Njuguna Ndung'u: East African integration as a solution to economic growth and employment generation

Remarks by Prof Njuguna Ndung'u, Governor of the Central Bank of Kenya, on the occasion of a public lecture, Kenyatta University, Nairobi, 16 March 2010.

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The Chairman of Council;
The Vice-Chancellor;
Deputy Vice-Chancellors;
Members of the entire University Community;
Distinguished Guests;
Ladies and Gentlemen:

It is a pleasure and honour for me to address this distinguished audience on a very topical and timely issue of EAC integration as a solution to economic growth and employment generation for Kenya and the EAC region. I wish to focus my talk on domestic and regional policy initiatives and how they impact on growth, and more specifically on the employment situation in Kenya.

May I start by pointing out that unemployment reflects the inability of economic activity to absorb labour or human resource at different levels. When we talk of economic activity, we mean growth. It allows economic opportunities to emerge. The most important one; investment opportunities that increase the demand for human capital. So employment is a derived demand, from the demands on economic activity and increased investment.

But how does regional integration improve economic activity (growth) for member countries and so increase labour absorption – employment? This is the question we need to focus our attention on. Let me try some quick avenues:

1. EAC will provide a wider market – this will induce firms' production expansion in size and product lines – to satisfy a wider market.
2. A larger market requires a larger investment outlay.
3. A larger market diversifies the sources of income flows.
4. Financial services to cover the region will have to adjust to a higher platform: for instance, Kenyan banks are currently expanding to the region in a significant way. The same applies to a number of other sectors such as retail services as evident with the expansion of Nakumatt and Uchumi retail shops to the region.
5. Larger demands for regional infrastructure to facilitate trade and production.

The list can be long and depends on where one starts, but at the end, labour demand is derived demand from all of these economic activities.

To develop this topic on Kenya, I wish to develop three arguments on Kenya's case:

First, the policy solutions, their evolution and shocks; It is often good to start from a perspective that policies, once implemented, will work and even when shocks hit the economy, the economy will return to its potential. How long it takes to return to its potential is determined by how pervasive and persistent shocks were. Having said that, the blue print of growth and employment creation was laid out by the NARC Government – "Economic Recovery Strategy for Wealth and Employment Creation" which covered the period 2003–2007. This bore fruit and the economy picked up from a low of 0.5 percent annual growth in 2002 to 6.3 percent in 2006 to 7.1 percent in 2007. This saw the number of new jobs created reaching 506.5 thousand, 488.4 thousand, 485.5 thousand, 467.3 thousand in 2004, 2005, 2006 and 2007 respectively.

The results of this blue print of policy paradigm show that success will always generate success. Once policies are followed to the paper, they will generate the desired results.

But then external and internal shocks hit the economy in 2008 stepped in. However, the economy is on the recovery path and it was expected to grow by about 2.1 percent in 2009 and at between 3 and 4.5 percent in 2010 and by over 5 percent in subsequent years. It is important perhaps to explain why in times of shocks, growth, investment and even economic decisions are affected and even affect other outcomes like consumption and employment.

Three examples include:

1. At the individual level optimizing welfare under uncertainty.
2. Irreversibility of fixed investment decisions.
3. Informal sector expansion as a disequilibrium queuing model of employment.

These are short-run and should not condemn us to a low equilibrium trap.

Second, the EAC Common Market and its potential for employment.

- In general, most countries in Africa are forming regional economic integration arrangements in order to; secure access to larger markets and enhance trade flows and in the process attract the much needed foreign direct investments; lower trade costs among neighbours; leverage or lock in domestic reforms; create a framework for regional cooperation and resource pooling; increase their bargaining power and political cohesion.
- Economic integration has the potential for economic growth; to create wealth; improve labour and social conditions and result in a better division of labour between countries based on comparative advantage. Exploiting relative comparative advantage of each integrating member country enhances the region's efficiency in production, increasing output and boosting economic growth of each member country.
- Regional integration, uniformity of policy and common goals will act as an agency of restraint and cushion the external shocks in some cases.
- The EAC brings together nationals of five countries namely, Kenya, Tanzania, Uganda, Rwanda and Burundi. In 2008, the five countries had a combined population of 126.6 million people and a nominal GDP of USD73 billion (based on EAC Facts and Figures Report, 2009). In the same year, Kenya's GDP stood at USD26.9 billion, that is 37 percent of the EAC total. It is the dominant economy in the bloc. This enlarged market means potential for increased free trade among members. Free trade is expected to lead to rapid expansion of trade and output, which in turn is expected to lead to demand for further investment, employment and GDP growth. These gains result from the dynamic effects of a Common Market, which have been shown to overshadow the static effects, that is, trade creation, trade diversion and terms of trade effects. The dynamic effects, which are cumulative in nature lead to growth. Indeed, the dynamic effects of a Common Market are often described as the long-run consequences for the economic growth of member countries as a consequence of increased market size and exploitation of economies of scale, increased competition, learning by doing and increased investment. Also, the stronger the potential economies of scale are, and the more rapid the autonomous productivity advantages, the more likely the economic integration will lead to growth. Thus, the contribution of the EAC Common Market to economic growth and employment will be greater if the economies of scale are possible by increased market size, takes place pari passu with learning by doing.

- However, higher levels of economic integration that would ensure such benefits are realized require heavy infrastructural investments in the region. With this realization, the EAC Development Strategy sets out the priority programmes for the region focusing on among others, cooperation in infrastructure development. An efficient infrastructure development mainly for EAC in terms of roads and railway interconnectivity has the potential to increase from 3.7 million tonnes in 2007 to over 16 million tonnes by 2030, at an annual rate of growth of 6.7 percent, according to a study on the EAC Railways Master Plan. Current EAC efforts to develop regional infrastructures are complemented at the continental level by such initiatives as the Infrastructure Consortium for Africa (ICA), established in 2005 and mandated to support and promote increased investment in infrastructure in Africa from both public and private sources. In addition, with the implementation of the EAC Common Market Protocol, regional infrastructural projects will be well defined.
- ***Ladies and Gentlemen***, it is worth noting that the overriding rationale for regional integration is development, with all the benefits that come with it. Theoretically, integration fosters growth through different channels such as increasing innovation through economies of scale and through technological spillovers and elimination of replication in research and development. Empirically, integration gives access to a larger market, more stock of technology and knowledge and therefore, more innovations and growth. Furthermore, expanded markets and increased productivity following integration, triggers increasing returns in the research and development sectors due to the implied scale effects. All these channels have important implications on employment generation and economic growth for the integrating economies.
- The overriding objective of the EAC Common Market is to widen and deepen cooperation among partner states in both economic and social fields for the benefit of the citizens of the member states. This is beyond what literature terms as “beg thy neighbour” effects. The Common Market Protocol provides for the free movement of goods, persons, labour, services and capital within the region as well as the right of establishment and the right of residence.
- The Common Market will unlock many other benefits among East African citizens. Currently, efforts are underway to move to the next level of economic integration, after the completion of a Study by the European Central Bank consultants on the East African Monetary Union (EAMU). The study has explored among other things the current preparedness for a Monetary Union, institutional frameworks and structure for an EAMU, design of a protocol on the EAMU to be negotiated by partner states, and proposals for monitoring and enforcing macroeconomic convergence in the region.
- ***Ladies and Gentlemen***, all these integration endeavours will create employment opportunities. I will emphasize on employment opportunities because it is a dynamic concept that focuses on gainful employment and space to utilize your own relative comparative advantage. It is upon you to position yourselves to take advantage of these new opportunities. Our higher institutions of learning have the responsibility of training an internationally competitive labour force to enable Kenya take full advantage of these regional initiatives. The investment opportunities that come with it will allow the appropriate signals of skill requirement.

Finally, the Vision 2030 and unemployment in Kenya: The Vision 2030 aims at transforming Kenya into a newly-industrialised, middle income country: what does it mean to solve the unemployment problem of Kenya?

To solve unemployment, we need a long-run vision for growth and investment supported by short-run policies like macroeconomic policies, specifically: fiscal and monetary policy and also trade policies.

a) Fiscal policy and fiscal stimulus

The economy is just emerging from the devastating consequence of drought and the global financial crisis. The pervasiveness and persistence of these shocks required that the government develops a fiscal stimulus. It is important to understand how fiscal stimulus works in an economy like ours:

1. Recognizes support and protection for the wage good through targeted public investment and public works – Kazi Kwa Vijana.
2. A shilling spent in rural Kenya has a higher multiplier effect in the economy.
3. Support local industries – via government expenditure and higher domestic consumption – preserve jobs – prevent layoffs.
4. Increase public investments that are complementary to private investments – in that they enhance profitability of private investments.
5. Finally, in this way the government crowds-in private sector but not crowd-out.

b) Monetary policy

But perhaps one may ask how has the monetary policy reacted to the crisis and how does it work to support economic activity? Monetary policy works to control the level of money supply consistent with economic activity.

Several instruments:

- ***Central Bank Rate (CBR)*** – as a signalling rate of the stance of monetary policy. It has been progressively reduced from a high of 9 percent in August 2008 to the current level of 7 percent. Lowering of the CBR signalled the intention of the Central Bank for a low interest rate regime to encourage credit extension to the private sector and so investment to support growth.
- ***Cash Ratio Requirement (CRR)*** – in order to avail liquidity to commercial banks and release more resources for financial intermediation, the Bank has lowered the CRR from 6 percent to 5 percent in December 2008 and further to 4.5 percent in June 2009.
- ***Liquidity management tools:*** To further enhance liquidity management in the banking system, the Bank has instituted several reforms to introduce new instruments like horizontal repo, vertical repo with fixed tenors.
- ***Financial development:*** In general an efficient and developed financial system is important to collect and collate savings from micro-savers to investors. Second, an effective monetary policy will depend on an efficient and developed financial system.

In concluding my remarks, let me emphasize that employment is a function of economic activity. Sustained economic growth is good for employment. One major solution for sustained growth is a wider market for trade and investment. EAC provides just that. But public investment infusion required to support the private sector investment is immense. Public investment especially in infrastructure will reduce transaction costs for the private sector and allow profitable regional trade. To date 43% of the total Kenyan exports of goods and services go to the EAC region. These exports are mostly manufactured exports. There is scope for more within the EAC and locational advantages. This is what we want to strive for in EAC and these are the positive development agenda EAC presents to Kenya and East African countries.

Thank you for your attention.