastructure plays a significant role in economic development process. It plays an enabling role as envisioned in Kenya Vision 2030, East Africa Community Vision 2050, African Agenda 2063 and the Sustainable Development Goals (SDGs).

A key policy issue emerging from the public discourse on infrastructure investments is project cost. The big concern is on maximizing the value for money and therefore appropriately costing the projects. In 2016, for example, the World Bank finds that investment in infrastructure was approximately 21% of GDP with a budget of approximately Ksh 800 billion for key infrastructure sectors. In Kenya, the Standard Gauge Railway (phase 1) spent Ksh 327 billion, Langata Road Ksh 2.6 billion, Thika Super Highway Ksh 32 billion, Southern Bypass Ksh 18.7 billion, and the Northern and Eastern Bypass Ksh 9.2 billion. In addition, the Lake Turkana Wind Power 310MW power project cost Ksh 68 billion and GDC 300MW Ksh 9 billion.

Infrastructure financing takes various forms. For example, debt financing that attracts loan interest depends on the type of loan. Unlike the concession loans, commercial loans attract higher interest rates, shorter payment period and sometime shorter grace period. In addition, insurance cost and foreign exchange contingencies may be accrued to loans. The high risk profile of infrastructure projects attract more cost of credit, as opposed to low risk investments.

For the case of SGR, 90% of the cost incurred in phase 1 was borrowed, with concessional loan amounting to approximately Ksh 145.8 billion, secured at 2% interest per annum with a grace period of seven (7) years and repayment period of 13 years. The commercial loan component was about Ksh 148.5billion with an interest rate of LIBOR + 360 base point interests per annum. A LIBOR rate is annual interbank lending rate, and whose average has been between 0.561% to 1.376% between 2010 and 2016, according to Global-Rates (2016).

Private sector engagement models through the annuity model proposed in 2015 to finance roads would have changed the financing of infrastructure projects in Kenya. However, its implementation has been complicated by high unit cost of submitted bids and interest rates quoted by financier beyond government target.

Capital costs in infrastructure projects increase due to import duty and level of technology applied, though exemptions are applied on some projects such as SGR. Labor costs are affected by policies such as those requiring a certain proportion of local content, especially on employment of local labour force. To enhance productivity

"Private sector engagement models such as the annuity model in the road sector would have changed the trends in financing infrastructure projects"

of the local labour, multiple trainings are required as the project traverses various host communities and this increases training costs.

Land speculation, environment protection, resettlement of project affected entities and alteration of project design are typical obstacles. In addition is the failure to honour project lead times, and manipulation of compensation plans which tend to inflate project costs. Relevant authorities need to be engaged to investigate such cases.

Inadequate project appraisal may result to over or under-estimation of costs. Furthermore, infrastructure project appraisal tends to largely concentrate on actual construction costs. Although manuals and standard unit rates exist to guide project costing, they lack dynamisms leading to delays in project implementation and increasing costs. For example, estimates are often adjusted during procurement process necessitated by higher costs by bidding contractors.

Least estimated in project costing is social and environmental costs, leaving room for cost escalation. Social costs manifest through speculation in land acquisition and resettlement of persons and relocation of social amenities such as markets, schools, hospitals and churches. Environmental estimates capture environmental restoration, conservation and sustainability costs.

In costing, data is critical to guide the process but it is not readily available. Absence of centralized repository to support analysis and decision making brings about unclear estimates. For example, the proposed Transport Sector Indicator Framework (TSIF) developed in 2010 was designed to focus on sector performance and on measuring policy dimensions of transport service delivery such as access, quality, affordability, efficiency and financial sustainability. The overall objective was to guide defining, collecting, collating, analyzing, storing and disseminating indicator data. Its implementation therefore is desirable.

The need for effective cost minimization by controlling sources of escalation cannot be gainsaid. Costs related to land speculation can be minimized through effective Land Value Index. The "land value index is an analytical representation showing the spatial distribution of land values in a given geographical area at specific time, which will be used for valuation of land. In addition, full implementation of the Community Land Act, 2016 will unlock the constraint of access to land for infrastructure. The Act provides for mapping and planning of community land and allocation of rights.

To avoid reemergence of additional costs on environmental and social concerns, the assessment of environmental and social impacts (ESIA) should be conceived as an integral component of project appraisal as opposed to being perceived as an auxiliary project component. This should be undertaken at early stage of project cycle.

Development of a comprehensive and integrated framework applicable to all infrastructure sectors is a priority. This would provide a common platform and source of data for cost estimation in the project lifecycle and lay a foundation for knowledge and data management.

To address costs arising from project financing, an optimal mix between debt and equity financing is required. This requires strategic negotiation on the balance between concessionary and commercial loans. Adequate allocation of risks among stakeholder and incentives to de-risk the investments should be considered too. Integrity issues can be fundamentally addressed through moral suasion guided by the National Values and Principles of Governance. In addition, effective supervision, monitoring and evaluation of projects will enhance transparency and accountability.

To reduce capital costs, the policy on exemption of duty has to be sustained. Enhanced research, innovation and technology transfer will significantly reduce importation. Labour costs can also be addressed by continued support and strengthening of Technical and Vocational Training. The TIVETs need to establish joint training programmes with institutions attached to international contractors for transfer of appropriate skills and knowledge.

> "To address costs arising from project financing, an optimal mix between debt and equity financing should be strongly considered."

Lowering Transaction Costs in EAC Cross-border Trade through Trade Facilitation

By Christopher H. Onyango

Intra-regional trade in Africa has remained dismal despite concerted efforts to remove tariff and non-tariff barriers within regional trade agreements. African markets are not just fragmented but remain largely isolated from the global trade arena. For instance, in 2015, the share of Sub-Saharan Africa's imports from its own region was merely 17.5% compared to 55% from Europe and Asia. Similarly, total exports accounted for 24.8% and 51.9% to SSA and Europe and Asia, respectively. Kenya's share of total trade with African countries was 15.7% in 2016 during which the shares of imports and exports from Africa were a paltry 9% and 29%, respectively. In other words, Africa trades with itself less than it does with the rest of the world.

High transaction costs are among the major factors contributing to Africa's under-performance. Indeed, intra-African trade costs are estimated to be 50% higher than those in East Asia, and are the highest of intra-regional costs in any developing region. Furthermore, it is estimated that trade costs are as high as 200% in *ad valorem* tariff equivalent terms for lower-middle-income countries and more than 250% for low-income countries.

Transaction costs can be classified as direct, i.e. (i) direct costs or costs of compliance associated with collection and processing of information and charges for trade-related services, e.g. for freight, insurance and handling; and (ii) indirect costs or time sensitive costs brought about by administrative processes and inventory charges. There is a general consensus that transaction costs can be remedied through effective implementation of trade facilitation instruments. Whatever the definitions, high trade costs which act as barriers to the integration of developing and least developed countries into the global economy were the driving forces behind the WTO's Trade Facilitation Agreement (TFA) concluded in 2013 during the Bali Ministerial conference. The latter aims to expedite the movement, release and clearance of goods, thereby further reducing the costs of trading across borders.

Improvements in trade facilitation along transport corridors in the East Africa Community (EAC) have significantly lead to increased cross-border trade and reduced transaction costs due to faster clearance and transit times. For instance, clearance and delivery of containers from the Port of Mombasa to Kampala has reduced to 10 days from 20 days five years ago. Similarly, recent surveys indicate that the price charged by trucking companies to ship a container from Mombasa to Nairobi and other destinations beyond the Kenyan borders have declined by more than 30% between 2013 and 2016. Reduced operational costs in the form of transit times and costs are anticipated to be passed on in form of lower transport costs and market prices.

Previous studies on Kenya have shown that improvements of business environment, the quality of port infrastructure, the number of days required for enforcement of contracts, and the activities that improve logistics performance have

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been critical in boosting the flow of foreign direct investments into the country.

Reducing trade costs through trade facilitation can also be essential in addressing food insecurity by helping bring staple foods from areas of surplus production across borders to growing urban markets and food deficit areas. Although East Africa has the potential to feed itself, some countries including Kenya suffer deficits and stand to benefit.

The potential for regional production chains in the EAC region to drive global exports of manufactures, such as those in East Asia, has yet to be exploited, due to high transaction costs. There are also opportunities to develop regional value chains around textiles as well mineral commodities such as phosphates for fertilizers and regional processing of nickel and copper.

In the services sector, cross-border trade in services in the region is hampered by restrictions in various sectors and in various modes of supply. Yet, trade in services offers untapped opportunities for exports as well as better access for consumers to critical services such as transport, communications, banking, distribution, health and education and firms to services such as accountancy and other professional services that boost productivity.

Unlocking regional trade potential through trade facilitation is therefore imperative if Africa is to remain steadfast in her quest to use trade as means to drive her development agenda. Increased regional trade can enhance the benefits of trade by creating opportunities for employment, increasing productivity and improving general welfare.

Policy News

Domestic Policy News

Minimum wages increased by 18.6 Per Cent

The President of Kenya announced an 18.6% increase in the minimum wage during the 1st May 2017 Labour Day celebrations. The minimum wage increases form an average of Ksh 10,995 to Ksh 12,926. Employers expressed fears that the increase in minimum wages could reduce employment creation and investments. However, based on many findings across the globe, low-wage labour has a relatively low elasticity of demand following a wage increase. An increase in the minimum wage is likely to have minimal effects on employment levels in Kenya.

New form of securitization

Movable Property Security Rights Act 2017, which was assented to by the President on 10th May 2017, allows the use of household goods, crops, live animals and intellectual property to secure commercial loans. The Act also allows the formation of a centralized electronic registry for mobile assets, which would be used by financial institutions to verify the security used to borrow a loan.

Financial Services Authority Bill

In April 2017, Cabinet approved the draft Financial Services Bill 2016 which proposes to merge four financial regulatory bodies, namely Capital Markets Authority (CMA), Insurance Regulatory Authority (IRA), Retirement Benefits Authority (RBA), SACCOS Societies Regulatory Authority (SASRA) into one central body. The Bill also harmonizes a number of regulatory, administrative and enforcement provisions, including the institutionalization of self-regulation in the sector. The existing sectoral legislations will not be repealed, but are amended to conform to the Constitution and the Financial Services Bill itself.

Enhancing financial inclusion

The government issued the first ever M-Akiba Bond, which is a special Retail Bond aimed at enhancing financial inclusion while raising money to fund infrastructure projects through individual's saving via the mobile phone. The government intended to borrow a total of Ksh 5 billion, at an interest of 10% per year, with maturity of three years, with a minimum investment of Ksh 3,000. The initial offer for Ksh 150,000 was launched in March while the second offer of Ksh 1 billion was made in June.

Mining (Use of Assets) Regulations, 2017

This regulation became effective on 9th May 2017. Upon termination of a mining license, the regulations provide that mining companies will cease to own all movable and immovable assets that were previously held by the mining company, including roads, power installations, schools and machinery. Mining firms are resisting the use of assets regulations arguing that the law violates Article 40 of the Constitution of Kenya and amounts to nationalization.

Launch of Standard Gauge Railway Services between Mombasa and Nairobi

His Excellence the President, on 31st May 2017, launched the much-awaited Standard Gauge Railway (SGR) passenger service christened the Madaraka Express. This marked a new dawn in Kenya's transport sector by replacing the "Lunatic Express" which was built in 1902. With the completion of the first phase of SGR, the nation's economy is expected to benefit from creation of jobs, improved efficiency of the transport sector, reduction in the cost of doing business and overall support to trade facilitation. The second phase is divided into three sub-phases; 2A Nairobi – Naivasha; 2B Naivasha-Kisumu; and 2C Kisumu-Malaba. Kenya Railways has signed commercial contracts with China Communications Construction Company towards development of the second phase. The Government of Kenya secured loans from the Chinese Government of Ksh 150 billion for construction of the Nairobi-Naivasha section and Ksh 370 billion for the Naivasha to Kisumu section.

Piloting the new education system in Kenya

The Kenya Institute of Curriculum Development has come up with a new school curriculum under the ongoing reforms in the education system. This is expected to address the shortcomings of the 8-4-4 system, which has been described in the 2012 report of Prof. Odhiambo's Task Force on education as: expansive, heavily loaded and examination oriented and thus putting undue pressure on learners. The focus of the new curriculum is to identify and nurture talent from an early age and shift focus from competition to acquisition of knowledge and skills. The pilot for this new curriculum is underway.

Affordable apparels from Kenya's EPZs

Under "Buy Kenya Build Kenya", EPZ companies made a sale of quality clothes at affordable prices in the Kenya market. The sale follows government's move to increase duty free local market access for designer apparels made by EPZ firms to 40% from the initial 20%.

Mergers and acquisitions

The banking sector saw the entrance of SBM Holdings Ltd, a financial services group in Mauritius pursuing "diversification and internationalization". The acquisition of Fidelity Bank by SBM Bank is informed by the company's strategy to increase its footprint in Africa. Fidelity Commercial Bank Ltd which was licensed in 1996 is classified as small, with 15 branches. This acquisition comes at a time when Central Bank of Kenya has enhanced their oversight of commercial banks. This follows the acquisition of Giro Commercial Bank by I&M Bank (effective February 2017). I&M bank now has a total of 43 branches and additional advances, deposits and assets totaling Ksh 28.4 billion. Giro Bank which was also classified as small was licensed in 1992 and had 8 branches. The consolidation being witnessed in the banking sector is attributable to, among other things, new business models being adopted by individual banks to expand client base, deposit base, financial services and portfolio opportunities. Diamond Trust Bank's (DTB's) intention to acquire Habib Bank (K) was also revealed this quarter.

Policy News

Global News

EAC moving towards common airspace

Flights within East African Community (EAC) partner states will be classified as domestic by the end of 2017 if EAC countries sign an agreement negotiated by the regional aviation regulators. Liberalization of air transport is expected to lower the price of air tickets by 12% and boost tourism. The realization of a common airspace will be a significant milestone in the EAC regional integration process with regard to the Common Market Protocol that came into effect in 2010.

US pulls out of Paris Climate Accord as others soldiers on

President Donald Trump announced that the US will withdraw from the Paris climate accord agreed on by the international community in 2015. According to Trump, the Accord imposed unfair environmental standards on American businesses and workers. However, leaders of the world's biggest economies under the G20 met in Hamburg Germany in July and resolved to continue shifting away from fossil-based economy towards a clean, affordable, reliable and sustainable energy future. Whichever way one looks at it, the Accord has implication on emerging oil producing countries such as Kenya.

One Belt, One Road: President Xi's signature foreign policy takes off

China hosted the Belt and Road Forum on 14-15 May 2017 in Beijing that was attended by twenty nine (29) heads of state and government and representatives from over 130 countries, Kenya included. The new Silk Road initiative is seen as President Xi Jingping's signature foreign policy that intends to create trade and economic corridors consisting of a network of roads, rail lines, ports and highways that will connect several countries across Asia, Africa and Europe. Since China is a major actor in transport infrastructure development in the country, Nairobi is likely to benefit from the One Belt, One Road initiative if Kenya realigns its transport development strategies to the new Silk Road phase in East Africa.

Djibouti as the logistics hub in the Horn of Africa

Djibouti is increasingly positioning itself at the logistics hub in the Horn of Africa after opening three (Doraleh, Tadjourah and Ghoubet) ports in two months. Currently, Djibouti handles about 95% of the inbound trade for Ethiopia. The recent developments in Djibouti are likely to have ramification on Kenya-Ethiopia cooperation on the Lamu Port-South Sudan-Ethiopia-Transport (LAPSSET) corridor.

The East African Crude Oil Pipeline Agreement signed

The President of Tanzania, His Excellency John Pombe Magufuli and his Ugandan counterpart, His Excellency President Yoweri K. Museveni signed the East African Crude Oil Pipeline Agreement (EACOP) on the sidelines of the 18th Ordinary EAC Heads of State Summit held in Dar es Salaam, Tanzania. The inking of the EACOP paves way for the construction of the proposed 1,445km crude oil export pipeline from Hoima, western Uganda to the Tanzanian Port of Tanga.

Kenya's workplace gender gap among highest globally

The International Labour Organization (ILO) revealed that Kenya's labour force participation gender gap is 9.9 points while unemployment rates for men and women were 13.0% and 9.0% respectively. Kenya's gender gap in the ratio of contributing family workers was 47.8% and 20.0% for men and women respectively, which is among the highest globally. Significantly more women are engaged in activities that limit earnings and are precarious in nature than men – thus compromising the wellbeing of many women.

Current KIPPRA Research Projects

Micro and Small Enterprises (MSEs) are an important source of employment, goods and services and innovation in Kenya. They account for over 70% of all modern establishments. There have been a number of policy developments over the years aimed at addressing challenges facing the sector. However, implementation has often been ineffective. A key contributing factor to weak implementation is weak coordination among key players and duplication of activities.

KIPPRA was contracted by Micro and Small Enterprise Authority (MSEA) to conduct a study to review the sector's coordination challenge with the aim of providing relevant policy recommendations. The study entails consultations with relevant key informants and review of relevant literature. The key outcome is the development of a Coordination Strategy to effectively coordinate and integrate MSE activities and programmes carried out by stakeholders in the public and private sector.

Assessment of health care delivery in Kenya under devolved system

This study was commissioned by KIPPRA and encompassed all counties. The study assessed the uptake of health care services in the context of the reforms introduced by devolution process. The study is important in not only documenting the effects that devolution has had on provision of health care services but also in identifying prevailing institutional and organizational gaps. Some of the examined areas were: adequacy of legal and legislative frameworks governing provision of health care in Kenya; compliance with the constitutional, policy and legislative provisions; and the appraisal of the availability of health inputs and levels of citizens' satisfaction with the health services.

Sub-national Public Expenditure and Financial Accountability Assessment (PEFA)

KIPPRA, in collaboration with World Bank-Kenya, and with additional funding from International Development Research Centre (IDRC) is undertaking a sub-national Public Expenditure and Financial Accountability Assessment (PEFA) covering six selected counties (Makueni, Kajiado, Nakuru, West Pokot, Kakamega and Baringo). This is the first sub-national PEFA to be undertaken for Kenya. The national government has undertaken four PEFAs, with the latest being in 2017. The PEFA Assessment focuses on seven key pillars, including: credibility of the budget; comprehensiveness and transparency of public finances; asset and liability management; policy-based planning and budgeting; predictability and control in budget execution; accounting, recording and reporting and; external scrutiny and audit. The assessment is expected to provide a better understanding of public finance management in counties and identify key areas of PFM reform. The outcomes will therefore be key inputs into the Kenya Devolution Support Programme (through International Development Association funding) whose main aim is "to strengthen capacity of core national and county institutions to improve delivery of devolved services at the county level".

Evaluation of FAOs Country Programme

KIPPRA, Tegemeo and FAO's Office of Evaluation are undertaking a joint evaluation of FAO's country programme covering the period 2013-2016. The purpose of the evaluation is to generate information to better orient FAO's position in order to be more impactful and relevant to the needs of the country. The project entails collecting evidence to support FAO's achievements both at national and county level and will provide important feedback for the next country programme framework.

KIPPRA News and Events

As per its core mandate to support the government in the policy making process, KIPPRA staff participated various technical working groups in preparation for the Medium Term Plan III. This including Macro working group, Devolution, Labour and Employment, Agriculture, Livestock and Fisheries, Manufacturing, Infrastructure, Science, Technology and Innovation, Environment, Water and Sanitation, Education and Training, Health, Gender, Vulnerable Groups and Youth, HIV/AIDS, and Financial services.

In each of the working groups KIPPRA policy analysts contributed in drafting of the situation analysis, performance review, policy, legal and institutional reforms; development of implementation plan for Vision 2030 flagship projects; identifying all key policies, programs and projects to be implemented over the period of the plan, and selection of projects to be funded under Private Public Partnerships. This was mainly done through written submissions and participation in working retreats organized by sector conveners.

Launch of report on Transforming Agribusiness, Trade, and Leadership: *A capacity Needs Assessment of Tea Value Chain in Kenya:* On 28th June 28, 2017 KIPPRA in collaboration with the African Capacity Building (ACBF) launched a report on gaps in institutional and human capacities in the tea sector and their recommendations. Participants were drawn from the Ministry of Devolution and Planning, the Vision 2030 Directorate, Ministry of Public Service and Youth Affairs, Public Sector Transformation Division (PSTD), Kenya Agricultural and Livestock Research Organization (KALRO), Agriculture and Food Authority (AFA) - Tea Directorate, Kenya Tea Development Agency (KTDA) among others.

Corporate Social Responsibility (CSR): KIPPRA, hosted sixty students under the Pupils Rewards Scheme (PURES) on 24th May 2017. KIPPRA interacted with the students on the budget, policy and legislation making process and the role played by economics, research and analysis in informing policy. KIPPRA staff also visited Gathirimu Girls' High School Saturday 27th May 2017 to interact students from Gathirimu Girls, Mitahato and Ndiriti secondary schools. Students were exposed to information on types of research, climate change, youth empowerment and various opportunities available for the youth. Further, on 26th May, 2017, KIPPRA Environment Committee Members joined staff of the University of Nairobi, College of Agriculture and Veterinary Sciences in a tree planting event at Ndumbuini, Kabete. For the last four years, KIPPRA has participated in tree planting as part of her commitment towards sustainable development goals.

KIPPRA Team Building: KIPPRA staff participated in a team building exercise on May 30th to June 4th 2017 in Naivasha. The event embraced a mixed programme which included formal presentations, lively deliberations and outdoor team building activities.

For upcoming events please visit KIPPRA website, **www.kippra.org**