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THE ROLE OF SERVICES IN ECONOMIC TRANSFORMATION – WITH AN APPLICATION TO KENYA

Anupam Khanna, Phyllis Papadavid, Judith Tyson and Dirk Willem te Velde

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List of acronyms

3PL	Third-Party Logistics
AFDB	African Development Bank
BIS	Bank for International Settlements
BPO	Business Process Outsourcing
CPI	Consumer Price Index
DRC	Democratic Republic of Congo
EAC	East African Community
ERD	European Report for Development
ERP	Enterprise Resource Planning
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FEER	Fundamental Equilibrium Exchange Rate
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GIC	Global In-house Centre
GPT	General Purpose Technologies
HIC	High-Income Country
ICT	Information and Communications Technology
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
IT	Information Technology
ITeS	IT-Enabled Services
KES	Kenyan Shilling
KPO	Knowledge Process Outsourcing
LIC	Low-Income Country
LMIC	Lower-Middle-Income Country
MIC	Middle-Income Country
NASSCOM	National Association of Software and Services Companies
NEER	Nominative Effective Exchange Rate
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
PPP	Purchasing Power Parity
R&D	Research and Development
RCA	Real Comparative Advantage
REER	Real Effective Exchange Rate
SET	Supporting Economic Transformation
SMAC	Social, Mobile, Analytics and Cloud
SMEs	Small and Medium Enterprises
TMEA	TradeMark East Africa
UK	United Kingdom
UMIC	Upper-Middle-Income Country
UN	United Nations
UNCTAD	UN Conference on Trade and Development
US	United States
USITC	US International Trade Commission
WDI	World Development Indicator
WEF	World Economic Forum
WTO	World Trade Organization
WTTC	World Travel and Tourism Council

Executive summary

The role of services in the debate on economic transformation

Services have long been ignored in the debate on economic transformation. The theoretical literature dating back to Adam Smith has featured an anti-services view of economic development. The empirical literature on growth in developing countries has also placed relatively little emphasis on services until recently.

Services used to be seen as following economic transformation, with demand increasing as incomes rise and services being endogenous to a country's structural position. This paper argues that is **important to follow a more comprehensive and balanced view that includes a supply-side view**, whereby services can lead economic transformation through direct, indirect, induced and second-order/productivity effects, depending on the specific services sector.

Two observations are behind this positive view. First, **services are increasingly important for their direct contribution to gross domestic product (GDP)**, exports and employment. The share of services increases as incomes increase. Some services feature high labour productivity and potential to contribute to growth; others are employment-intensive. Second, **a balanced view of services also considers their role in creating indirect effects through second-order productivity effects**. For example, information and communications technology (ICT) and financial services make other companies more productive, developing value chains, safeguarding jobs and providing a key engine behind developing country growth. Other services, such as tourism, create a lot of jobs within suppliers. We also show how services increasingly contribute to value added of exports in African countries (in addition to the servicification of manufacturing). Thus a measure of direct job creation alone (or even services sector productivity alone) is not an adequate assessment criterion for services sectors.

However, there **are potentially negative implications from too much focus on services**. High-productivity services could naturally follow manufacturing activities, but economies can deindustrialise prematurely when manufactured jobs are replaced by low-productivity services jobs. Moreover, too much export-oriented services has opportunity costs. It could lead to Dutch disease effects, with an appreciated real effective exchange rate (REER) damaging manufacturing industry. Finally, from a dynamic point of view, the development of skills for the service sector may be to the detriment of skills development for other sectors and hence difficult choices with respect to human capital formation may need to be made.

Applying a comprehensive framework to the analysis of services and economic transformation

We **apply a comprehensive framework of the services sector to four services sectors in Kenya** (financial sector, IT services, transport services and tourism services). First of all, we test the usefulness of the approach. The analysis suggests that different service sectors contribute differently to growth and jobs. We also find that a strong performance in trade in services has coincided with a REER that has hampered the goods sector. Such international effects need to be taken into account in any cost–benefit analysis of a services push. We also apply this framework to draw out policy implications for individual services sectors, clearly suggesting the importance of policy in improving the impact of services on economic transformation. We discuss this below.

Kenya's **financial sector** could benefit from a processing hub, but the potential of a financial centre for economic transformation is more complex and less clear. There should be immediate **policy support to develop financial processing hubs in Nairobi**. This is because of gains in high-volume and low-skill employment combined with little risk to economic and financial stability. There needs to be a much more **cautious approach to progress towards being the financial hub for Sub-Saharan Africa**. The immediate short-term goal to prepare for this should be to strengthen regulation – especially macro-prudential regulation – and partner with private institutions to establish Nairobi as their regional headquarters. It is also important to monitor exchange rate developments so these contribute to rather than hamper real sector development.

Kenya has certainly achieved considerable success in the **IT industry** (particularly in areas associated with mobile telecommunications) as well as in business and professional services (notably business

process outsourcing (BPO)). However, not surprisingly, owing to rapid technological change and evolving business models, the accomplishments are different from those originally envisaged, requiring changes in policy and strategic direction. The Kenya brand appeal is still positive, the IT/IT-enabled services (ITeS) sector remains attractive to domestic and foreign investment, and – perhaps the most promising – the country is emerging as a hub for digital innovation, albeit overwhelmingly concentrated spatially in and around Nairobi. The challenge going forward is to sustain, scale up and spread these developments. **The key to future success lies in de-emphasising the export-only enclave mindset (which would lead to exchange rate appreciation) in favour of diffusion of IT-enabled productivity improvements across other economic sectors**, particularly those where re-engineered processes will enhance international competitiveness and market reach.

Transport services are important for indirect productivity effects. The main policy options to enhance the impact of **transport services** in improving the productivity of downstream sectors and to help the most productive among them grow faster are **those that lower the cost to customers (i.e. the prices they pay), reduce the time merchandise or people spend in transit and improve reliability, predictability and safety**. Achieving some of these aims requires investments in modern equipment and civil construction as well as in modern IT that can not only dramatically reduce paperwork but also obviate corruption. As important as investments are **institutional reforms** and related changes in policies and regulations. These are the focus of **sustained dialogue within government** and with external agencies such as the World Bank or TradeMark East Africa (TMEA).

The indirect and induced effects of **tourism** in Kenya are greater than the direct effects, suggesting it is important to understand how the sector affects the rest of the economy before making any judgements on its success. Kenya's tourism has a fundamental comparative advantage – a beautiful natural environment that has successfully attracted many people to the country. Further development and diversification strategies are needed to grow the industry while also optimising gains to the national economy and managing negative benefits, especially environmental degradation. The contribution the sector could potentially make to structural transformation is high – especially because of the potential to provide low-skill employment (indirectly) and to create spillover benefits such as infrastructure development and backward linkages.

Final conclusions

Overall, the analysis with application to Kenya has the following important general implications, which should lead to **an update of traditional views of the role of services in economic transformation**:

- Examine the role of services in economic transformation in greater depth;
- Differentiate among services sectors and different assessment channels, including direct, indirect and productivity effects, and exchange rate impacts;
- Revisit the manufacturing–services distinction and re-examine the link between services and other sectors from both a macro perspective (through exchange rate effects) and a more disaggregated perspective.

1. Introduction

Much of the debate on economic transformation in low-income countries (LICs) has centred on moving out of agriculture and into manufacturing (e.g. Timmer, 2007), but this fails to appreciate the role services can play. Labour productivity in agriculture in 30 Sub-Saharan African countries is only 28% of non-agricultural labour productivity (Gollin et al., 2014), so moving resources from agriculture to other sectors will help aggregate productivity change. However, as Rodrik (2015a) has pointed out, there is now less scope for developing countries to industrialise and develop on the basis of manufacturing. This has led some to suggest that services could be a growth escalator and an engine of transformation (Ghani and Connell, 2014). Economists have studied the services sector since at least the 1940s (Clark, 1967), but its role in driving growth in developing countries was never fully appreciated. In fact, te Velde (2008) referred to it as one of Africa's forgotten growth issues. This paper examines the role of services in economic transformation, by discussing the main conceptual issues and applying these to the case study of Kenya.

The structure of this paper is as follows.

Section 2 has four subsections. It first provides the intellectual history of the debate on services and economic transformation. It then provides a range of data on services and points to the heterogeneity in the way different services sectors relate to economic transformation, presenting a mapping of different types of effects of different sectors. This mapping suggests that it is important to use a broad range of assessment criteria, broader than direct employment or direct gross domestic product (GDP) effects alone. Finally, the section argues that it is important to assess the effects of services on other industries through the exchange rate.

Section 3 examines the role of services in Kenya's economic transformation. Kenya has the potential to offer many lessons as well as learn lessons from an analysis on services and economic transformation. On the one hand, Kenya offers lessons because it has already become a major exporter of services in areas such as transport services, financial services and (to a lesser extent) information and communications technology (ICT) or communication services. Kenya's Vision 2030 prioritised a number of sectors in driving transformation, and these include tourism, retail trade, business process outsourcing and financial services. On the other hand, Kenya's services also face challenges in (i) bringing the services sector up to the level of the most successful global service exporters and (ii) ensuring job creation and economy-wide benefits. Section 3.1 covers Kenya's services sectors in general, arguing there are a number of challenges and opportunities. Sections 3.2-3.5 discuss four different services sectors in Kenya. Section 3.6 examines Kenya's exchange rate in the context of its services sector. Section 3.7 synthesises the evidence.

Section 4 concludes by arguing that we need to consider a more comprehensive role of services in economic transformation, in a way that is more complex than only examining the direct GDP or direct employment effects. The new way of looking is by examining the role of services in supporting other sectors through value chain development. This opens up new avenues; for example, it is not necessary to be as pessimistic as Rodrik (2015a) on the role of services, as we are not looking at services sector indicators alone when assessing the role of services.

2. Conceptual and empirical issues on services and economic transformation

2.1 Literature on the role of services

The observation that an increase in incomes goes together with an increasing share of services in economic activity dates back to at least the 1940s (Clark, 1967; Fuchs, 1980; Kuznets, 1957). The earlier theoretical contributions suggested a linear path of transformation in which resources, such as labour and capital, shift from the agriculture sector to the manufacturing sector (Chenery, 1960; Chenery et al., 1986; Kaldor, 1967; Kuznets, 1966). The dual sector model by Lewis (1954) emphasises this concept of transformation in terms of shifts in labour shares between sectors. Such transformation is perceived to be positive, as the manufacturing sector embeds larger benefits than more traditional sectors (e.g. agriculture). These benefits, some of which apply also to the services sector, include increasing returns to scale and a larger income elasticity of demand, in addition to the effects of employment absorption, productivity increases and spillovers. As economies develop further and move beyond manufacturing production, an increasing share of resources flows to the services sector (Bhagwati, 1989a).

More recent evidence suggests that the growth of the service sector does not happen in a linear way. Eichengreen and Gupta (2013) suggest that the increasing share of services in the economy occurs in two waves: during the first wave, traditional services emerge at low levels of income; at higher levels of income the share of services increases further and in particular includes modern services, including communication, finance, computer and business services. Buera and Kaboski (2009) provide empirical evidence that the recent growth in the US service sector has been largely driven by high-skill services rather than low-skill services. Rodrik (2015a) argues that developing countries reach their manufacturing peak (measured as real value added as a percent of GDP) earlier in what he calls premature deindustrialisation, with an increasing share of activity and employment taking place in the services sector, albeit at low-productivity levels.

The literature provides three explanations for the rise of the services sector's share in the economy. First, the supply-side interpretation emphasises differential trends in sector productivity. The shift of employment from manufacturing to services is explained by a similar growth in wages in the services and manufacturing sectors but a simultaneously higher-productivity growth in the manufacturing sector (owing to capital accumulation and technical progress). Thus, the services sector must absorb a greater share of employment because of a slower growth in productivity (Baumol, 1967; Baumol et al., 1985; Bonatti and Felice, 2008; Nordhaus, 2008). Empirical evidence supports this hypothesis of lagging productivity as the global economy shifts towards services (Inman, 1988, p.5).

Second, the shift of employment towards the services sector is argued to owe to inter-industry divisions of labour (Schettkat and Yocarini, 2006). Manufacturing industries increasingly outsource their services activities.

Third, in the demand-side explanation, the shift of employment towards the services sector originates from the change in composition of demand as income rises – that is, non-homothetic consumer preferences (Bonatti and Felice, 2008; Echevarria, 1997; Laitner, 2000). This explanation implies that services *follow* rather than *lead* economic transformation. Kuznets (1966, p. 150) concurs that various structural changes would shift employment towards the services industry, including increasing concentration of production locations and thus the need for distribution services; the demand for financial services as personal wealth expands; and the expansion of government services (e.g. education, sanitation) as urbanisation takes place.

There are therefore two opposing views on the importance of services in economic transformation. Much of the traditional development literature has attached a rather limited role to the services sector in economic development, arguing instead that manufacturing plays the lead role in economic transformation. Adam Smith argued that services are 'unproductive of any value' (Smith, 1811, p.3)

because he believed that the consumption and production of services slows down the process of capital accumulation, economic growth and development. Baumol points towards the 'cost disease of services' (Baumol, 1967, 2012; Baumol and Bowen, 1965; Baumol et al., 1985). That is, it is generally more difficult to generate productivity growth in the services sector. In his model of 'unbalanced growth', Baumol (1967) suggests that higher productivity in the manufacturing sector *vis-à-vis* the services sector causes shifts in employment from manufacturing to services, and this in turn reduces aggregated total output growth as the sector with relatively lower productivity (i.e. the services sector) expands. Services also tend to be associated with sheltered non-traded sectors (Balassa, 1964; Bhagwati, 1984).

However, the more recent trade and development literature is more positive about the role of services in leading economic transformation. First, services tend to be increasingly tradable, with few negative consequences for employment in the host economy, and with higher wages *vis-à-vis* the manufacturing sector (Jensen et al., 2005). Ghani and Connell (2014) conclude that the globalisation of services provides the opportunity for LICs to find new niches -so called growth escalators) where they can specialise and scale up and achieve rapid growth just as East Asian countries did in manufacturing. There is much room for this as services play an important role in any economy, yet they remain weakly globalised, and there is ample room for catching-up and convergence. Rodrik (2015b) suggests that market services also involve unconditional convergence, just as manufacturing does. Second, the services sector tends to *work with* the manufacturing sector and can in fact facilitate or drive productivity in the manufacturing sector (Nordås and Kim, 2013).

Jones and Kierzkowski (1988, p.31) highlight this supporting role for services, consistent with current specialisation and distribution of production activities through global production networks (Gereffi and Memedovic, 2003; Kaplinsky, 2000; Kaplinsky and Morris, 2001): 'Bundles of activities consisting of coordination, administration, transportation, and financial services, are increasingly required as essential inputs when the fragmentation of the production process allows joint use of production blocks located in different regions.' The authors also note, that, 'As services become cheaper, service links at the international level become more frequently and intensively utilised as integral ingredients in the production process.' The latter is important because it has helped shape the global networks that have in turn changed the way in which developing countries (can) transform. In other words, whereas earlier industrialisers were successful through domestic development of whole industries, current developing countries may need to focus on a particular activity in the productivity chain that could be a bundle of agriculture, manufacturing and services.

Lanz and Maurer (2015) calculate that services constitute some 20% of world trade; however, in value added terms, services account for 40% of world trade. Services account for a third of manufactured exports in developed countries and 26% in developing countries. This is sometimes called the 'servicification of manufacturing'. Lanz and Maurer further suggest that the relatively low 'domestic service value' added by developing countries (in contrast with higher service value by developed economies) provides scope for improvements, although globally services tend to be less fragmented than goods.

What are the implications for the role of services in economic transformation? Some authors have pointed out that services follow economic transformation, whereas others suggest services can lead economic transformation by facilitating manufacturing and agriculture through value chains, as well as by bringing export revenues.

2.2 Data on services and economic transformation

Two data concepts can help categorise services: (i) the National Accounts and (ii) trade in services. The National Accounts distinguish among the following services (we include in parentheses the share of GDP in Kenya in 2013): accommodation and restaurants (1.4%), education (6.1%), finance and insurance (7.4%), health (1.8%), information and communication (1.6%), other services (1.5%), professional and support services (2.5%), public administration (5.4%), real estate (8.9%), transport and storage (8.3%) and wholesale and retail trade (8.8%).

Trade in services is often grouped around the 12 sectors of the World Trade Organization General Agreement on Trade in Services (WTO GATS): business services; communication services; construction and related engineering services; distributional services; educational services; environmental services; financial services; health-related and social services; travel-related services; recreational, cultural and sporting services; transport services; and other services. GATS uses four different modes of supply of services: cross-border supply (Mode 1), services consumed abroad (Mode 2), services supplied via commercial presence abroad (Mode 3) and services supplied via temporary movements of labour (Mode 4).

World Bank data on trade in services distinguish among four types of commercial services: travel; transport; communication; and finance and insurance. These data measure only Modes 1 and 2 trade.

We assess the role of services in economic transformation on the basis of the following indicators:

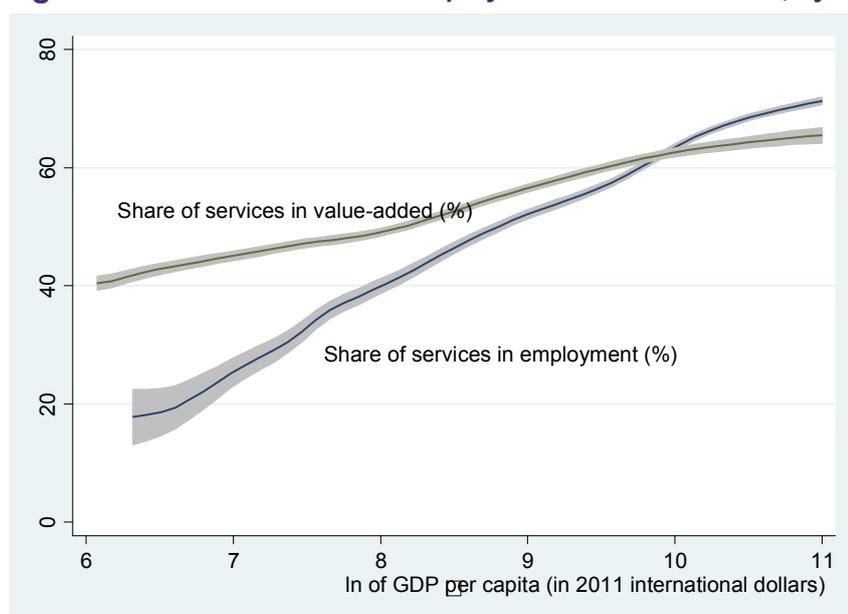
- Share of services in value added given a level of income;
- Share of services in employment given a level of income;
- Share of services in exports given a level of income;
- Level and growth of the contribution of services to value added in exports;
- Level and growth of productivity in services and the rest of the economy.

A high level of each of these measures implies a strongly performing services sector.

2.2.1. Services share in value added and employment

The share of services in value added and employment usually increases as countries become richer and transform themselves. Figure 1 shows that a typical LIC or lower-middle-income country (LMIC) has a share of services in value added between 40% and 50%, while upper-middle-income countries (UMICs) and high-income countries (HICs) have between 50% and 70%. The figure also shows that at lower levels of income the employment share is lower than the value added share (i.e. services productivity is higher than the average of the economy), but the reverse is true for higher levels of income (i.e. services productivity does not increase as fast as the rest of the economy, in line with Baumol's observations in the previous section).

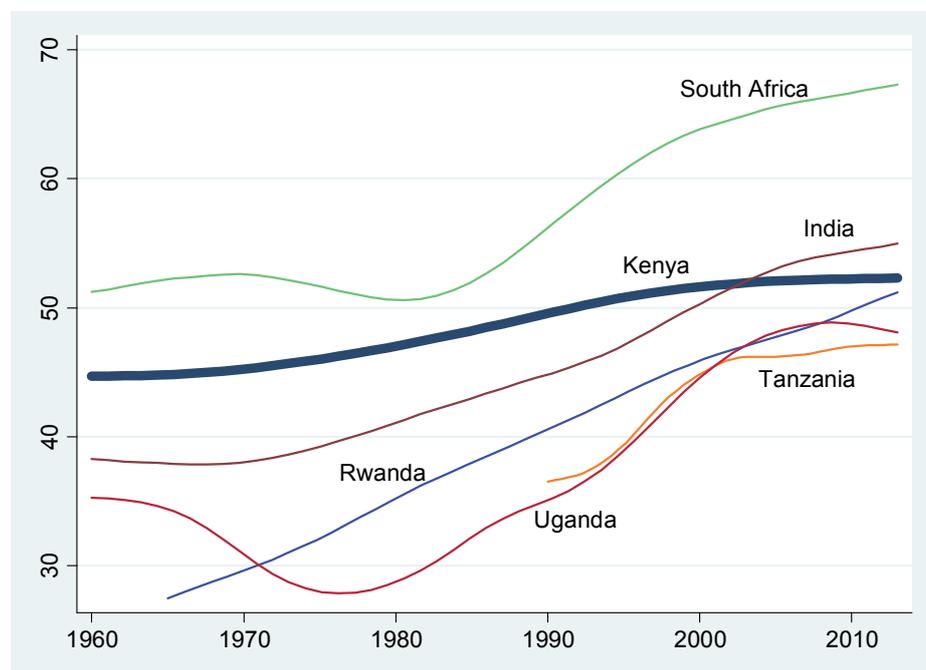
Figure 1. Share of services in employment and value added, by level of income



Source: Data from World Development Indicators (WDI); data for all countries from 1990 onwards, shaded area in 95% confidence interval.

Figure 2 shows the share of services in value added over time for a number of individual countries. South Africa and Kenya are still ahead of most other countries in Africa but Tanzania, Uganda and Rwanda are catching up rapidly.

Figure 2. Share of services in value added (current values), 1960-2013



Source: Data from WDI; data for all countries from 1990 onwards. Data smoothing used.

The increasing importance of services in GDP can also be seen from Table 1, which presents data on the share of services before and after the recent rebasing of the National Accounts data on GDP. Several African countries have recently rebased their accounts and as a result have produced higher estimates of the share of services (e.g. discovering new service activities).

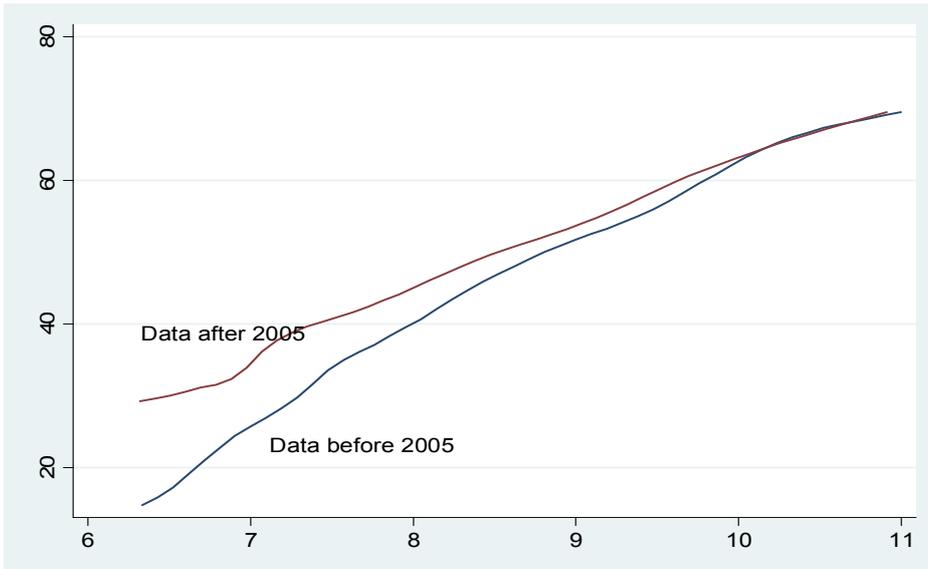
Table 1. Share of services in GDP, pre- and post-rebasing

	Share pre-rebasing	Share post-rebasing	Difference	Year of observation/rebasing
Tanzania	47.0%	50.0%	3.0%	2007
Zambia	42.1%	54.0%	11.9%	2010
Uganda	48.0%	52.0%	4.0%	2009/10
Kenya	54.2%	52.9%	-1.3%	2009
Nigeria	23.6%	50.2%	26.6%	2010
Ghana	36.1%	51.1%	15.0%	2006

Source: te Velde presentation at a SET workshop (30 January 2015) based on national statistical offices.

Figure 3 shows the share of services in employment for all countries for two data periods (the horizontal axis is the log of real GDP per capita at constant purchasing power parity (PPP) prices). This reveals the interesting finding that the share of services is much higher after 2005 than before 2005, especially at lower levels of incomes. For example, the share of services in employment in LICs and LMICs is now 10-20% higher than previously. Authors such as Rodrik (2015a) have called this premature deindustrialisation, as employment ends up in low-skill services rather than manufacturing activities.

Figure 3. Share services in employment, 1980-2005 and 2005 to now (%)



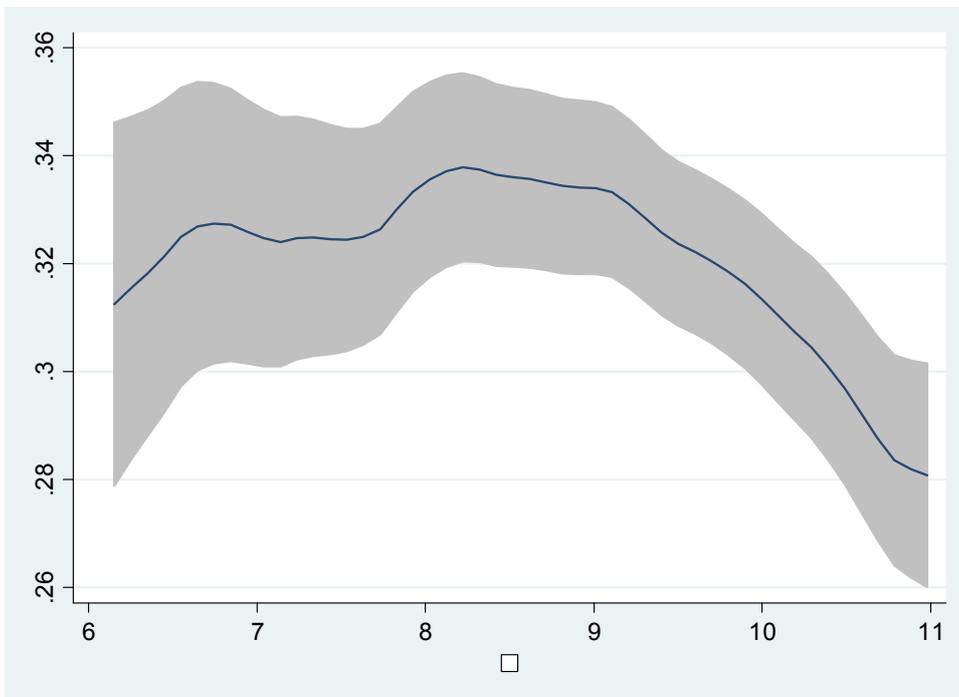
Source: WDI data all countries after 1990, horizontal axis is \ln of GDP per capita (2011 international dollars).

2.2.2. Share of services in trade

Figure 4 shows the share of services in total trade (average of exports and imports) in goods and services by the level of income (horizontal axis). Interestingly, it does not show the same upward trends as found for the share of services in GDP. However, this can change as the globalisation of services takes hold. Moreover, it does not take into account the contribution of services to manufactured exports.

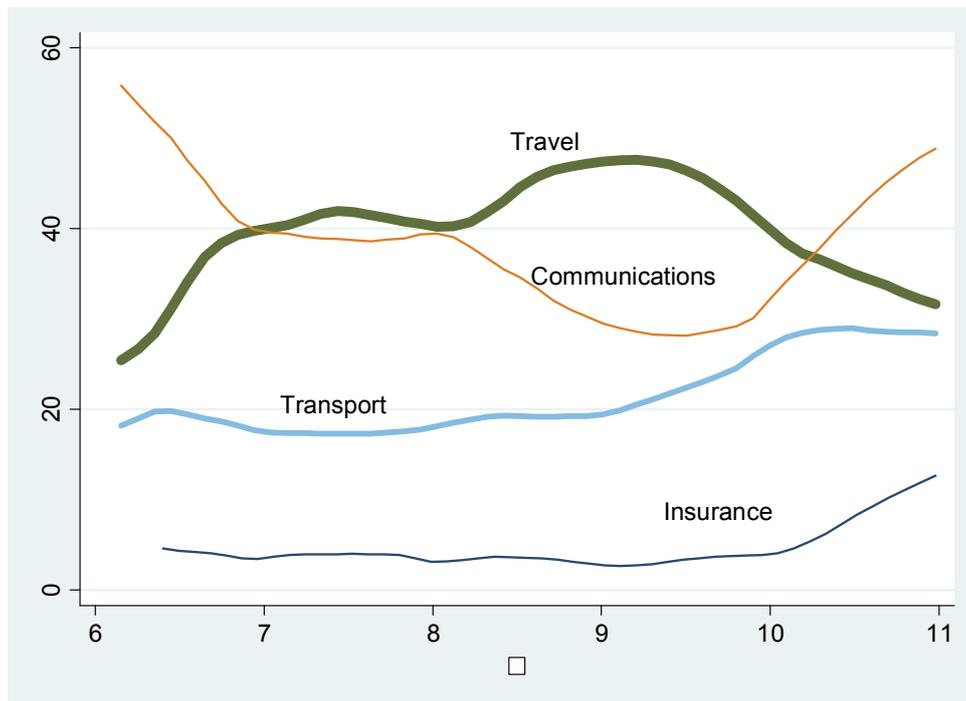
Figure 5 shows the share of individual services categories in services exports as income progresses. Travel and communications (including ICT) are the main items, followed by transport and insurance.

Figure 4. Share (expressed as ratio) of services in exports of goods and services



Source: WDI data all countries after 1990, horizontal axis is \ln of GDP per capita (2011 international dollars).

Figure 5. Share of subsectors in total services exports



Source: WDI data all countries after 1990, horizontal axis is ln of GDP per capita (2011 international dollars).

There is much heterogeneity among countries. For example, some Caribbean countries have a services exports to GDP ratio that is higher than 50% (based primarily on tourism). Others have a very low share. There are also interesting examples of successful services exports in all modes of service delivery such as (see e.g. Qureshi and te Velde, 2008):

- ICT exports from India, online as well as through foreign direct investment (FDI) (Modes 1 and 3);
- Health tourism in Caribbean and Mauritius (Mode 2);
- Festival event organisation in St Lucia, Trinidad, etc. (Mode 2);
- African, Asian and Caribbean nurses in the UK (Mode 4);
- Shipping services provided by the Philippines (Mode 4);
- Air transport services from Dubai (Mode 2);
- Port services in Kenya, South Africa and Tanzania (Mode 2);
- Call centre services from countries including India, Mauritius and South Africa (Mode 1);
- Headquarter and education services in Singapore (Mode 2);
- Hydropower services exports by Lesotho (Mode 2).

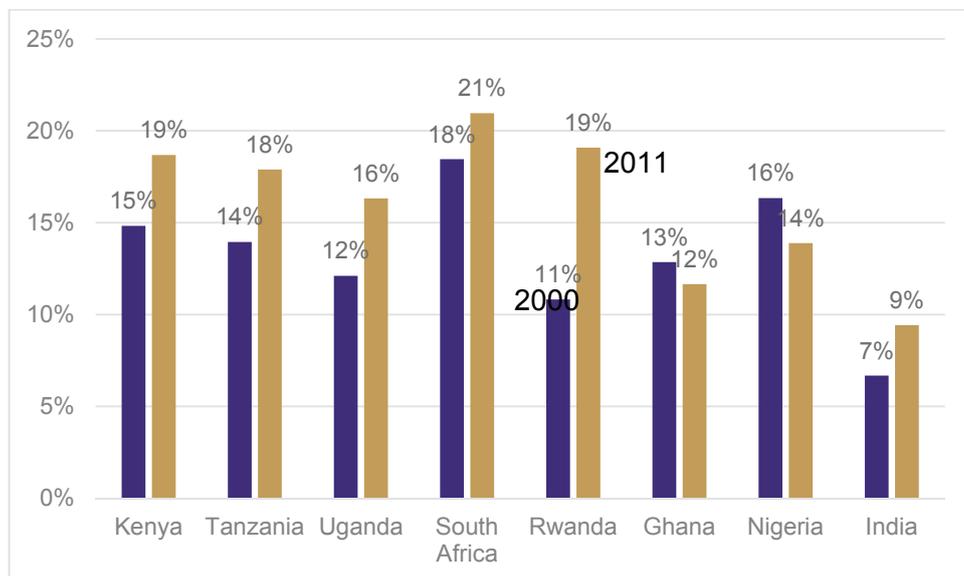
Some of these are significant; others are still small. But these examples could become growth escalators especially in small countries that lack economies of scale for agriculture or manufacturing (Qureshi and te Velde, 2008).

2.2.3. Share of services in value added in exports

Figure 6 shows the contribution of the services sector to value addition in exports for a number of African countries as well as India. It uses input–output data to calculate the amount of services needed to export agriculture and manufacturing, as well as the services value addition in services exports. The data show that the services share in value added in exports increased in all countries listed apart from Ghana and Nigeria, where increased commodity prices increased the share of the primary sector. After South Africa, Kenya holds joint second position with Rwanda, but increases have been much faster in Rwanda. This could be a sign that developing country services sectors are increasingly linked to exports, which could

be good news – but at the same time it could be bad news if the costs of services have increased while services productivity has not increased (Baumol, 2012).¹

Figure 6. Contribution of the service sectors to value addition in exports (2000 and 2011), selected countries



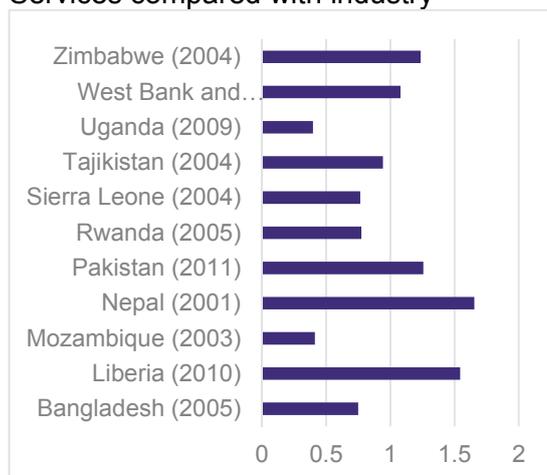
Source: Own calculations using EORA database. Services include financial and business, hotels and restaurants, post and telecommunications and transport.

2.2.4. Productivity in services and other sectors

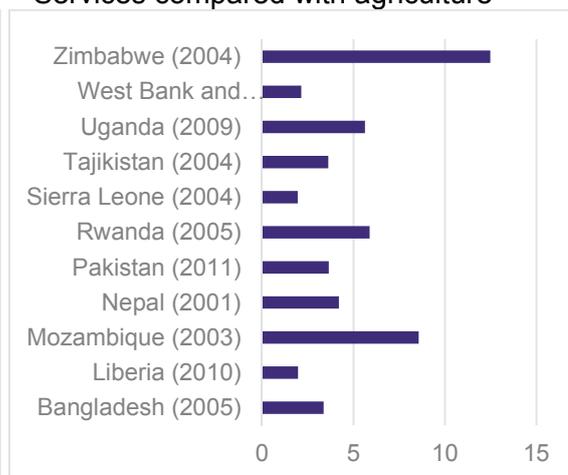
Services can be more productive than other sectors and they can lead to greater productivity in other sectors. We use the University of Groningen’s Africa Sector Database to examine sectoral labour productivity. Figure 7 and Table 2 present relative labour productivity levels. They suggest that services are generally much more productive compared to agriculture, but not always compared with industry. Within industry, mining tends to be highly productive. Some services are very productive (e.g. finance and business services) whereas others are not (e.g. other non-market services). The existence of large gaps in relative productivity means there is much scope to raise productivity through sectoral changes.

Figure 7. Relative labour productivity

Services compared with industry



Services compared with agriculture



Source: WDI and ILO, based on SET calculations.

¹ When we compare services value addition embedded in exports with total services exports, we find that the indirect contribution of services to exports via other sectors is very low in Kenya (and higher in other countries) compared with direct services exports.

Table 2. Relative labour productivity by sector, relative to country average, 2010

	Ethiopia	Ghana	India	Kenya	Malawi	South Africa	Tanzania
Agriculture	0.6	0.7	0.3	0.5	0.5	0.2	0.4
Manufacturing	0.8	0.8	1.5	0.9	2.4	1.6	3.8
Mining	1.2	2.7	5.2	0.9	25.0	3.1	10.9
Other industry	3.5	3.1	1.4	2.5	1.5	0.8	4.3
Distribution services	2.3	1.0	1.7	1.4	1.9	1.0	2.1
Finance and business services	13.4	2.5	5.0	6.7	11.5	1.6	23.4
Government services	4.4	1.5	2.8	2.5	1.1	1.1	2.1
Other non- market services	1.2	0.7	0.7	0.6	2.1	0.6	0.3
National level	1	1	1	1	1	1	1

Source: Own calculations using the Africa Sector Database (<http://www.rug.nl/research/ggdc/data/africa-sector-database>);

A further important point is that more efficient services can lead to productivity in other sectors. This is not easily shown by descriptive data, but requires careful econometric analysis. Hoekman and Shepherd (2015) analyse the impact of services on manufacturing productivity using World Bank Enterprise Surveys data for 60,000 firms in 120 countries and find that a 10% increase in services labour productivity is associated with an increase in manufacturing labour productivity of 0.3%. On the basis of 4,000 Indian firms for the period 1993-2005, Arnold et al. (2014) find that banking, telecommunications, insurance and transport reforms had significant positive effects on the productivity of manufacturing firms. Using data from geographic information systems for Sub-Saharan Africa, Doresh et al. (2010) find that agriculture production is highly correlated with proximity (as measured by travel time) to urban areas, suggesting that more efficient transport systems raise agricultural production. Stifel and Minten (2008) argue that isolation leads to lower agriculture productivity in Madagascar.

2.3 Services and economic transformation: pathways

Calli et al. (2008) discuss the role of services in growth and development, pointing to the heterogeneity among service sectors. The services sector is an important component of any country's economy. Indeed, the various services sectors make direct and significant contributions to GDP and job creation. Some services provide crucial inputs for the rest of the economy, thus having a significant effect on the overall investment climate, which is an essential determinant of growth and development. Other services sectors, such as the health, education and water and sanitation sectors, are directly relevant to achieving social development objectives as income rises. A key message is that differentiation among service activities is crucial.

How can we differentiate between the roles of different sectors in economic transformation? Table 3 examines three broad types of effects (IFC, 2014; Jouanjean et al., 2015): (i) direct impact (employment, exports, GDP: a direct service); (ii) indirect impacts through input–output analysis (jobs and output in supplier industries); and (iii) second-order effects, for example productivity effects and forward linkages.

The table shows some sectors are expected to be important in generating jobs for less to medium-skilled workers (e.g. retail trade, accommodation and, to some extent, health and education), and others for skilled workers (e.g. finance and insurance, professional services). Some services tend to be important parts of GDP (e.g. education, finance and insurance, real estate, transport and storage, wholesale and retail trade). Others are less important contributors to GDP directly. Some sectors can be important export earners (ICT, finance, transport, accommodation), whereas other are not (public administration and health and education in most countries). Some sectors can also have major knock-on effects on suppliers (e.g. accommodation, retail trade and transport) and some can have important productivity effects throughout the economy in the medium run (ICT, finance, transport) and others not (real estate, accommodation) or only in the very long run (e.g. health and education). Of course, the table remains very general but Section 3 contains an application of this table in the case of four services sectors in Kenya.

Table 3. The effects of services on economic transformation: conceptual pathways

Sector	Direct effects			Indirect effects (static and dynamic)	Induced/ productivity effects
	Jobs (skilled, medium or low-skilled workers)	Exports	GDP		
Accommodation and restaurants	Medium important for skilled jobs	Important export revenues	High in certain developing countries	Very important including for less skilled workers	Less important
Education	Important for medium-skilled employment (e.g. teachers)	Less important, apart from a few countries	Relatively high share	Mostly temporary	Important for human capital in the long run
Finance and insurance	Important esp. for skilled workers	Potentially a major source of exports and capital inflows	High (around 10% of GDP)	Less important for offshore centres, but potential for forward linkages	Less important for offshore centres, but important for finance directed at the real economy
Health	Important for medium-skilled employment (e.g. nurses)	Less important, apart from a few countries	Relatively low share	Mostly temporary	Important for human capital in the long run
Information and communication	Important esp. for skilled workers	Potentially a major source of exports and capital inflows	Medium (mostly less than 10% of GDP)	Mostly forward linkages	Important productivity effects
Professional and support services	Important esp. for skilled workers	Potentially a major source of exports and capital inflows	Low in developing countries	Not very important	Important for firm-level productivity
Public administration	Important for low-medium-skilled workers	Insignificant	Medium-high in developing countries	Medium important	Not very important, except e.g. public infrastructure works
Real estate	Very few jobs	Not important	Important share of GDP	Important effect on construction	Less important
Transport and storage	Potentially important (e.g. truck drivers)	Important for some countries (e.g. Kenya)	Important share of GDP	Less important (apart from energy)	Important for economy-wide productivity
Wholesale and retail	Important for less to medium skills	Less important for most developing countries	Important share of GDP	Important effect on agriculture and manufacturing value chains	Less important

Source: Own analysis.

This mapping and the review in Section 2.1 suggest we can consider two different concepts of a services-led economic transformation strategy: (i) services *at the service* of the economy as a whole; and (ii) a services sector important in its own right directly (export, jobs, GDP).

First, services *at the service* of the economy as a whole, including manufacturing and agriculture means tackling many problems in low-income countries. Access to services is low in Africa generally (e.g. electrification rates), and where there is access the costs of services are high; road freight, water and electricity services in African countries are twice as expensive as those in other developing countries – high trade costs will hamper the development of (manufacturing and agriculture) value chains and economic transformation. Moreover, the interest rate spread (between deposit and lending rates) is currently 2 percentage points higher in Sub-Saharan Africa than in other developing countries (ERD, 2015) – an inefficient intermediation function will go against transformation and diversification. Growth diagnostics and value chain analyses often find the specific service sectors are binding constraints to

growth and development, and some studies find a positive link between services productivity and manufacturing productivity (Hoekman and Shepherd, 2015) and between services productivity and agricultural productivity (Doresh et al., 2010).

Second is a services sector that maximises services export revenues and capital inflows without considering the links to the rest of the economy. In this situation, the links to the wider economy and transformation are more complex. On the positive side, increased export revenues from, for example, ICT or financial services are welcome. However, this will also attract more short-term capital, which could be risky and inflationary. Indeed, it would increase the real effective exchange rate and draw in resources such as skills, which would hamper the competitiveness of manufacturing and agriculture. Manufacturing is traditionally the main sector responsible for the diffusion of innovation and productivity change, but it has lost competitiveness and performed poorly in much of Africa. As an example of the failure to link financial services to the rest of the economy, much of the commercial bank lending in African countries does not go to the real sector, small and medium enterprises (SMEs) or long-term infrastructure (instead it goes to consumer lending and real estate), limiting its role in transformation.

Some authors have also pointed to a third concept, the agglomeration of low-skill informal services around urban areas. As people move out of agriculture, and from rural to urban areas, the current type of industrialisation, especially in many African countries, creates insufficient jobs to absorb new labour market entrants. These people end up doing low-productivity services or are engaged in service activities with few productivity increases.

We should consider the broader impacts of pursuing service strategies through international effects.² The way the development of services sectors affects other sectors also depends on the exchange rate, which is an important additional pathway from services to economic transformation. The framework above (direct, indirect, induced effects) is in essence a closed economy model, but the services sector can affect the domestic economy through a change in exchange rates. The real effective exchange rate (REER)³ is an important relative price (Elbadawi, 1994) in this context. An appreciation in the REER, stemming from an expansion of the services sector, can hinder or crowd out growth in other sectors of the economy.

The level of the REER can hinder or facilitate economic transformation. Significant exchange rate misalignment, particularly a currency's overvaluation, can hamper the development of export sectors. Sustained real exchange rate misalignment usually generates severe macroeconomic disequilibria; the eventual correction of associated external imbalances (such as unsustainably large current account deficits) will require demand management policies and real exchange rate devaluation (Edwards, 1994; Krugman, 1999).

Overreliance on services sector growth can cause currency appreciation that hinders economic transformation. 'Dutch disease' is illustrative: increased revenue from a particular sector (e.g. oil) brings foreign exchange flows that will typically increase domestic prices or the nominal exchange rate (depending on whether it is fixed or flexible), strengthening the REER (Ebrahim-Zadeh, 2003). In both cases, the appreciation weakens the competitiveness of the country's exports and, hence, causes its traditional export sector to shrink.

In addition to reduced competitiveness from a Dutch disease-type syndrome, there is a 'resource transfer' effect (IMF, 2015a). This occurs when resources of capital and labour are shifted to the production of domestic non-traded goods to meet the increase in domestic demand and into the 'booming' sector. Both of these transfers, or resource shifts, effectively shrink production in the other lagging sectors and minimise prospects for economic transformation.

² There are other areas that require further consideration. For example, there may also be dynamic implications of a services-led strategy for skills development. Certain service sectors require significant investment in high-skill education.

³ We define the REER as a multilateral index. We calculate the REER as a trade-weighted sum of trading partner countries' nominal exchange rate (e) multiplied by relative prices. $REER = e \cdot (P^*/P)$ where P^* and P denote foreign and domestic price levels. An increase in the REER denotes an appreciation.

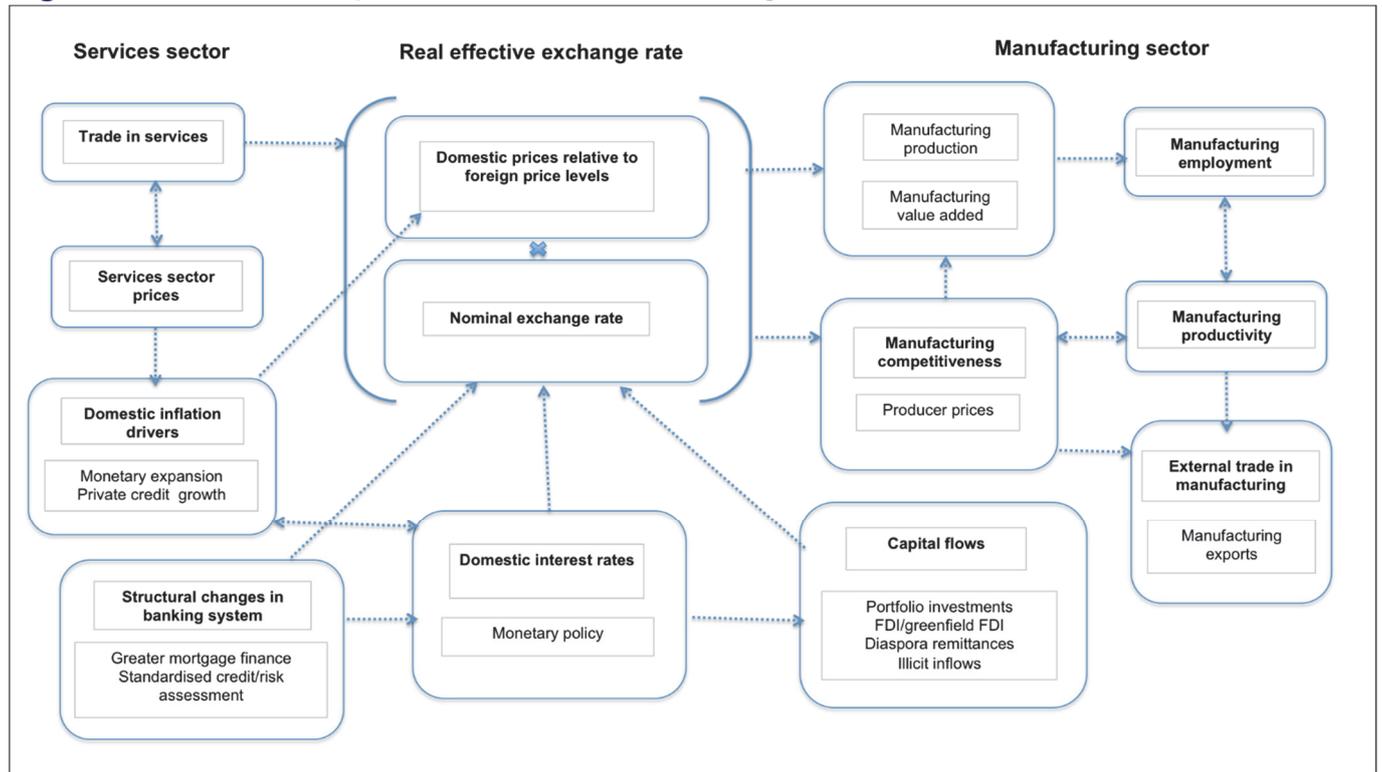
An appreciation of the REER is therefore likely to bring about deterioration in competitiveness given shifts in relative prices, or a stronger nominal exchange rate, or both. This ultimately makes the REER an important barometer for export promotion, the generation of optimal output and employment paths (Caballero and Corbo, 1989). Services development affects the key drivers for the REER through a number of avenues.

- *Domestic prices.* Relative prices capture differential movements in international competitiveness, making the REER an instrumental gauge for country's external competitiveness *vis-à-vis* its trading partners. Domestic prices will largely be influenced by the domestic economy and domestic asset prices. For example, an increase in non-tradable goods prices, such as domestic real estate prices, typically exerts a strong influence on a country's REER. Thus strong service sector development can lead to price pressures in the domestic (non-tradable) economy that would affect the tradable sector.
- *Wage-price pressures.* A second transmission mechanism that drives the REER is an increase in domestic wages. Expansion in a particular sector, for example a country's education or financial sector, will push up sector-specific wages. This may also attract certain skills into the sector, pushing up economy-wide wages. This will have a knock-on impact, strengthening domestic demand and domestic inflationary pressures that will boost the REER. Wage-price pressures are important in driving REER dynamics and the overall competitiveness of the domestic economy.⁴
- *Nominal exchange rates and nominal exchange rate regimes* (Liang, 1998) are an important determinant of the REER. Nominal exchange rates themselves have multiple drivers, predominantly nominal interest rate differentials (Nadal-De Simone and Razzak, 1999), though Frankel and Rose (1994) find that, more often than not, nominal exchange rates behave randomly.
- The *political economy of exchange rate policy*, and in particular industry interests and institutions, matter. There is not one major political variable that consistently affects exchange rate policy, and many variables have opposite effects in different circumstances (Steinberg and Walter, 2013). However, preferences between actors in the tradable sector relative to the non-tradable sector differ, with the former preferring a lower and less flexible exchange rate (Frieden, 1991).

Figure 8 illustrates some of the key pathways through which various variables influence Kenya's REER. These pathways then affect prospects of economic transformation. There may also be other dynamic implications for a services (rather than manufacturing) push. For example, the development of skills for the services sector may be to the detriment of skills development for other sectors and hence difficult choices with respect to human capital formation may need to be made.

⁴ As Turner and Van't dack (1993) highlight, changes in relative costs and prices are a both a cause and a reflection of developments in an economy. As an economy outperforms in certain sectors, the rise in wages is a sign of economic success rather than a narrowly defined deterioration in cost competitiveness.

Figure 8. Services development, the real effective exchange rate and economic transformation



3. Services and economic transformation in Kenya

After a general discussion of the role of services in the Kenyan economy (Section 3.1), this section examines four services sectors in Kenya. We have selected four different types of services: finance (Section 3.2) and ICT (Section 3.3) as skilled intensive services that can be exported as well as support productivity throughout the economy; tourism (Section 3.4) as a sector that generates export revenues, value addition and many jobs directly and indirectly; and transport services, discussed in Section 3.5. For each sector, we include an introduction, a discussion on the linkages between the sector and economic transformation and some policy challenges. Section 3.6 discusses the role played by the exchange rate. Section 3.7 concludes.

3.1 The general role of services in Kenya

The data suggest that the services sector in Kenya has played a comparatively important role; however, several other African countries have experienced more dynamism in the services share of GDP over the past decade. There are also notable experiences in Kenya, for example financial and insurance services have performed particularly well. Moreover, exports of services have been buoyant (although much is regional in nature). Increasingly, there are clusters of financial services and ICT. Hence, Kenya is rapidly consolidating its position as a regional services hub.

Table 4 shows the sectoral distribution using the latest data for 2009 and 2013. There are few large changes in the sectoral distribution, but by type of service it is noticeable that finance and insurance increased from 5.9% in 2009 to 7.4% of GDP in 2013, whereas information and communication declined from 2.9% to 1.6%. Further, agriculture increased over the period, whereas manufacturing declined.

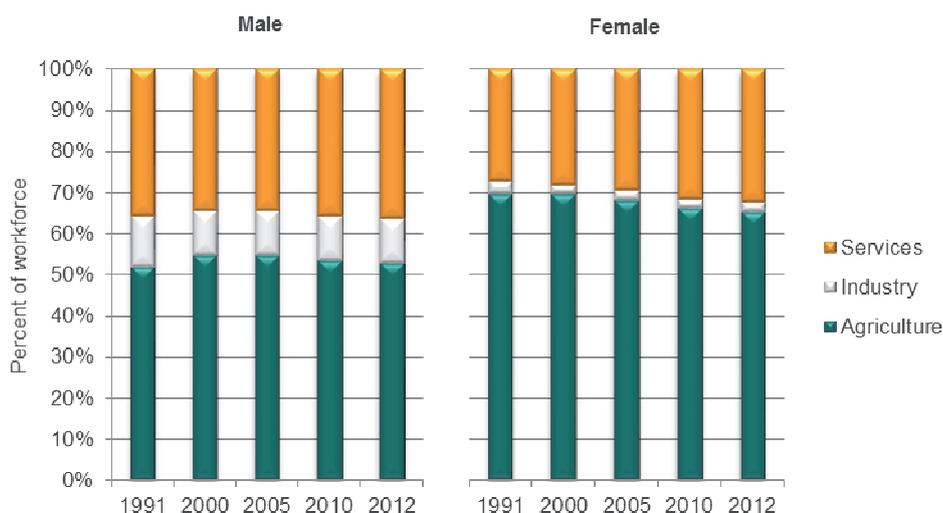
Table 4. Share of GDP by sector, Kenya

	2009	2013
Agriculture	26.1%	29.5%
Mining and quarrying	0.7%	0.9%
Manufacturing	13.4%	11.7%
Electricity and water supply	2.5%	2.2%
Construction	4.4%	5.0%
Total industry	21.0%	19.8%
Wholesale and retail trade	7.8%	8.8%
Accommodation and restaurant	2.0%	1.4%
Transport and storage	8.0%	8.3%
Information and communication	2.9%	1.6%
Financial and insurance services	5.9%	7.4%
Public administration	5.0%	5.4%
Professional and support services	3.0%	2.5%
Real estate	9.6%	8.9%
Education	6.9%	6.1%
Health	2.3%	1.8%
Other services	1.7%	1.5%
FISM	-2.3%	-2.9%
Total services	52.8%	50.7%
All industries	100.0%	100.0%

Source: Kenya National Statistical Office.

Figure 9 presents employment by sex and sector from the International Labour Organization (ILO) source. The share of employment in the services sectors has increased over the past decade, whereas the share of employment in agriculture has declined and that in industry has also contracted.

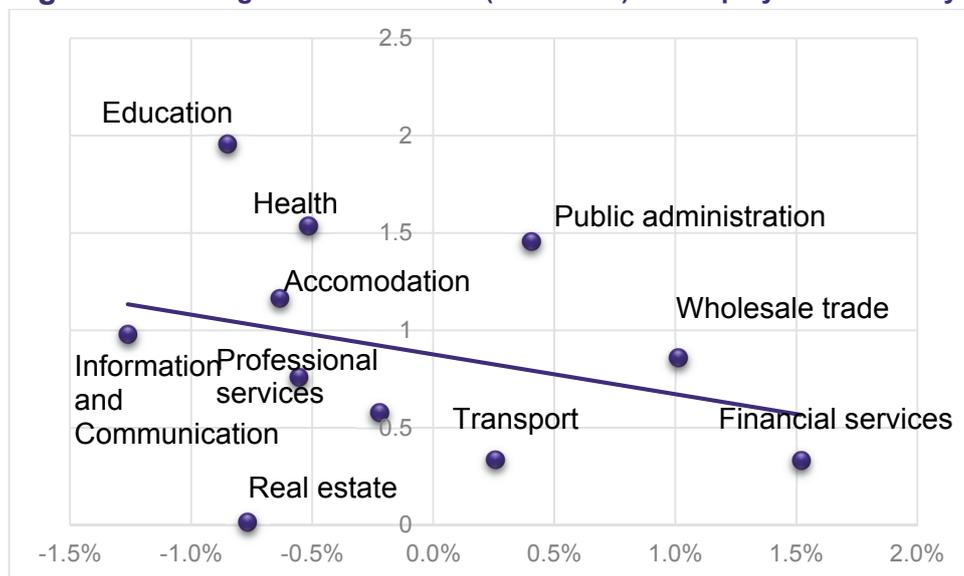
Figure 9. Total employment by sex and sector, Kenya



Source: ILO Global Employment Trends 2014.

Figure 10 plots the change in the share of GDP for services sectors (horizontal axis) over 2013-2009 and the level of employment intensity (2009). It shows that those services that have grown fastest in terms of share of GDP are the least employment intensive.

Figure 10. Change in share of GDP (horizontal) vs. employment intensity (vertical), Kenya

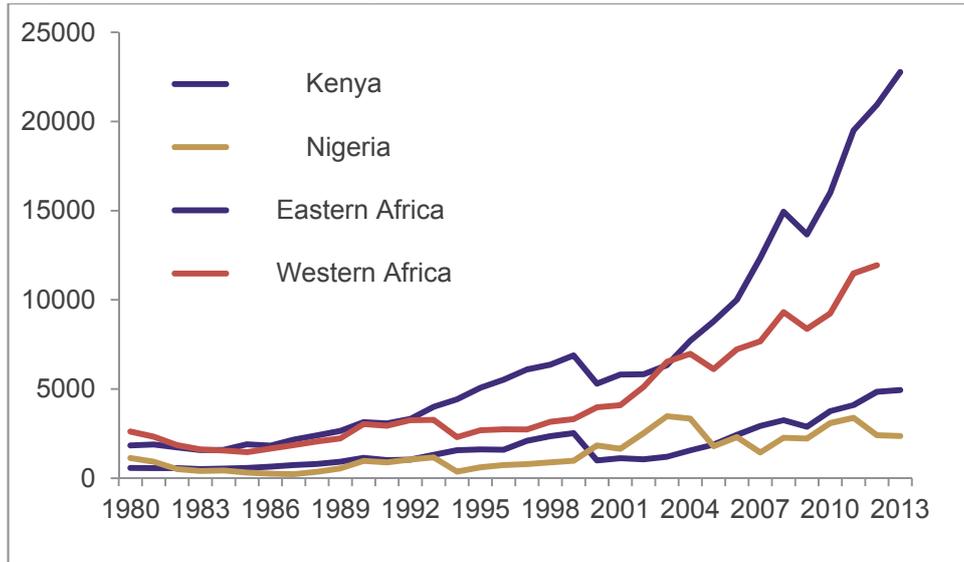


Note: Change in GDP share (2013-2009), percentage point and employment intensity (2009) as wage employment divided by value added.

Source: Statistical Abstract 2014.

Figure 11 shows the dynamism of Kenyan (and East African) exports of services in the recent decade, compared with, say, Nigerian (and West African). Exports of services from Kenya nearly tripled from \$1.9 billion in 2005 to \$4.9 billion in 2012, which is much more dynamic than exports of goods as total exports of goods and services, which doubled from \$5.3 billion to \$11.0 billion over the same period.

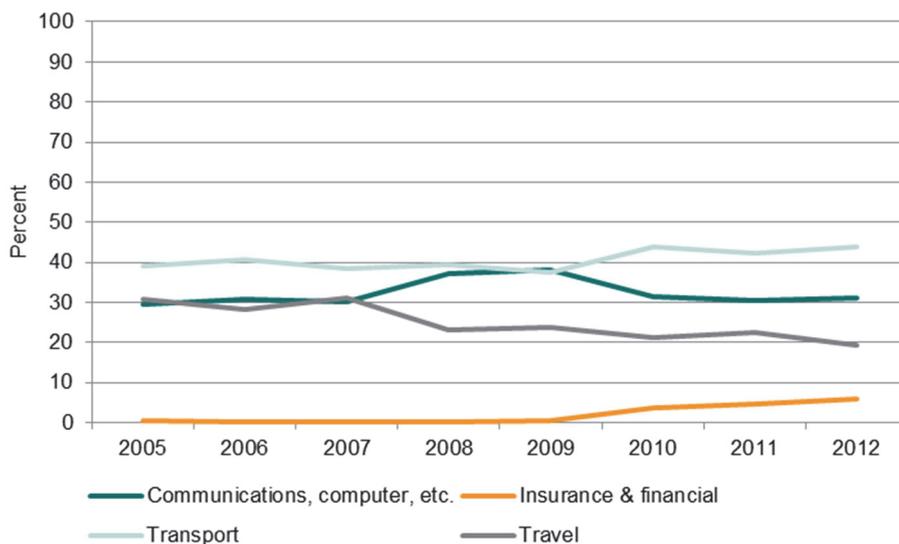
Figure 11. Dynamism in exports in services in Kenya (\$ million)



Source: UNCTAD.

Figure 12 shows the share of exports of services by type of service. Travel and communications (including ICT) are the main items, followed by transport and insurance. Kenya's share are respectively 19%, 31%, 44% and 6%, showing the relative weak performance of travel services (19% vs. an average of 40% at that level of income) but the relative strong performance of transportation services (44% compared with 20% at that level of income).

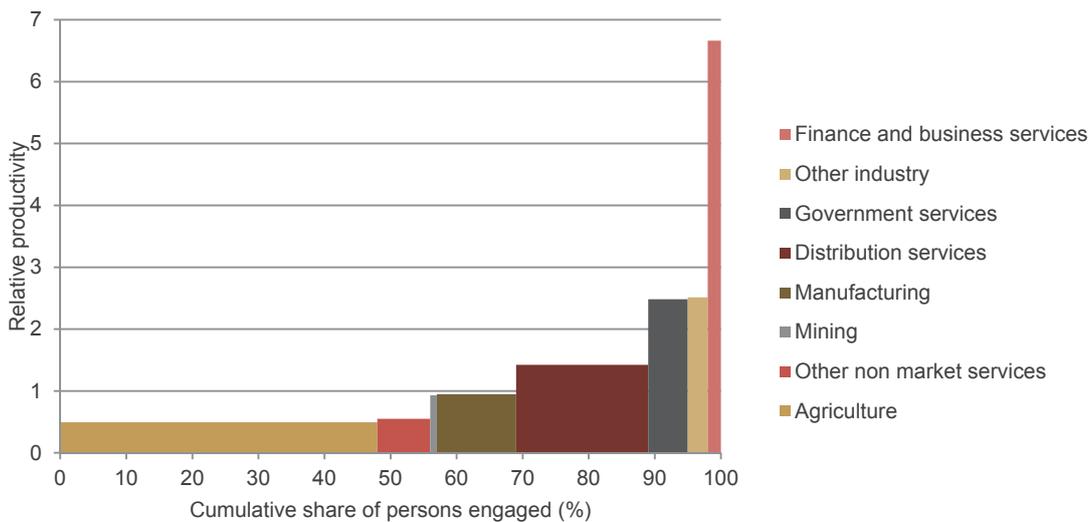
Figure 12. The share of selected services in exports of services, Kenya



Source: World Bank.

We use the University of Groningen's Africa Sector Database to examine sectoral labour productivity. Labour productivity in services is more than three times higher than in agriculture and 1.5 times higher than in industry. Moving resources into services might seem to address productivity gaps, but so far there has been little employment in services. Moreover, growth of employment in services has taken place in low-productivity services including non-market/other service categories (also see Figure 13).

Figure 13. Labour productivity gaps in Kenya, 2010



Source: Authors' calculations using the Africa Sector Database; de Vries et al. (2013).

3.2 Financial services for economic transformation – opportunities and challenges

3.2.1. Introduction

Financial services currently account for a significant portion of global GDP and trade. In 2009 they represented 5% of the world GDP – or \$3.2 trillion – and 10% of total world services exports. However, developing countries' share of this is relatively small, with financial services representing only 2.7% of their GDP and 14.7% of their global trade (World Bank data).

However, this structure is being challenged by rapid financial development in some sub-Saharan African countries including Kenya. By 2012 financial services had grown to represent 5.2% of GDP (Kenya National Bureau of Statistics data), and many of its indicators of financial development are approaching, or even exceeding, those of middle-income countries (MICs), illustrating its differentiated success in the sector.

Such progress raises the possibility that there may be an opportunity for Kenya to develop an important economic sector as a financial services hub – or 'cluster'⁵ in economic terms – and as an export sector. This exciting possibility has already been highlighted as one of the flagship projects of Kenya's Vision 2030 the goal of which is for Kenya to become a 'globally competitive and prosperous ... middle-income country providing a high quality of life to all its citizens'.⁶

Different types of international financial service hubs could be developed. This could include the development of Kenya as a hub for regional onshore banking⁷, as a processing hub to export financial services or as an offshore banking centre.⁸ Such development has been successfully achieved by other

⁵ Defined as a geographical concentration of interconnected companies and institutions in a given field. They include an array of linked industries and other entities important to competition including specialist input suppliers, infrastructure, complementary products and institutions (Such as governable institutions, universities, regulators, educational or training providers and trade associations). Critical are the linkages, complementary and competitive interactions within the cluster (Porter, 1998).

⁶ <http://www.vision2030.go.ke/index.php/vision>

⁷ Defined as centres where the bulk of financial sector transactions on both sides of the balance sheet are with individuals or companies that are residents and transactions are initiated within the jurisdiction and subject its legal and regulatory frameworks. On-shore banking centres have some or all of the following characteristics: Concentration of business activities, management and capital of regional and global financial institutions; host jurisdiction for financial markets, exchanges and over-the-counter transactions; high levels of financial intermediation transaction volumes and credit relative to GDP; centres for supportive business services including legal, accounting and consulting services.

⁸ Defined as centres where the bulk of financial sector transactions on both sides of the balance sheet are with individuals or companies that are not residents, where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents. Centres provide some or all of the following opportunities: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity (IMF, 2000).

countries, including Hong Kong and Singapore as onshore banking hubs for Asia; processing centres in India, China and the Philippines; and offshore banking centres in the Seychelles and Mauritius.

Development of a financial services hub in Kenya offers a number of advantages. Key among them is its potential to create high-skill, high-wage employment. It also has the potential to provide important secondary economic benefits including stimulating backward and forward linkages and accelerating growth in aggregate demand and investment.

But there are also risks and challenges. Challenges include a fierce competitive landscape for the race to become the financial services hub for Africa, and the need to quickly build institutional capacity and human capital. Risks include weakening of the effectiveness of domestic macroeconomic policy, and the potential for increased financial fragility.

This section examines the possibility of Kenya becoming a financial services hub – including what form it might take – and what is needed for it to be realised. Section 3.2.2 sets the background, examining the roles that financial services can play in economic transformation in more detail. Section 3.2.3 discusses what policy initiatives are needed to encourage the development and manage the risks of a financial hub. Section 3.2.4 concludes.

3.2.2. *The role of financial services in economic transformation*

The attractiveness of the development of Kenya as a financial services hub depends upon the benefits that it will bring to the country and its economic transformation. Financial services can bring a number of benefits. These are differentiated by the three types of financial services hubs – onshore hubs, offshore hubs and processing hubs (Table 5).

Table 5. Impact of financial services on economic transformation

Type of hub	Direct employment effects		Indirect effects		Induced and second-order growth effects		
	High skill	Low skill	Employment	Spillover to other sectors	Aggregate demand	Financial development	Exports
'Onshore' financial services hub	High	Low	High	High	Medium	High	High
'Offshore' financial services hub ⁹	High	Low	Medium	Medium	Medium	Low	High
Processing hub	Low	High	High	High	Medium	Low	High

Source: Own construction.

Direct effects

Hubs create employment. Onshore and offshore financial services create high-skill, high-wage employment. The numbers of jobs can be limited, but their creation has important indirect effects (which are discussed below).

By contrast, processing hubs have the potential to create much larger numbers of lower-skill, lower-wage jobs. This is because the basic driver for processing hubs is lower costs and, particularly for financial services, this is predominantly in wage costs (WTO, 2013).

There are two important points to note regarding these direct employment effects from a policy perspective. First, there can be supply-side constraints to employment growth for high-skill jobs because they require higher education in relevant disciplines (such as engineering, accounting and financial

⁹ Offshore finance can be defined as the provision of financial services by banks and other agents to non-residents, including the bank intermediation role of taking deposits from non-residents and lending to non-residents. Other services provided include fund management, insurance, trust business, asset protection, corporate planning and tax planning.

services) as well as language proficiency. Competition for talent from domestic companies and low regional mobility is likely to further reduce the pool (WTO, 2013).

Second, the experience of low-skill processing hubs outside of Africa is that in the medium term there are increases in productivity and skills levels, which increase wage levels associated with the hub (Geishecker and Görg, 2008; Thangavelu and Chongvilaivan, 2013; WTO, 2013).

Indirect effects

Financial service hubs create multiple indirect effects including additional employment and investment inducement. This includes in business support services – for example in real estate, legal services, technology and communication services, consulting and accounting services – and employment. Regarding employment, it has been estimated that every financial service job creates two to three additional jobs (Kaufman, 2001; Oxford Economics, 2009).¹⁰

Investment inducement is particularly likely in information technologies because of the interdependence of financial services and information technology. This includes in in-house banking systems, and owes also to the importance of these technologies in financial markets (such as electronic trading and settlement platforms). This may then create a ‘virtuous circle’ of growth and investment between the two sectors, accelerating the development of a financial services cluster.

Induced and macroeconomic effects

The induced effects of a financial hub are complex, and there is a lack of empirical research. However, we suggest the most likely effects would be increased aggregate demand, accelerated financial development and export growth – all of which could contribute to economic transformation.

AGGREGATE DEMAND

Financial hubs can create broader links into economic growth through increasing aggregate demand and consumption.¹¹ It is hoped – as has been experienced in North Africa – that this will support domestic demand-led growth (Ncube et al., 2011).

FINANCIAL DEVELOPMENT

The development of an onshore financial service hub could accelerate domestic financial sector development with benefits of increasing investment – which is essential to accelerating economic transformation – and financial inclusion. Such development has this effect directly by increasing credit as a share of GDP, and indirectly by acting as a source of technology transfer and by exerting pressure to accelerate regulatory and supervisory frameworks (UNCTAD, 2004). These effects could be of particular importance in the SME sector, where finance constraints can be high.¹²

Such development also has the positive effect of increasing competition and thus decreasing the cost of intermediation as measured by bank margins, spreads and overhead costs (UNCTAD, 2004). This is particularly important for Kenya, where spreads have been exceptionally high (BIS, 2014).

However, being an onshore and offshore financial hub can increase financial fragility and lead to economic and financial instability in host countries (BIS, 2014). This is because of increased cross-border capital flows and the larger scale of the financial sector relative to GDP. These problems can be worse for relatively small or emerging economies such as Kenya (Tyson et al., 2014).

Risks are associated with both inflows and outflows. Inflows can create currency appreciation that negatively affects inflation and export competitiveness (colloquially termed Dutch disease) (Ebrahim-Zadeh, 2003) and asset bubbles. Outflows can create collapse in asset markets and currency depreciation. Both run the risk of creating financial and macroeconomic shocks and instability.

¹⁰ Although such estimates are specific to the countries studied and so should not be over-generalised.

¹¹ It is possible that difference the changes in consumption patterns will occur between different types of hubs. However, there is no empirical research to support a proposition on this point.

¹² Conference material.

Such risks are heightened by the presence of systemically important institutions and as interbank markets deepen, because this increases contagion risk within the domestic financial system. Systemically important institutions have characteristics such as a large share of deposits and loans, and being important in key financial markets and payments systems. Such institutions and deepening interbank markets are, arguably, present in Kenya (Tyson, 2015b).

Risk can also be increased by foreign bank entry because the increased competition that it brings is associated with a deterioration of the loan portfolio of domestic banks (UNCTAD, 2004). Again such vulnerabilities – notably bank balance sheet weaknesses associated with rapid credit growth and stretched loan-deposit ratios – have been highlighted in Kenya (IMF, 2014b, 2014c).

By contrast, processing centres are less likely to have any of the positive or negative effects discussed above, because they do not encourage the establishment and growth of financial markets and institutions. Instead, they encourage the growth of specialist businesses for financial services processing with a more limited scope of activities.

EXPORTS

Financial services in all three forms of hubs can be an important export sector.

For those financial service hubs that have been successful, exports of financial services have grown significantly. Export value is greater for onshore than offshore banking centres because of the greater scale and breadth of activities. However, for small countries, offshore financial hubs provide a material component of their exports. Processing hubs act as components of global supply chains. They have been considered to be material contributors to export growth in a number of countries including India, the Philippines and Singapore.

This is illustrated below for selected countries that have developed financial hubs. Hong Kong and Singapore have become well-established financial hubs in Asia in recent decades, supported by proactive government policy, and financial services are an import component of their exports. Since 2006 other countries have also successfully built export markets in financial services, including the Seychelles and Mauritius. Kenya is also beginning to build exports in the sector and, although financial service exports remain small in absolute terms and relative to the established Asian hubs, they have grown rapidly.

3.2.3. Policy options to attract and manage a financial services hub

The locations of international financial hubs are not random but have emerged because of a cluster of factors that make them attractive. A few hubs – such as London and New York – have long histories as international financial centres and today have a strong comparative advantage based on the path-dependency of this history (BIS, 2010).

However, more diversified and numerous hubs have emerged in recent decades. This has been driven by the internationalisation and deregulation of global financial systems combined with technological advances. The successful hubs have been differentiated by their comparative advantages (BIS, 2010).

Critical to success in Kenya's strategy of developing itself as a financial hub are its relative competitive advantages, and how policy can improve them. Three key areas of competitive advantage are identified as being of relevance to Kenya – the level of development of its financial sector, its labour markets and its political and economic environment (Table 6).

Table 6. Kenya's key competitive advantages and disadvantages as a financial hub

Area	Requirements for competitive advantage in this area	Kenya's competitive position
Level of development of financial sector	Liberalised financial market regulation including for capital flows, interest rates and foreign ownership	Medium/improving (WEF (2015) rating of financial market development as 5.7/7 (on an index of 1-7 where 7 is the best))
	Strong and credible financial institutions and regulatory bodies	
	A critical mass of financial activity to achieve economies of scale and scope	
	Complementary sectors including ICT, audit and accounting	
	Established interbank markets, payment systems and capital markets	
Compatible labour markets	Compatible time zone with global financial centres	Low to medium/improving (based on Government of Kenya, 2013c)
	Labour pool of high-skill financial employees including financiers, managers and regulators/supervisors	
Economic and political environment	A large talent pool of graduate-quality labour with widespread competence in English	Low to medium (based on World Bank CPIA transparency, accountability and corruption in public sector rating for Kenya of 3 (1=low to 6=high))
	Domestic security and low levels of crime, fraud and corruption	
	Stable macroeconomic environment	Medium/improving (IMF, 2015)
	Attractive and transparent tax regimes	Low to medium (KPMG, 2014)
	A strong legal system, including property rights, contract enforcement, functioning court system, bankruptcy processes	Low to medium (Transparency International ranking of Kenya as 145th of 175 countries in relation to corruption (www.transparency.org/cpi2014/results); US Embassy analysis (http://nairobi.usembassy.gov/doing-business-local.html))

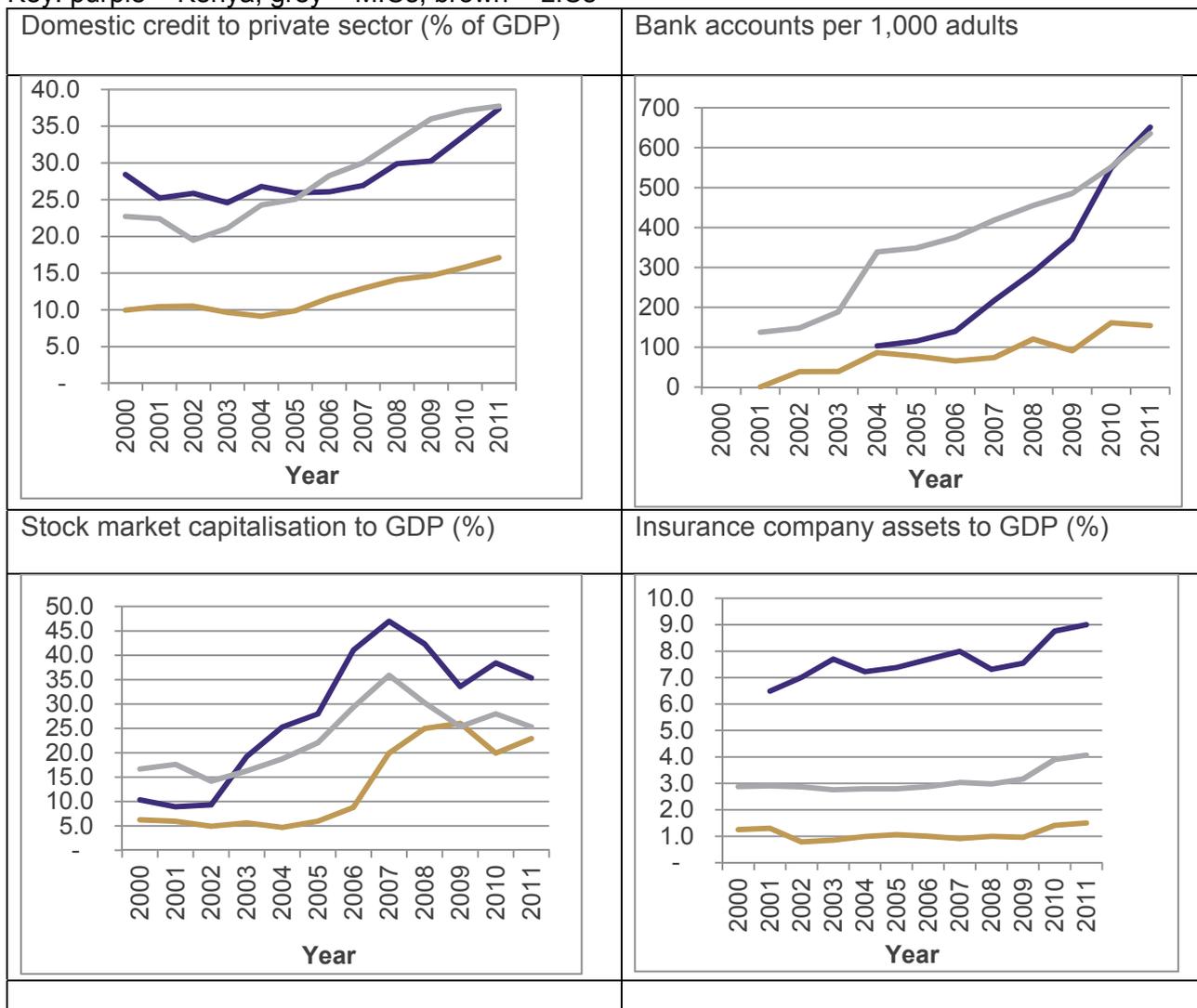
Source: (i) Criteria: Kaufman (2001); (ii) ratings: author; IMF (2015).

In relation to the level of financial development, Kenya's financial system has experienced significant development since 2000 and is, arguably, one of the best-developed financial sectors in Sub-Saharan Africa except for South Africa and Nigeria. Progress has been strong in a number of areas. Recent financial development has included strong credit growth relative to GDP, significant increases in financial access¹³ and improving – although still moderate – domestic resource mobilisation. Indeed, many of these indicators have now reached or exceeded the level of middle-income comparatives (Figure 14), with Kenya having been graduated just this year.

¹³ Conference material from Gitau Mburu indicated that recent household survey data from FSD continues to see improved access. Use of informal services remains high at about one-third but continues to fall as their use of services transition into the formal sector. Conference material from Jared Oloro and Sam Makome also pointed to the need to deregulate prices in order to stimulate financial inclusion.

Figure 14. Key indicators of domestic financial market development

Key: purple = Kenya; grey = MICs; brown = LICs



Source: World Bank's Global Financial Development database (downloaded 26 February 2015).

Financial access has expanded. This has been driven by emerging institutions – such as Equity Bank, Co-operative Bank and Family Bank – that have built business models based on economies of scale and innovation in mobile platforms and other distribution networks to expand financial access. The widespread adoption of mobile banking in Kenya has allowed ‘leap-frogging’ using technology within the industry. This has encouraged the realisation of economies of scale and pooling of assets, which will facilitate further financial sector deepening including through new services such as for mortgages and SME lending. Diversification of business risks has been enhanced through increasing regional expansion of these financial institutions (Beck et al., 2014).

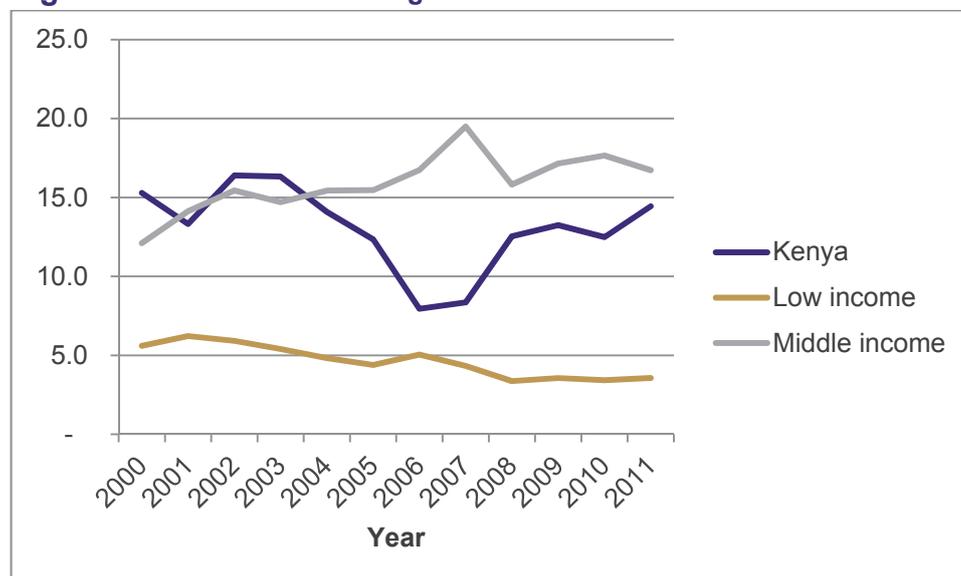
However, access gaps remain, particularly in the SME sector, where employment creation is potentially concentrated. If the constraints on finance in the SME sector could be reduced, this would significantly increase the indirect benefits of financial hubs through indirect low-skill employment creation.¹⁴

Nevertheless, this progress – and the related linkages and externalities in Kenya’s labour markets and technology sector discussed in Section 3.3 – are its key competitive advantage today.

¹⁴ Conference material (28 April 2015).

Equally important from the perspective of Kenya's advantages as a financial services hub has been the growing importance of its international links including for regional banking in Sub-Saharan Africa.¹⁵ International banks have been increasing their participation in Kenya in the past decade, with foreign claims in Kenya rising from 8% of GDP in 2006 to 15% by 2012 (Figure 15).

Figure 15. Consolidated foreign claims of Bank for International Settlements reporting banks to GDP (%)



Source: World Bank's Global Financial Development database (downloaded 26 February 2015).

This reflects the growing importance in Sub-Saharan Africa of regional banks. Regional banking groups have emerged as major market participants in Kenya, and Kenyan banks are increasingly becoming regional businesses, including Kenya Commercial Bank, Equity Bank, Fina Bank and Commercial Bank of Africa (Beck et al., 2014).

They have also been supported by policy. This includes regulatory changes in the region including liberalisation of entry rules in host countries and policy-led integration in the East African Community (EAC) (Beck et al., 2014). The EAC Treaty, signed in 2000, established a customs union (in 2005), a common market (July 2010) and a monetary union. It also included a commitment to harmonising the regulatory environment for financial banking and services including a common payment and settlement system for the five member states with settlement in local currencies (BIS, 2014).

These developments in the financial sector have increasingly led to a second major competitive advantage – deepening of the labour pool of skilled workers in financial services and supporting business services. This is providing a source of finance professionals required to build financial hubs.

However, the current labour market also provides a pool of less skilled potential employees that could be a source of labour for both processing centres and indirect employment. The absorption of such labour – for example untrained graduates, of which a large number are unemployed in owing due to the lack of skilled employment opportunities (Government of Kenya, 2013c)¹⁶ – has been the experience of other processing hubs, such as India and the Philippines. Such labour would – at least initially – be expected to be at wages that are globally competitive because of the levels of unemployment in this group.

Finally, an important area of competitive advantage – but one of more concern for Kenya – is a need for a stable economic and political environment. These factors have improved in recent years – for example inflation and exchange rate volatility has declined and the recent elections were positive – but security remains a concern. In addition, strong legal institutions are needed for a financial hub, and some see the

¹⁵ Conference material from Jareh Osoro, Kenya Bankers Association.

¹⁶ Unemployment or informal employment is high among graduates: 30% of those with tertiary education aged 25-30 are unemployed. As expected, average wages increase with formal education, most notably for those with tertiary education, suggesting a mismatch in the supply of labour against formal market demands (Government of Kenya, 2013c).

need for greater progress in relation to ‘ensuring property rights, enforcement of collateral, credit information about borrowers, and a more efficient resolution system for commercial disputes’ (Beck et al., 2014) in order for a financial service hub to develop.

Overall, Kenya currently has important competitive advantages that make its emergence as one of the region’s key financial hubs a real possibility. In this context, in the remainder of this section we examine specific policy options to be considered in order to seize this opportunity for Kenya.

We suggest three policy areas to consider – micro-prudential regulation, labour market policy and taxation. However, as noted, private institutions in Kenya have been critical in the achievements to date. This means that it needs to be considered whether a ‘hands-off’ policy – that is, a liberalised business environment – is the best policy. For example, there is a need to deepen interbank markets, and a need for secondary trading in a wide variety of instruments and establishing best practices among participants (Bai et al., 2013; Farid, 2013). Such deepening, which needs private institutional capacity-building and development of private market conventions and practises, may be best led by private – not public – institutions.

However, equally, policy needs to address the risks of a financial hub to create macroeconomic policy challenges and financial instability. This includes the need to ensure financial stability and related monetary policy effectiveness – such as exchange rate and interest rate management, as they are important policy instruments in Kenya (BIS, 2014). We examine the need for further development of macro-prudential regulation in this context.

MICRO-PRUDENTIAL REGULATION

As noted, key to establishing a financial hub – especially for onshore and offshore markets – are strong private and public sector institutions. In recent decades, Kenya has seen significant progress, including the emergence of strong private financial institutions and regulation by the Central Bank of Kenya (Tyson, 2015b).

The IMF recently praised ‘the authorities’ strong commitment to strengthening prudential and regulatory oversight’ (IMF, 2014c). In 2013, enhanced powers for the Central Bank of Kenya’s regulatory powers were introduced (Central Bank of Kenya, 2013). In 2014, Kenya was removed from the Financial Action Task Force (FATF) following its sustained improvements in anti-money laundering and terrorism financing measures (IMF, 2014b). In 2015, the Central Bank of Kenya implemented enhanced capital buffers to comply with the Bank for International Settlements (BIS) ‘Core Principles for Effective Banking Supervision’ (BIS, 2012).¹⁷

However, some concerns have been raised relating to the need for further progress (BIS, 2014; World Bank, 2013). One such concern is that, in Sub-Saharan Africa,¹⁸ ‘supervisory resources are limited, including qualified staff and the availability of analytical tools and skills [...] the ability to monitor risk at the institutional [...] level is hampered by insufficient quality in data and reporting processes’ (World Bank, 2013).

Similarly, the BIS commented that ‘timely and good-quality data are often not available to bank supervisors. This includes information on intra-group risk exposure [...] credit rating agencies either do not exist or have arrived only recently, which means that it is difficult to evaluate the underlying riskiness of a bank asset. This undermines the reliability of risk analysis [...] open foreign currency positions are a potential risk factor [...] extending foreign currency loans can be transformed into a credit risk in the case that a country devalues its currency’ (BIS, 2014).

Given that the establishment of a hub will result in more numerous and more complex markets and institutions, the excellent progress to date needs to be sustained. This includes the need to develop a framework that provides for regulation of regional banks through cross-border cooperation by supervisors and regulatory harmonisation. Supervision of a banking group – that is, of its holding

¹⁷ <https://www.centralbank.go.ke/index.php/news/402-introduction-capital-buffers-to-promote-financial-stability>

¹⁸ Comments specific to Kenya have not been made in this paper.

companies and subsidiaries – is normally the task of bank supervisory bodies in home countries. Agreement on this home supervision and information-sharing between regional regulatory authorities is needed for cross-border credit and exchange rate risk¹⁹ (BIS, 2014; Christian and Temilade, 2013; IMF, 2014a).

MACRO-PRUDENTIAL REGULATION

As noted, onshore and offshore banking hubs can increase financial fragility and lead to economic and financial instability in host countries (BIS, 2014). Financial instability can cause disruption in exchange and interest rates that can be difficult to manage effectively through monetary policy (ibid.).

Macro-prudential frameworks for Kenya need further development to manage these risks. Again commentators have raised concerns. For example, the World Bank comments that ‘supervisory processes focus on compliance with regulatory standards but are not set up to identify and manage the changing risks in banking systems’ (World Bank, 2013). BIS has identified a number of gaps that may be present in cross-border supervision (BIS, 2014).

Key aspects of the IMF-proposed framework that are of relevance to Kenya include countercyclical capital buffers, containment of liquidity and foreign exchange mismatches and controls on ratios of loans to assets and incomes. The IMF also supports the selective use of capital flow management (IMF, 2013). Kenya – in conjunction with international efforts to strengthen macro-prudential frameworks – needs to adopt these aspects of regulation.

In addition, the Central Bank of Kenya²⁰ needs to examine its framework relating to its role as lender of last resort for systemically important cross-border institutions and in foreign currency including the possibility of swap arrangements and other cooperative measures between the regions’ central banks (BIS, 2014).

LABOUR MARKET DEVELOPMENT

The Kenyan government has set out a strategic plan and is executing important policy initiatives for labour market development (Omollo, 2012; Zepeda et al., 2013). However, to date it has been focused on development of lower-skilled labour because of the need to create mass employment for unskilled workers and for the young.

However, consideration should be given to a greater policy focus on developing a higher-skilled workforce including through tertiary education and professional training and certification. As noted, graduate unemployment and wages for the employed are high – suggesting a mismatch currently between the numbers and skills of graduates and the needs of the private sector (Government of Kenya, 2013).

Policy initiatives that seek to resolve this issue need to be considered. These could include partnerships with professional bodies such as the Kenya Bankers Association. There is also a need for a professional register in order to ensure appropriate people are working in the industry (Tyson, 2015b).

TAXATION AND SUBSIDY REGIMES

Tax incentives and light-touch tax regimes for non-resident entities are common among successful financial hubs and are important in being competitive in attracting international financial institutions. This is especially the case for offshore financial centres when tax regimes are one of their key attractions.

Tax incentives can include taxation exemptions for financial institutions²¹ and expatriate employees and favourable tax treatments for foreign financial institutions. Similarly, direct and indirect fiscal subsidies are also used. These can include spending or subsidies on regulation, training and construction of infrastructure to provide pertinent facilities and services (Furstenberg, 2008).

¹⁹ This process has already been led by South Africa and Nigeria (BIS, 2014).

²⁰ Currently stated as ‘The Bank, as lender of last resort, may provide secured short-term loans to commercial banks on overnight basis at punitive rates, thus restricting banks to seek funding in the market resorting to Central Bank funds only as a last solution’.
<https://www.centralbank.go.ke/index.php/monetary-policy>

²¹ For example for exemptions from withholding taxes, capital gains tax and value added tax.

Kenya's current policy provides mixed incentives to potential financial service providers including non-residents. Some are positive – for example capital gains tax has been suspended²² and financial companies are exempt from withholding tax on dividends. Others are not – for example non-resident corporations pay higher rates of corporate tax²³ and higher withholding tax on interest income on certain types of bonds and double-taxation treaties are not comprehensive (KPMG, 2013). The government has special tax treatment for 'export processing zones', which – while well thought of²⁴ – have not been applied for financial services.²⁵ Government spending on direct subsidies has been limited.

These policies could be reviewed to increase incentives for financial services participants to locate in Kenya. This review needs to balance the externalities that this would create – such as employment and contribution to the formation of a financial services cluster – over the fiscal cost and forgone tax revenues to ensure that the country has a net benefit from such concessions in the medium term.

3.2.4. Conclusion

The section has discussed the opportunities and risks of the development of Kenya as a financial services hub. There is an opportunity to create employment and linkages into economic transformation, and a preliminary assessment of Kenya's competitive position makes this a real possibility. However, there are risks accompanying financial and economic instability that need to be considered. These opportunities and risks are also differentiated between the three possible types of financial hub – onshore banking, offshore banking and processing.

However, making choices among these options needs to be placed in the context of Kenya's overall economic priorities as set in its Vision 2030. Among these are the needs for stable macroeconomic conditions, increased levels of investment and strong employment creation – particularly for the young (Collier and Ndung'u, 2010).

In this context, development as an offshore financial centre seems relatively unattractive as it offers the key disadvantage of increasing possible economic and financial instability without the key advantages of employment creation and indirect linkages. Onshore banking hubs and processing centres can build on Kenya's existing competitive advantages but with advantages and disadvantages that contrast with each other. Choosing between them needs to be examined in the context of these priorities. Building an onshore centre offers low-volume, high-skill, high-wage employment creation. However, it creates the highest risk of financial and economic instability. The attractiveness of this option for Kenya depends on its ability to manage such risks. Strengthening of micro- and macro-prudential regulation and monetary policy will assist.²⁶ Tackling these issues requires further institutional development that is achievable but will require more resources and time.

However, it is the experience of developing countries that, even with reasonably strong institutional environments, avoiding these risks is not always achievable. This has particularly been the case where capital flows are being driven by exogenous factors. Most recently, since 2013, developing countries have repeatedly been exposed to 'temper tantrums' when global financial markets have reacted to an anticipated reduction in the exceptionally loose monetary policy in advanced economies by rapid capital outflows from emerging markets. Indeed, in the second quarter of 2015 alone, more than \$4.3 trillion was withdrawn from emerging markets globally including \$2.7 trillion on a single day in August (Institute of International Finance, 2015). These current global financial market conditions heighten the risks of financial instability for countries that are deepening their linkages with them. Caution is needed – especially in the immediate term.

By contrast, creating a financial services processing hub offers high-volume, low-skill and low-wage employment that closely matches Kenya's immediate needs. It also creates little risk to financial and

²² For all tax payers.

²³ 37.7% of taxable profits vs. 30% for resident companies.

²⁴ For example, the US Embassy (<http://nairobi.usembassy.gov/doing-business-local.html>)

²⁵ <http://www.epzakenya.com/index.php/sector-profiles.html>

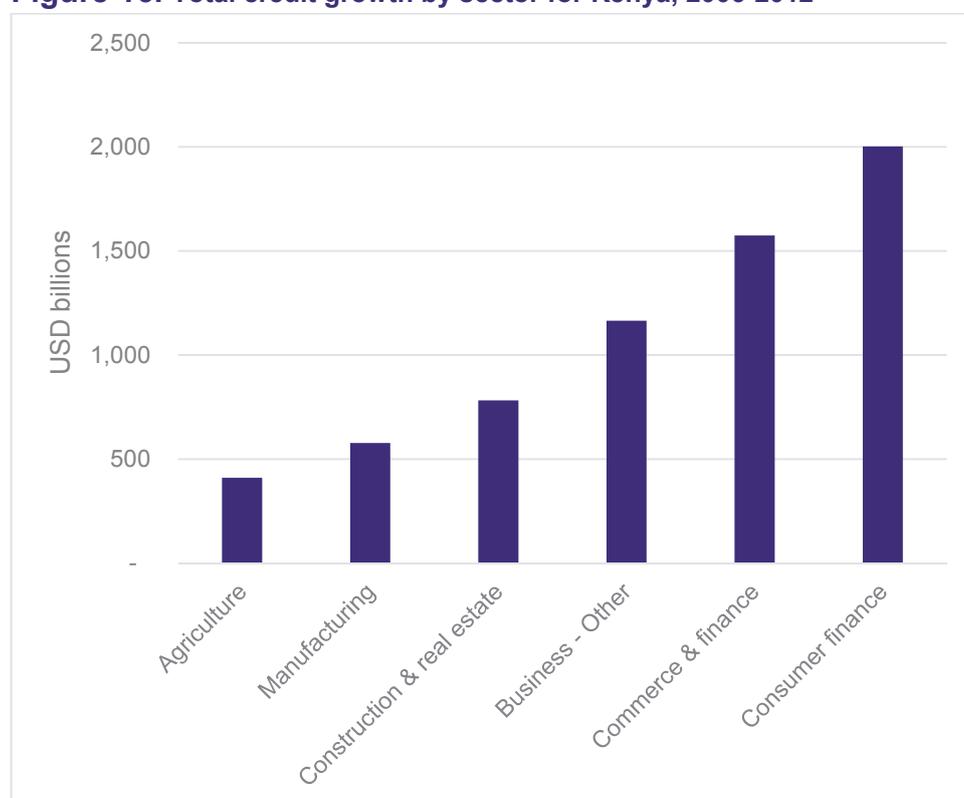
²⁶ Conference material from Lemma Senbet.

economic stability. The payoff is more moderate – although still good – linkages. Given the urgent need to create employment for lower-skill workers, and the question of the ability to manage risk of instability in the short-term, this is an attractive option.

In addition, more empirical research is needed into the induced effects of a financial hub. Although we suggest the most likely effects would be increased aggregate demand, accelerated financial development, and export growth – all of which could contribute to economic transformation – this requires further examination.

In particular the induced effects of financial development are not well understood because of the measures of financial development – such as domestic credit to GDP or households financial access surveys – and the intermediation of credit to ‘pro-development’ sectors in Kenya is not well understood. For example, recent credit expansion in Kenya has differentially been absorbed by consumer credit and short-term business financing rather than alleviating financing constraints in key development sectors including manufacturing and agriculture (Figure 16).

Figure 16. Total credit growth by sector for Kenya, 2006-2012



Source: Tyson and Patel (forthcoming).

In conclusion, we suggest that Kenya pursue development of both a processing hub and a financial centre but with different strategic approaches. There should be immediate policy support to develop processing hubs in Nairobi. This is because the gains in high-volume and low-skill employment combined with little risk to economic and financial stability can contribute to one of Kenya’s most pressing needs – mass employment creation.

In particular, we suggest targeting partnering with the strongest Kenyan banks that are establishing regional businesses to build hubs to service their businesses. These could then be expanded to service newly incoming regional banks. Although further analysis is needed, it would appear that there is currently limited competition in the region from other hubs – exposing a business opportunity to fill this gap in the market – and because being an established processing centre will act to attract further regional banks to Nairobi compared with other competing locations in the region and so contribute to the ‘critical mass’ needed for the second goal – to become an onshore financial hub.

This can be combined with a more cautious but steady approach to progress towards being the financial hub for Sub-Saharan Africa in the medium term. The immediate short-term goal to prepare for this should be to strengthen regulation – especially macro-prudential regulation – and partner with private institutions to establish Nairobi as their regional headquarters.

However, we suggest a more aggressive policy should wait for more favourable global financial conditions including a successful and stable reversal of quantitative easing in advanced economies and better market sentiment towards emerging market risk by global investors.

3.3 IT-enabled services for economic transformation – opportunities and challenges

3.3.1. Introduction

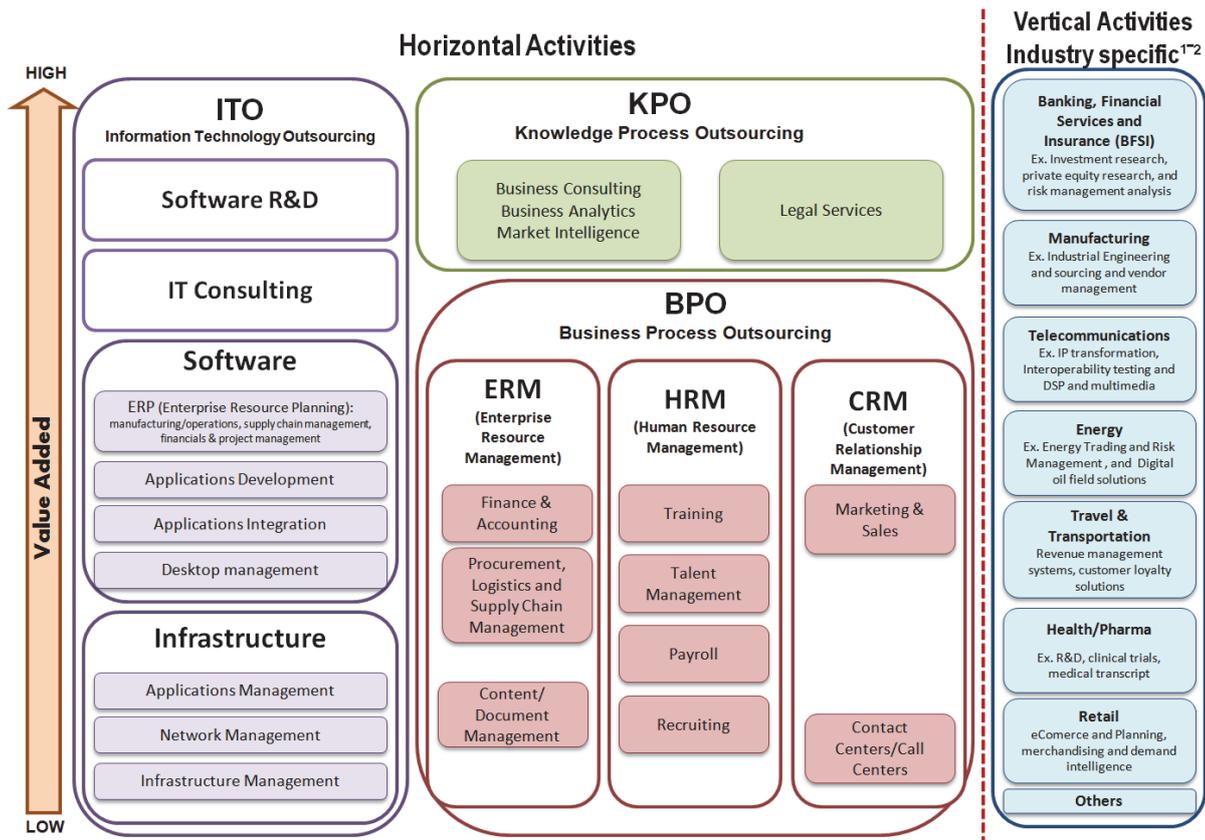
The ICT sector is widely considered the defining core industry of the Information Age. Its vast size and rapid secular growth, albeit with some cyclical volatility (see the dot.com and telecom ‘bust’ at the turn of the century), has captured the imagination of governments and business people alike, in both developed and developing countries, for the past three decades. While the advanced industrialised countries have focused on the ubiquity of the ‘digital economy’ (OECD, 2014; Oxford Economics, 2013) and its role in increasing productivity in all the various sectors of the economy and society, developing countries have placed their emphasis on segments (such as business process outsourcing (BPO)) that appear easy to enter and yet represent activities with much higher productivity and export potential than their existing economic structures. In either case, however, the key shift has been the dramatic rise in the share of services as compared to the value of merchandise (physical goods) production and trade.

IT is big business, not just in terms of the world’s largest and best-known firms, and it is the most buoyant. The National Association of Software and Services Companies (NASSCOM), the association of IT/ITeS (IT-enabled services) firms (both domestic and multinational) in India, estimates overall global IT spending to be \$2.3 trillion, of which only about \$1.0 trillion is for hardware. The remainder splits between IT services – \$657 billion; BPO services – \$177 billion; and software – \$420 billion. Of the total spending on IT/ITeS, a significant part is outsourced and offshored; in recent years this global sourcing market has been growing at roughly twice the rate of overall spending, reaching about \$150 billion in 2014. It is in this market that offshoring to selected developing countries is taking place, with India being the dominant player with a market share over 50%.

The numbers are indicative. For a variety of reasons, notably the rapid pace of technological change that has led to sharp declines in the cost of communicating and processing information and dramatic – even disruptive – evolution in business processes (and ‘models’) blurring lines between sectors and entities, it is difficult to estimate the economic dimensions. Even the advanced countries are struggling with the scope of concepts such as ‘digital trade’ (USITC, 2013, 2014) while most developing countries are well behind the curve in adequately accounting for service activities, especially the newer IT-related ones in their national accounts and economic surveys and statistics. Kenya is no exception; so much of what follows eschews quantitative analysis and is based on secondary sources, interviews, published case studies and other anecdotal information.

It is useful to briefly distinguish between different segments of the IT/ITeS industry in order to understand both the recent history of the sector and its prospects. In the past, the industry was typically divided in two segments – IT services and BPO. In popular conception, the first employed the ‘techies’, the software developers and engineers to set up and maintain the computer systems, while the latter comprised people manning the call centres and data entry personnel. This was never the complete story, and a more instructive representation of the offshore services value chain is provided in Figure 17, thanks to Gereffi and his colleagues.

Figure 17. Segments in the ICT sector



Source: CGGC (2010).

The spectacular performance of the iconic Indian IT/ITeS industry and its contribution to the national economy (discussed in more detail in the following section) engendered widespread efforts across all continents to emulate the Indian experience. Most countries, though, focused their attempts on particular segments of the industry, for example the Philippines on BPO, the Czech Republic on select industry verticals and Chile on higher-end knowledge process outsourcing (KPO) (Gereffi, 2010; Herguner, 2013; Hewitt Associates, 2006; Norbhu et al., 2009; Sudan et al., 2010). The government of Kenya also initially focused on the BPO sector that was identified as a priority in its Vision 2030.

3.3.2. The role of IT/ITeS in economic transformation

As alluded to above, the focus in advanced industrialised (Organisation for Economic Co-operation and Development (OECD)) economies has been on increasing the pervasiveness of ICTs, seen as general purpose technologies (GPTs) that can improve not only technical efficiency of processes but also broader economic efficiency through reducing search costs and trade frictions as well as 'nudging' behaviour through information provision (e.g. to reduce energy intensity).

Direct contribution

In emerging markets and developing countries, on the other hand, the attraction has been the opportunity for massive export expansion and job creation. India, which has a 55% market share in global sourcing, is seen as an exemplar in this regard; indeed, the IT/ITeS sector is the vanguard of its fabled services export revolution. Remarkable growth milestones were achieved year after year, despite the global crisis in 2008-2009 and well-known structural deficiencies in India related to infrastructure and education. The industry turnover reached \$120 billion (excluding hardware) in value added terms, contributing over 4% of GDP. Computer-related and modern business services exports account for three-quarters of total services exports, which in turn are a quarter of total exports. The sector has generated over 3 million jobs directly, and applying the general rule of thumb indicates four times as many indirect jobs (Gokarn et al., 2007).

Indirect impacts, including induced and productivity effects

The direct contribution to GDP, export volumes and employment is just the tip of the iceberg. The sector is seen as the primary driver in sophistication of service exports (IMF, 2010), a leading indicator of sustained economic growth. Moreover, it is contributing significantly to skill enhancement and build-up of technical capacity. Indeed, the industry has reskilled itself to move up the ladder of technological and business complexity every decade, and this has played a key role in maintaining growth momentum and obviating negative impact of generous wage growth on competitiveness. The IT/ITeS industry has been a preeminent destination for incoming FDI, and the nature of the sector is such that there are substantial technological spillovers (Kite, 2012). Indeed, one indication is the booming number of start-ups in the sector that appears to be stimulating entrepreneurship, perhaps more than government programmes *per se*.

A major social impact is the expansion of job opportunities for women (around a third of the current employment, though the share in new recruits is higher) and youth in general. Recent research (Oster and Steinberg, 2013) points to a significant induced impact through job opportunities stimulating the demand for secondary education of girls. The industry is widely acknowledged for instituting good modern practices for corporate governance and lending its weight behind measures to reform the economy. Finally, the industry established the Indian 'brand' firmly in the world of business strategy and soft power.

Needless to say, some observers have also pointed to the downsides of such strategies. We focus only on a few that may hold some relevance for Kenya going forward. One has to do with a variant of the Dutch Disease caused by bloating of capital inflows (FDI and export earnings) that arguably distort development patterns, stunting the growth of manufacturing in particular. The second is also related to the sucking in of scarce resources, and concerns the rising wage inequality and job polarisation owing to growth in specialised services and high-tech industry (Mehta et al., 2013).

Third, and perhaps the most salient consequence of pursuing a narrow export/employment focus, has been the relative neglect of promoting adoption of IT in the domestic economy as an instrument for enhancing productivity, financial inclusion, access to information generally and education, health and other services, promoting accountability in government or mobilising greater civic engagement. Indeed, until recently, the rapid penetration of cell phones in most developing countries over the past decade has almost constituted a parallel universe that the advent of smartphones is likely to alter dramatically. Even in India, where IT/ITeS firms are making major contributions to digital innovations in the OECD members (e.g. Smart Grid technology, chip design, etc.), the adoption of digital technologies in manufacturing, services and primary sectors is very low.

The role of IT in improving competitiveness and driving broad-based economic transformation is now no longer in dispute even for developing countries. Several growth accounting studies (e.g. Bloom et al.) in the economic literature also demonstrates that, notwithstanding the critical importance of the IT/ITeS sector in expanding exports and generating employment in some countries, the biggest contribution comes from increasing productivity both directly through technology and through new business processes and economic organisation. This aspect becomes especially relevant for Kenya, as the latest mega-trends in the industry, especially mobile communications, cloud computing and social media, are precisely those where its relative strengths lie.

While the early IT applications around the world were oriented towards large-scale corporates, such as enterprise resource planning (ERP) systems, today the most innovative applications are targeting decentralised and/or geographically dispersed sectors such as transport, tourism and hospitality industries as well as SMEs that are critical to much of East Africa. The advent of cloud computing, for example, allows small businesses to avoid lumpy investments in IT systems and pay-per-use of computing and communicating facilities.

It is important also to appreciate that the economic transformation wrought by new technologies can be truly structural in terms of radical changes in the industrial organisation of the economic sector. For example, mobile applications can have a dramatic impact on urban transport including taxi fleets; social media has disrupted advertising; and analytics and cloud computing together have major implications for

retail and distribution trades as well as agriculture and financial inclusion. The mobile phone has already had a profound economic and social impact in many parts of the developing world, with Kenya being a recognised leader in harnessing this technology for public good. It may now be time to raise the game to the more complete set of information technologies, especially ITeS that are traded domestically or internationally. Moreover, as experience around the world has shown, the impact in sectors such as manufacturing, agriculture and fisheries is only limited by the extent of our imagination.

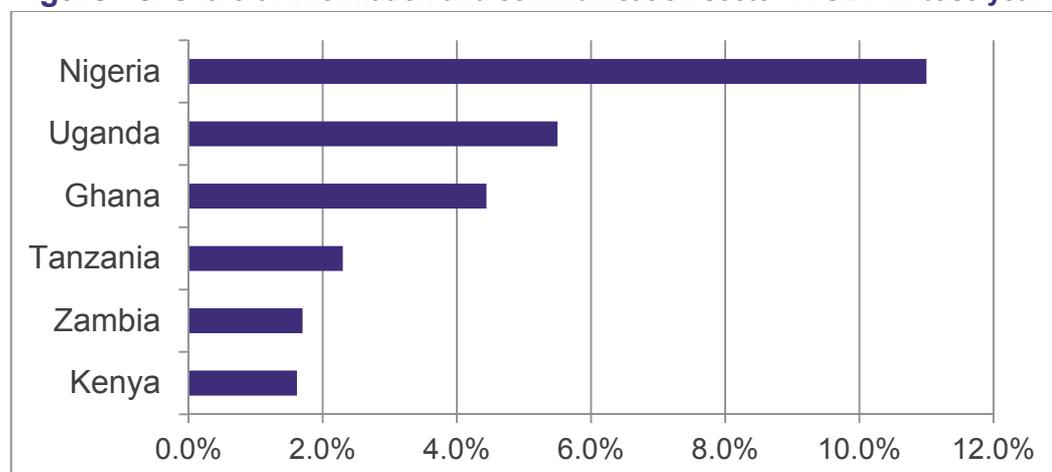
Kenya experience

Kenya boasts remarkably high mobile and Internet penetration rates, and the contribution of the Internet economy to GDP reportedly exceeds that of most other developing countries (not just Africa). Exports of IT services (including telecommunications) were \$468 million in 2012, and public expenditure continues to focus on ICT – broadband infrastructure as well as laptops for schoolchildren. On the other hand, BPO ambitions have had to be tempered.

Recent megatrends in technology across the globe related to social media, mobility (especially smartphones), analytics ('big data') and cloud computing, collectively referred to as SMAC (social, mobile, analytics and cloud), are already disrupting the established order, so informed observers are further articulating the segments above in order to follow the business dynamics as well as their policy implications, especially in Kenya. In particular, software innovation (research and development (R&D) and product development including apps) is increasingly the domain of start-ups and other entities. Moreover, e-commerce, including its hybrid variants, is growing rapidly as well, which brings into focus a segment that may be termed 'connectivity enhancers' (Mann et al., 2015).

Figure 18 shows the share of information and communication in GDP in rebased GDP data. The data look questionable, especially when it comes to Kenya.

Figure 18. Share of information and communication sector in GDP in base year after revisions



Source: *te Velde presentation at a SET workshop (30 January 2015) based on national statistical offices.*

It is beyond the scope and duration of this exercise to analyse the performance of the Kenyan IT/ITeS industry in any meaningful depth, more so given the absence of any reliable data. Yet, to move beyond banalities of generic competitiveness analyses, one needs to draw sharp lessons from past experience, particularly when it is very recent and contrary to expectations of similar analyses. Hence, this section draws heavily on the report released this quarter by the Oxford Internet Institute on 'The Internet and Business Process Outsourcing in East Africa' (Mann et al., 2015).

The Kenyan BPO industry had its genesis in the early years of this century through informal work farmed out through online outsourcing platforms, often with Internet cafes morphing into BPO centres after hours. The first firm, Kencall, was formally established in 2005, and was followed by several others like Technobrain and Adept, that remain active today. Employing typically 100-500 workers, they exclusively sought international clients and rang up modest success that created enough of a splash to be noticed in the outsourcing world. Kenya was presumed to have a comparative advantage given its English language skills, and the advent of submarine cables was expected to lead to a quantum jump in

international connectivity. The potential was not realised as the economics (including Internet prices) did not work out as planned, and the North Atlantic financial crisis made new entry into the market difficult. (The same factors that put a premium on stable client relationships and business continuity were partly responsible for the surprising resilience demonstrated by the more established players.)

Given the clear handicaps related to scale, relative costs and available skill sets, the Kenyan industry and the policy-makers stepped back from competing at the global level. The key challenge, well appreciated by industry veterans, is maintaining direct access to clients, exposure to front-end business and intimate familiarity with value drivers of the BPO work. The focus has shifted decisively to local and regional (East Africa) markets save for a few firms specialising in impact sourcing that do cater to international clients.

3.3.3. Policy options to support ICT-enabled economic transformation in Kenya

In less than a decade, Kenya has emerged from being a ‘technological backwater’ to establish a reputation as a leader of IT-led economic transformation in Sub-Saharan Africa, with Nairobi laying claim to being the ‘Silicon Savannah’. The transition has been driven by the combination of visionary and determined efforts in both the private and public sectors. Perhaps the most iconic is m-Pesa, the pioneering mobile payments system that has earned worldwide renown and is being emulated by countries all around the globe. Its salience lies not only in providing access for the ‘unbanked’ to modern money transfer and other financial services but also in its role as a platform for continuing innovations and new business models that are transforming commerce in general.

Equally significant was the advent of the fibre-optic cable infrastructure, starting with the first East African landing of such undersea cables in Mombasa five years ago and complemented by significant public investment in inland backbone. The government also explicitly identified BPO as a key sector in its Vision 2030 that would make Kenya the preeminent destination among firms seeking to locate such activities in Africa as well as among educated youth seeking productive employment. In quantitative terms, the aim was 20,000 direct jobs and output of KSh 10 billion by 2012.

Kenya’s opportunities and strengths

Kenya remains moderately attractive to international firms because of its business-friendly reputation, availability of office space in Nairobi, pleasant climate and reasonable political and security situation (though recent terrorist incidents did add some concern). The Kenya brand, although based around just a few success stories, most notably m-Pesa, remains an attractive one in the IT/ITeS industry. This is a significant lever to be utilised as FDI has played a critical role in the establishment and growth of the IT industry (both hardware and software) in most successful countries, including China and India, as well as others, such as Ireland, Czech Republic and Costa Rica. More than the provision of financial resources, it is the transfer of technology, both explicit and implicit, that has been the critical factor, and, within this function, development of business skills and technical capability has been particularly instrumental in diffusion of productivity improvement.

Going forward, another key strength of the industry is related to the presence and growth of software start-ups and the evolving innovation ecosystem including incubators and accelerators. Another complementary segment is IT connectivity enhancers, such as electronic payment intermediaries. Collectively, these capabilities place Kenyan IT/ITeS in a strong position to rise to thrive in markets that are being radically transformed by disruptive technological innovations such as SMAC. Moreover, the joint presence is also critical for leveraging local knowledge into viable business solutions.

The focus on local and regional markets also opens a tremendous opportunity to address the other leg of economic transformation that lags in most developing countries – digital reengineering of various sectors of the economy. To date, most of the IT applications appear to be oriented towards e-government, usually projects commissioned by national or county governments, often with the support of aid agencies. The track record of such programmes worldwide is not very promising but, even if they are effective in improving governance, they are unlikely to diffuse rapidly or have major economic impact soon. Given Kenya’s present condition, it is important to place as much emphasis on applications that will enhance economic growth, competitiveness and inclusiveness of various sectors of the economy.

Distillations from international experience

There is a reasonable consensus among experts and knowledgeable observers on the necessary ingredients for ensuring the competitiveness of the IT industry. These are popularly couched as frameworks for assessing geographic locations or political jurisdictions that are part of the basic toolkit of major consulting firms (e.g. A.T Kearney, EIU, Gartner, Hewitt and McKinsey), advising firms, investors and governments. While the precise scoring rules may differ, they all concur in the importance of the available talent pool, the cost parameters, the state of physical infrastructure and the business environment that subsumes issues related to policy predictability and transparency. Not surprisingly, these criteria are similar to those applied to other industries, with the main difference being one of emphasis or primacy of the talent pool and a relatively greater weight to language and cultural attributes as well as intellectual property regimes in the case of IT/ITeS industries.

An alternative framework proposed by Jane Drake-Brockman, drawing on lessons distilled from a number of case studies, may be more appropriate in terms of devising policies to promote the competitiveness of services value chains, which is a major part of what ICT-enabled economic transformation seeks to achieve. Once again, the human capital endowment (comprising talent, education, skills, ideas, culture) leads the list that also stresses the salience of investment in intangible assets, enabling digital infrastructure, quality of institutions, efficiency of domestic regulations, international connectedness, stakeholder engagement and policy focus. These appear unexceptional, even obvious, but are often missed in practice.

The last three merit some additional comment: international connectedness refers not just to telecommunication links but also to physical connectivity (e.g. visits), which is necessary to bridging social distance and building trust, as the experience of the IT/ITeS industry both in Kenya and in India attests. Kenya and India had similar advantages relating to English language skills, but the latter benefited heavily from its large diaspora in the US and the social connections and trust built up during the period when Indian software engineers established Y2K defences in the late 1990s.

Stakeholder engagement and facilitating institutions such as industry associations (e.g. NASSCOM), as well as conclaves, networking events and hackathons, are critical staples for IT/ITeS innovation in Silicon Valley and the major Indian outposts. Stakeholder engagement with governments is especially useful in educating policy-makers about technologies as well as novel business models, to avoid misunderstandings that have often led to policy or regulatory disasters (e.g. transfer pricing tax adjustments in India). Indeed, the ICT Authority is engaged in such activity, but it would be helpful to have an active business association.

Similarly, the salience of having a policy focus is less about facilitating bureaucratic or regulatory capture and more about ensuring policy coherence across different agencies and tiers of government in the context of new activities and business practices that do not fit into existing regulatory frameworks. A prime example of this would be mobile payments, such as m-Pesa, which took off in Kenya but were stymied in other countries.

Policy and programme priorities

Moving beyond process suggestions to more substantive suggestions for policy and programmes to stimulate digital structural transformation of the Kenyan economy, the key priorities are as follows. First, a strategy to promote the adoption of IT/ITeS-based productivity improvements in various sectors of the economy needs to be developed. This need not be administered or managed monolithically; rather, it may be delegated to line ministries or business associations or pursued through a mission mode. The focus could be on areas where Kenya could enjoy first mover advantages by addressing the needs of rapidly growing mobile Internet/broadband users in East Africa. A few priority sectors could be selected to start with, such as tourism, for example. As discussed in Waema (2014), this would entail addressing issues in a variety of areas including human resource development, implementation of the planned national payment system and issues under the jurisdiction of the banking and ICT regulators.

Second, given the present structure and size of the Kenyan firms, a policy framework could be designed to attract FDI in captive subsidiaries, often termed 'global in-house centres' (GICs).²⁷ It should seek to bring in those firms that see a future in East Africa and are interested in product development, if not R&D, for the region. The incentives, if any, should be structured to marry local knowledge of Kenyan or East African staff with external technical expertise and should progressively encourage undertaking more complex activities in Kenyan locations. Moreover, it may be advantageous to seek partners who have similar delivery centres in other countries with a view to providing opportunities for wider global exposure to Kenyan employees.

Third, skills development in cross-cutting functions and/or GPTs needs to be strengthened in Kenya. This is unlikely to be provided in requisite quantities by private sector employers. Programmes with industry sponsorship could be developed as supplementary courses in colleges around the country. For such training to be effective, a rudimentary system of accreditation will be needed as well. Since training interventions like these have a chequered record, an experimental approach merits consideration. A case can be made for complementing any training interventions in Kenya with short-term internships abroad for Kenyan staff, especially in SMEs. This could be done in conjunction with current or prospective foreign firms active in Kenya, funded perhaps through some foreign assistance programmes.

Fourth, support for SMEs is needed, particularly those engaged in product development as opposed to pure service provision, since the latter confront fewer financial constraints. Once again, the design should carefully account for lessons from past experience, such as the perverse impact of fiscal subsidies. A complementary initiative would be to promote adoption of digital technologies and processes by small and medium-sized businesses across various sectors of the economy through a combination of incentives (e.g. expensing software and knowledge-based intangibles) and support services (e.g. extension, training).

Fifth, strategic use of public procurement can address market failure in the innovation ecosystem. The principles underlying the design of the Advance Market Commitment for Vaccine Development could be applied to various other sectors to stimulate demand for IT/ITeS innovations (e.g. provide subsidies for guaranteeing a market for certain services). The most evident place to start would be the various e-government programmes contemplated by the national government; but, given the devolution of administration to county levels that is in progress, some thought should be given to encouraging local initiative while avoiding repeated reinventions of the wheel. This would also allow quicker diffusion and economies of scale.

Finally, Kenya needs to promote greater geographic diversification of the IT industry, which is almost exclusively based in Nairobi. This is admittedly easier said than done, and most countries around the world continue to struggle in this regard. A careful analysis of attempts by others (including states in India or municipalities in China) may be helpful, if only to avoid major boondoggles or real estate scams.

3.3.4. Conclusions

Kenya has certainly achieved considerable success in the IT industry (particularly in areas associated with mobile telecommunications) as well as in business and professional services (notably BPO). However, not surprisingly, owing to rapid technological change and evolving business models, the accomplishments are different from those originally envisaged, requiring changes in policy and strategic direction.

The Kenya brand appeal is still positive, the IT/ITeS sector remains attractive to domestic and foreign investment and – perhaps the most promising – the country is emerging as a hub for digital innovation, albeit overwhelmingly concentrated spatially in and around Nairobi. The challenge going forward is to sustain, scale up and spread these developments.

²⁷ GICs (or 'captives') are global delivery centres to support technology and contact centre operations.

The key to future success lies in de-emphasising the export-only enclave mindset in favour of diffusion of IT-enabled productivity improvements across other economic sectors, particularly those where re-engineered processes will enhance international competitiveness and market reach. A variety of structural features of the Kenyan economy suggest a focus on the East African region as a market in terms of geography, and SMAC-oriented applications in terms of business lines.

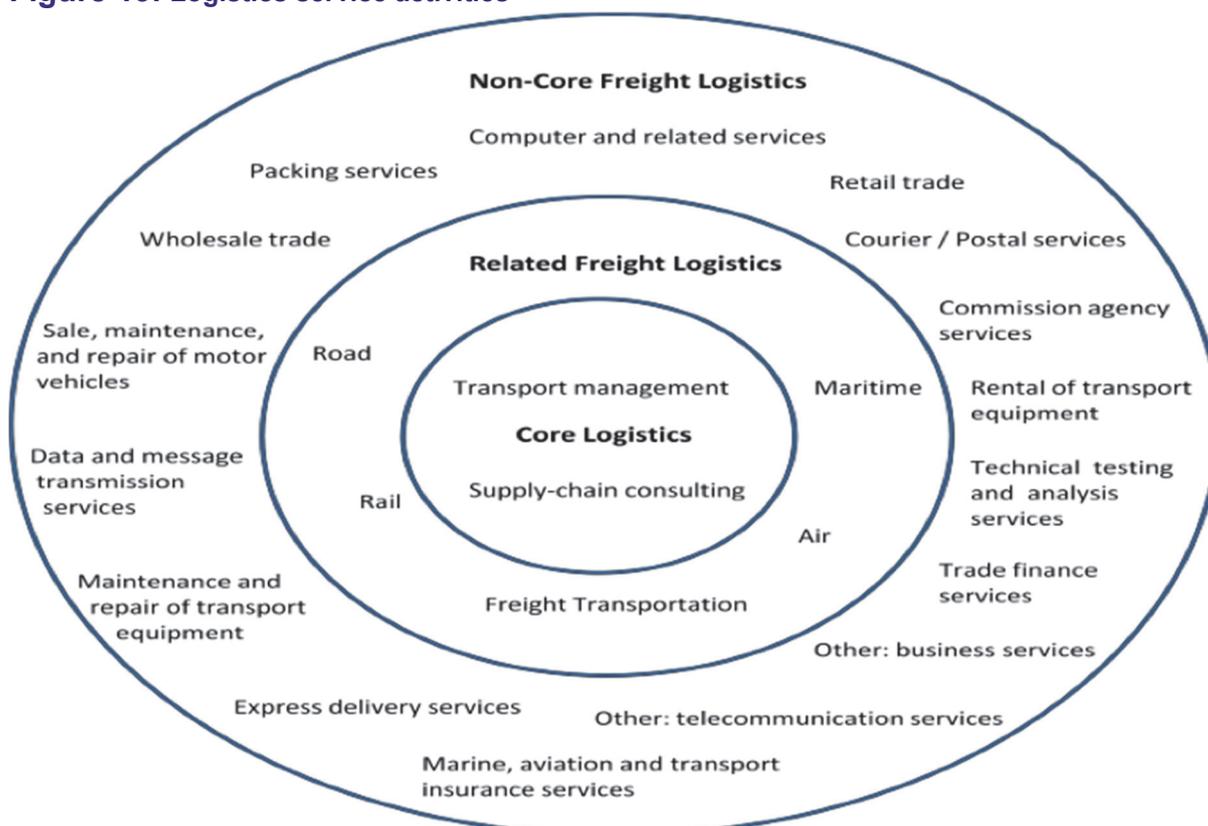
3.4 Transport services for economic transformation – opportunities and challenges

3.4.1. Introduction

Transportation has been inextricably linked with the emergence of the modern world at least since the Industrial Revolution, when initially canal waterways and subsequently the steam engine contributed to the expansion of markets, which allowed manufacturing to flourish and the specialised division of labour. Indeed, the second era of globalisation – that is, the post-war boom in international trade and investment – is widely acknowledged to have its roots in the sharp decline in transport costs and improved speed and quality of services owing to technological developments, not least among which was containerisation, which diffused rapidly into the developing world as well.

The next phase of globalisation, one driven by ICT, is also contributing in a major way extending the reach and key attributes such as reliability and predictability of transport systems, spawning a whole new industry, third-party logistics (3PL) providers, that are increasingly salient in developing countries. Conversely, it is also recognised that countries or regions with landlocked geographies or other features that handicap transportation confront especially severe challenges to economic development.

Figure 19. Logistics service activities



Source: World Bank (2010); adapted from USITC (2005) and WTO's Logistics Checklist.

The transport sector typically accounts for 6-12% in terms of economic output in most countries and a similar share of employment. The elasticity of direct employment is typically in the medium range and until recently the bulk of the numbers were those considered low to medium skill such as car- and truck-drivers. In Kenya, the transport sector has accounted for 8-9% of GDP and there are a number of reasons it is likely to remain a major driver of economic growth in the country.

Part of this has to do with geography and history – indeed Nairobi had its beginnings as a railway stop and the second largest city, Mombasa port, was the gateway to East Africa from the Indian Ocean. The other part has to do with policy and strategy, whereby Kenya (and other East African countries) have developed road networks and reformed and rejuvenated their aviation systems. Although higher than in other continents, transport prices are lower in East Africa (Mombasa–Kampala corridor) than in other regions of Africa and quality of service is highest in Kenya (World Bank, 2012). Indeed Kenya appears well placed today to capitalise on the next wave of development and establish itself as a logistics hub for eastern Africa, though perhaps not in as extreme a form as Panama or Singapore in Central America and East Asia respectively.

The key to this would be continued progress, as much on the institutional front as on physical infrastructure on the regional transport corridors, especially the port in Mombasa, which anchors one end of the Northern Corridor, as well as air shipment facilities for high-value and perishable commodities like flowers or other horticultural produce. The transport and logistics sector will continue certainly contribute to economic transformation of Kenya as it has in the past, but with suitable policy and institutional reforms complementing the investment programmes being pursued by the government, the structural transformation can be deeper and more pervasive across all sectors of economic activity as well as social development, such as health and education. Briefly summarised, this entails improvements in road transport as well as intermodal systems.

3.4.2. The role of transport services in economic transformation

The World Bank has termed transport the ‘ultimate facilitator’ and identified five channels for its role in economic development. Quoted verbatim from its Transport Business Strategy (World Bank, 2008), these are essentially the basic drivers of comprehensive development or two structural transformation of the economy including dimensions pertaining to inclusivity and sustainability:

- Facilitating economic growth and regional integration through international trade;
- Making cities work better for their citizens, for the environment and for economic growth;
- Creating economic opportunity and growth in rural areas;□
- Providing access to facilities that deliver health and education services;□
- In all these functions, becoming safer and cleaner for users and the community.

Direct effects

The transport sector is among the largest segments of the service sector in both developed and developing countries. As noted above it has accounted for 8-9% of GDP. The employment numbers are less reliable in developing countries because a large proportion of the labour force is engaged in informal activities, for example Matatu drivers in Kenya. Nevertheless their productivity is likely to be at the upper end of the informal sector given the lack of formal sector public transport. At the other extreme are employees in the aviation sector, among which flight crews are among the highest paid salaried workers in many developing countries. (Air transport employment in Africa in 2012 was estimated at 428,000 of which a whom over a quarter were employed by airlines and handling agents, another 11% in airport management and operations and a little over half in commercial outlets at airports.) ILO estimated that the transport and communications sector accounted for 6.6% of the total employment in developing countries in 2012.

In addition to service operators, the transport sector also employs a significant number of workers in road maintenance and in traffic management, especially in urban areas. These are usually not included in the sector’s employment and nor are those employed in road construction, though these activities are non-trivial parts of public expenditure.

Yet another direct contribution of the transport and logistics sector to the Kenyan economy is through service exports, which have hovered around 40% of total service exports in the past decade (World Bank, 2010; Section 3.1). The revealed comparative advantage (RCA) was estimated to be over 3.5 so the sector is internationally competitive and can be expected even to increase its share in the future for reasons alluded to earlier.

Indirect effects

The transport sector has forward linkages to virtually every other sphere of activity in the national economy. Hence the prices it charges and the services it delivers are a key ingredient in the competitiveness of other sectors, especially manufacturing, which requires movement in of raw materials and shipment out of products. Various studies (e.g. Amjadi and Yeats 1995) have found transport costs to be bigger impediment to trade performance than tariffs. Others (e.g. Freund and Rocha) have focused on other service attributes such as time and predictability to be salient. Recent analyses by the World Bank distinguish between costs of the service providers and the prices charged by them, finding the latter to be the bigger problem (especially in West Africa).

There is scope for costs to be reduced as well, improvements in productivity of trucking companies, better maintenance of roads to reduce vehicle operating costs and improved connectivity and intermodal systems at ports. The resulting benefits to freight transportation will have substantial economy-wide impacts even if precise quantitative estimates are difficult to obtain, especially because the general equilibrium impacts swamp individual microeconomic estimates of output growth and employment creation.

Passenger transport is often neglected in such analyses but should not be. The efficiency of urban transport is a major determinant of productivity in service industries, and intercity connectivity has been found to be an important factor in city competitiveness. Equally important is the impact on access to health care (e.g. 75% of maternal deaths in developing countries could be prevented through timely access to childbirth-related care), especially in rural areas.

A second category of indirect effects relates to those induced by the advent of new transport links or improvement of existing ones. Experience in other developing countries indicates these range from social impacts such the enrolment of girls for education (World Bank, 2008), to the location of new manufacturing enterprises and improvement of plant productivity (Ghani et al.), to the expansion of employment (Gertler et al.) in general. Economists and historians may debate the 'cart or horse' but an extensive literature (e.g.) is unequivocal in demonstrating the strong correlation between the development of transport networks and the spatial distribution of economic activity in general and urbanisation in particular, which is increasingly recognised as a key driver (and/or correlate) of structural transformation not only of the economy but also of the polity.

Kenyan examples

Two examples from Kenya highlight the structurally transformative impact of the transport sector. The first relates to the case of flower exports. Kenya is today one of the largest exporters in the world of cut flowers, 80% of them being roses. These are exported to Europe, Dutch auctions being the preeminent destination, and have made the industry one of the top earners of foreign currency within just a decade of its genesis. There are about a hundred firms in the business and the employees are mainly women from poor rural backgrounds who are trained in plucking, packing, etc. The critical ingredient of success was of course reliable airline service, made possible with the privatisation and revamping of Kenya Airways, but equally important has been the development of refrigerated warehouses and related facilities. As the industry has developed it has led to spillovers in the area of logistics as well as the Kenya 'brand'.

The port of Mombasa is the critical element of the Northern Corridor for movement of goods in the EAC. About 30% of the cargo is for Kenya's neighbours, Uganda accounting for over two-thirds, but it provides vital services also for Rwanda, Democratic Republic of Congo (DRC) and South Sudan. Over the past few years, a combination of strategic investments and policy reforms has led to significant improvements in performance of the transport system, notably a reduction by half in the transit time between Mombasa and Kampala. At the same time, traffic has been growing by over 7% a year, with container traffic growing faster and now exceeding the liquid bulk traffic. While it is tempting to surmise that this reflects structural transformation in economic activity in the hinterland, this may be premature, as 85% of the throughput was imports. The main exports are coffee, tea and soda ash, accounting for over half the total. The primary mode is by road, which makes improvements in road transport especially important if the port is not to become a bottleneck for the Northern Corridor. Indeed, in terms of the focal theme of

this paper, the main issue to note is the strategic opportunity created by Mombasa port for Kenya to enhance its *entrepôt* role. In this regard, it may also be necessary to address the issue of the still high charges for container-handling at the port.

3.4.3. Policy options to improve the impact of transport services on economic transformation

The main policy options to enhance the impact of transport services in improving the productivity of downstream sectors and to help the most productive among them grow faster are those that lower the cost to the customer (i.e. the prices they pay), reduce the time merchandise or people spent in transit and improve reliability, predictability and safety. Achieving some of these aims requires investments in modern equipment and civil construction as well as in modern IT that can not only dramatically reduce paperwork but also obviate corruption.

As important as investments are institutional reforms and related changes in policies and regulations. These are the focus of sustained dialogue within government and with external agencies such as the World Bank or TradeMark East Africa (TMEA). Suffice it therefore simply to highlight those that appear most salient from the point of view of having a positive impact on other sectors of the economy.

- Promoting competition in the road haulage industry so as to reduce the rents and lower the prices to competitive levels. Towards this end, simplification of road freight licensing would be a significant measure;
- Developing intermodal systems and transshipment facilities at the downstream (lake) end of the corridor to avoid bottlenecks at that end;
- Improving connectivity in terms of access with land transport, both road and rail, at Mombasa port and others;
- Improving the regulatory framework for port operations to reward efficiency and lower charges, which are high by international standards;
- Redoubling efforts to improve road safety, which continues to be a major challenge (at tremendous cost to the economy) in developing countries, including Kenya, where some innovative initiatives have been tried;
- Dramatically improving urban transport in major cities if they are to remain attractive business destinations. Towards this end, the nascent and innovative software start-ups could be mobilised to develop custom applications that will likely find markets in other African countries;
- Given Kenya's geographic location and its presumptive comparative advantage in selected sectors such as tourism and IT-enabled services, growing the aviation sector. The public sector role should remain focused on infrastructure provision but the government may consider thinking through a strategy to promote efficient and steady growth that avoids sharp booms and busts typical of the sector in many countries;
- Considering articulating a development strategy for the logistics industry, not with the intention of government investment but to address the variety of coordination issues that arise in such a cross-cutting industry that is likely to be especially strategic for Kenya;
- Promoting energy efficiency in the transport sector through suitable standards (vehicles, fuel), incentives and other 'nudges';
- Harmonising transport as well as customs policies and regulations with other members of the EAC.

3.4.4. Conclusions

The transport sector is a key component in GDP and employment in developing countries, and this is also the case for Kenya, which includes the port of Mombasa, Kenya Airways and freight. What is also clear is that these transport activities have major spillover or indirect effects onto the rest of the economy.

3.5 Tourism for economic transformation – opportunities and challenges

3.5.1. Introduction

The tourism industry²⁸ accounted for 9.1% of the world's GDP in 2011, or over \$6 trillion, and has seen strong growth in recent decades.²⁹ The potential benefits for developing countries through growth in GDP and employment are widely recognised, and the industry has a high potential to contribute to job-intensive economic transformation through the creation of the low-skilled employment.

Given this, the Kenyan government has deemed tourism a key sector for its economic growth, and today tourism is one of the main industries within the country's services sector, and a priority sector for Vision 2030.

Further development of the tourism sector in Kenya could contribute to growth in GDP and in employment, including low-skill employment. This section discusses the potential benefits of the tourism sector, the current state-of-play of the Kenyan tourism sector and what policy approaches could support its further growth.

3.5.2. The role of tourism in economic transformation

Tourism can affect economic transformation in a number of ways, including direct and indirect effects (Table 7).

Table 7. Impact of tourism on economic transformation

		Effect	Comment
Direct employment effects	High skill	Low	Dependent on number of expatriate staff in senior roles
	Low skill	High	Including in catering, domestic and property work and in direct client services
Indirect effects	Spillover to other sectors	High	Including through tourist spending and demand for services associated with tourism such as from hotels

Source: Own construction.

Direct effects

The most important direct effect of tourism is through sales in hotels and tourist attractions, which includes lodging, restaurants, transportation, amusements and retail trade. This creates employment and business revenues.

Employment includes a wide range of skills, from low-skill employment (e.g. cleaning, service and catering staff) to higher-skilled employment requiring professional training and/or tertiary education (e.g. professional hotel and restaurant staff, guides and park wardens and business support staff, including management, accounting and marketing personnel).

Importantly for Kenya – given the high levels of unemployment and informal sector employment especially among youth – tourism employs a high number of unskilled workers.

Tourism is Kenya's top service sector today. It contributed 11.8% of Kenyan 2014 GDP or \$5.6 billion.³⁰ It is also a leading earner of foreign exchange in Kenya.³¹

Indirect effects

Tourism creates indirect effects in the host economy through secondary demand for goods and services.

These include through backward-linked industries (i.e. industries supplying products and services to hotels) such as transport, agricultural products, conservation, entertainment and handicrafts.

²⁸ Including travel (tourist transfer and air travel).

²⁹ 'A result of the direct, indirect and induced impact of this industry' (National Tourism Strategy).

³⁰ Refers to total GDP contribution (WTTC)

³¹ \$800 million in 2006 (Government of Kenya, 2012)

The scale of secondary effects depends on the propensity of businesses and households in the region to purchase goods and services from local suppliers. This is of importance to Kenya because of the high propensity of some tourism businesses to purchase imported goods (Stynes, undated).

In 2014, tourism accounted for 3.9% of formal sector employment³² and 6.4% of indirect employment – thus accounting for 10.3% of total employment.³³ Tourism also creates informal sector employment such as in handicrafts, informal services and transport (although this has not been well quantified) (Government of Kenya, 2012).

Tourism has also created linkages and spillover effects in Kenya. It has led to upgraded airport facilities in Nairobi and Mombasa – including the construction of international quality airports – and smaller domestic airports in Kenya. This infrastructure has become an important enabler of other sectors such as, for example, export of agricultural products including cut flowers and high-value vegetables – today some of Kenya’s most important exports.

Because of its potential for further growth – including low-skill job creation – and creation of further spillover effects, tourism is one of the six priority sectors in Vision 2030. Vision 2030 aims to make Kenya one of the ten main long-haul destinations on the planet (Government of Kenya, 2013a).

Induced effects

Induced effects of tourism include those in the public sector, where tourist development can induce investment in transport and other infrastructure. Such infrastructure can then act to enable other sectors (Oxford Economics, 2014a).

Tourism can be an important sector in generating tax revenues – including through specific taxation of tourism and international travel – and foreign currency earnings (Government of Kenya, 2013a; Oxford Economics, 2014a).

Tourism can also have environmental effects, although they can be both positive and negative. For example, positive effects could include greater incentives to preserve natural environments. Negative effects may include pollution, degradation of natural environments and overuse of public infrastructure such as transport or water and sewage (Stynes, undated). A number of ‘ecotourism’ projects in Sub-Saharan Africa have tried to manage the economic and environmental impacts of tourism, but there are mixed views as to their impact.³⁴

The World Travel and Tourism Council (WTTTC) has estimated these type of effects for Kenya in 2013. It finds the following. The direct contribution of tourism and travel in 2013 was 4.8% of GDP, but the total contribution was estimated as 12.1% of GDP (ranked 74 in the world). For employment these numbers were 4.1% and 10.6% of total employment (ranked 53 in the world). These data indicate that the indirect and induced effects are greater than the direct effects. The sector received 7.6% of total investment.

3.5.3. Policy options to raise tourism’s contributions to economic transformation

The government, through this plan and legally under the Tourism Act of 2011, seeks to improve product development and infrastructure with the goal of increasing the appeal of Kenya as a tourism hub. This includes seeking to diversify its products and improve the quality of its services. The plan also promises a development opportunity that is combined with environmental sustainability (Government of Kenya, 2013a). However, tourism’s development has challenges and risks that require management through policy. These include its susceptibility to external economic shocks, such as demand from advanced economies, and domestic problems such as social unrest and terrorism (Government of Kenya, 2013a).

The following sections elaborate on these challenges and then discuss policies that the Kenyan government has executed or proposed or could consider addressing.

³² <http://www.wttc.org/datagateway/>

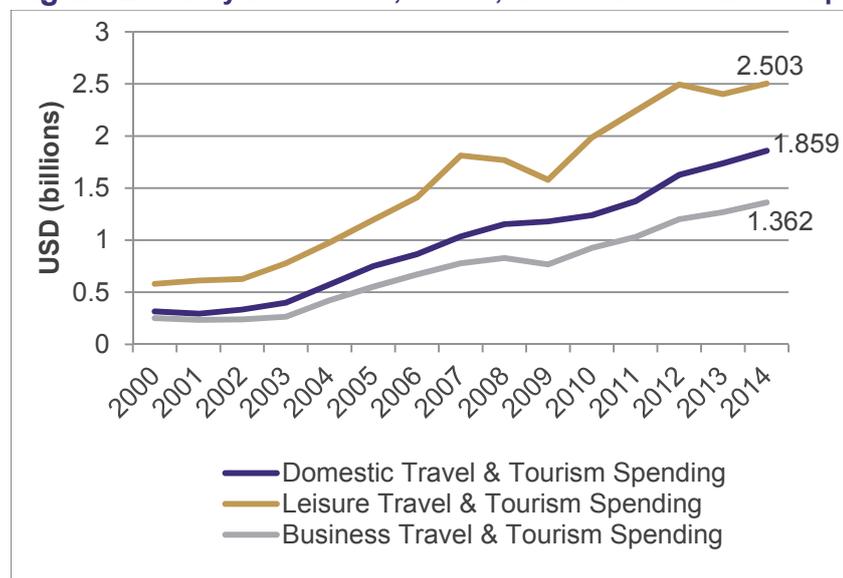
³³ <http://www.wttc.org/datagateway/>

³⁴ Including negative social and community impacts. For example, the UN ‘Voices from Africa’ includes negative comment from civil society groups: <http://www.un-ngls.org/orf/documents/publications.en/voices.africa/number6/vfa6.12.htm>

Vulnerability to security concerns

Security and foreign perception of a country's safety are vital components of the rate of visitors in any given year. There have been two recent significant drops in expenditure in leisure travel because of security concerns in 2007 and 2012 (Figure 20).

Figure 20. Kenyan domestic, leisure, and business tourism expenditure (US\$ billions)



Source: WTTC.

The Kenyan crisis of 2007-2008 was a period of serious social unrest following a presidential election. There was then a surge of terrorist attacks in the country from late 2011, including the 2012 attack on the Westgate Shopping Mall and the 2015 attack on Garissa University, which were widely reported in international media. Repeated incidents in the coastal and border regions of Kenya, including kidnapping of foreign tourists, impacted foreign perception of safety and led governments to warn their citizens against travel to these areas. This resulted in sharp declines in the number of foreign tourists. The tourism industry was severely affected, especially on the coast in Mombasa and Lama Island areas.³⁵

Nevertheless, by 2010 the industry had rebounded, and there has been a return to continued growth in the sector – a testament to its resilience and the inherent attractiveness of Kenya as a tourist destination (Government of Kenya, 2013a) – although the impacts of problems in 2014 and 2015 have not yet been reported.

Concentration risk in Kenyan tourism

These issues have exposed the Kenyan tourism sector's reliance on European and US international demand. In 2013, 50.8% of tourism spending was by foreign visitors and 49.2% by domestic visitors³⁶ (Oxford Economics, 2014b).

Business is also concentrated during peak seasons, leaving a significant gap in expenditure that results in having part-time workers and lack of use of existing infrastructure out of season.

Tourism also relies on the natural environment, including beaches, wildlife and landscapes. This means Kenya's tourism is geographically concentrated in beach and safari destinations on the coast (Mombasa,

³⁵ It has been reported that this has increased recruitment by extremist Islamic groups amongst disaffected youths, resulting in an unfortunate vicious circle that is negatively affecting one of the most important sectors (http://www.nytimes.com/2015/02/24/world/africa/as-tourism-sags-on-kenyan-coast-terrorists-could-lure-the-unemployed.html?_r=0)

³⁶ Foreign visitor spending is expected to grow by 5.2% by 2024 and domestic visitor spending by 5.3% by the same date (Oxford Economics, 2014b)

South Coast and Malindi) (Valle and Yosebia, 2009) and in the seven national parks³⁷ (Government of Kenya, 2012).

Increasing the benefits from tourism

A number of factors suggest that Kenya – while benefiting from the current structure of the tourist industry – could increase the benefits it realises.

The tourist industry in Kenya has been developed mainly through private investment, including foreign investment (Christie et al., 2013). In some instances, this has reduced the benefits realised by Kenya. For example, there are high numbers of foreign staff in the high-skill employment that tourism offers, such as managerial and client service positions. The impact of the industry has been reduced owing to repatriations of profits (Valle and Yosebia, 2009) and the use of imported goods and foreign suppliers of services (Akama, 2000; UNCTAD, 2008).

Environmental effects

Kenya has rapidly developed its tourist industry. However, there has been criticism of the negative social and environmental effects.

There has been a steady decline of wildlife populations and a net loss of biodiversity. Although this is not exclusively because of tourism – land overuse and overpopulation have been more important factors (Homewood et al., 2001; Ottichilo et al., 2000) – increased visitors numbers, vehicles and lodges have made problems worse and impacted animal behaviour in particular (Cheung, 2012). Local ecosystems have seen the effects of the construction and overuse of tourism-related infrastructure. For example, lodges are generally built close to water sources, which subsequently have been polluted by sewage or have run dry (ibid.). There have been negative social effects on local communities, such as community discontent and attrition to herding livelihoods through loss of land and predation by wild animals (ibid.).

3.5.4. Policy options to develop the tourism industry in Kenya

One of the key goals of the Vision 2030 initiative is the development of tourism. This has included a range of policy initiatives such as the Tourism Act of 2011, which introduced reforms directed at developing and managing sustainable tourism. This involves marketing and regulation strategies, including standardising hotel classifications and establishing professional standards for agents (Government of Kenya, 2013b).

It has also mandated the establishment of a research centre focused on data acquisition – a vital part of policy-making – and an autonomous regulator to monitor levels of competition within the industry (AfDB, 2013).

Other policies include the operation of the East African Tourism Wildlife Coordination Agency (Government of Kenya, 2013a) and enhanced antiterrorism and security provisions, which have a budget of KSh 7.3 billion to be spent between 2013 and 2015 (Government of Kenya, 2013b).

The Kenya Investment Authority also has an active policy seeking private investment in the tourism sector

However, further policy initiatives could be considered to both optimise the opportunity for Kenya in the tourist sector and tackle some of the risks and challenges discussed earlier. The following sections discuss some of the possible options.

Maximising gains from employment

One of the key benefits of tourist development is employment creation for nationals, both high- and low-skill employees. Quality of employees is particularly important in order to attract high-spending consumers.

³⁷ Kenya has 65 national parks and reserves, operated by the Kenya Wildlife Service.

Most low-skill work is already largely being performed by national employees. Nevertheless, training and education could assist in ensuring a suitable labour pool to support the development of the industry – such as, for example, catering and hotel service vocational training.

However – as discussed – there is also a need to provide expanded employment opportunities for nationals in higher-skill employment. Again, education can help ensure an appropriately skilled labour pool.

These needs have already been recognised by the National Tourism Strategy of 2013-2018, which sets training of staff as a priority, to improve professionalism and quality of service. A number of training facilities and university courses have already been established in Kenya as well as professional standards and training in national park management and conservation.

However, specific policies for foreign investors and tourist operators could be strengthened. This could include targets for formal or informal employment of Kenyan nationals in senior roles such as management. It could include incentives for investment companies to provide on-the-job training and professional development for employees, to increase higher-skill employment levels for Kenyan nationals and to accelerate knowledge transfer.

Diversifying the sector

Developing new markets, promoting domestic tourism and extending off-season visits could help diversify and stabilise the tourist sector. A number of strategies could be considered.

Vision 2030 has already selected some specific initiatives to diversify the sector. These include supporting three new coastal resort cities (Isiolo, Kilifi and Diani); developing niche,³⁸ conference and business tourism³⁹ in addition to the established coastal and safari sectors; and improving the quality of infrastructure (airports, roads, hotels) and service (through employee education). These are important initiatives. However, further options could also be considered.

Kenya is already focusing on developing new markets from which to attract visitors. Vision 2030 promotes a more active marketing strategy that targets high-spending tourists (UK, US, Germany, France, Italy and Germany) and potential high-spending tourists (India, Scandinavia, South Africa and Japan) in MICs and HICs.

Similar initiatives could be considered for other countries where newly wealthy middle classes are emerging as important sources of tourism for other countries. For example, Kenyan tourism could be marketed in China⁴⁰ and within Africa.

Kenya can also develop domestic tourism – especially as per capita income increases and more is spent on leisure. The Kenya Tourism Board is targeting domestic tourism to compose 60% of hotel occupancy in the medium term (Government of Kenya, 2013a). Domestic tourism may also be a more diversified source of tourism, because it will include business travellers or those travelling for personal reasons (such as family visits or events), and this will allow a more diverse geographical and non-seasonal tourist industry to be supported.

In addition, domestic tourism may support more small- and medium-sized business such as smaller hotels and restaurants – which are typically owned by Kenyan nationals – rather than international hotel and travel businesses. This will add to business and employment opportunities for nationals.

Policy could encourage visits to be more evenly distributed throughout the calendar year. This can be achieved by the private sector, for example through discounts or the arrangement of events, such as

³⁸ Refers to products such as ecotourism, ecotourism, sports tourism and lake tourism, which are all high-value offerings that can be marketed at high prices (Government of Kenya, 2012).

³⁹ Kenya has an advantageous strategic location that enables it to easily build international connections. Sessional Paper #10 mentions plans to increase and develop this product through the investment of international chains in major cities, such as Nairobi, Kisumu and Mombasa.

⁴⁰ It is estimated that by 2020 there will be 30 million annual international tourists from China (<http://www.economist.com/node/7088698>).

special cultural festivals, during the off-season (Christie et al., 2013). Similar events – for example in the arts – have already been successful elsewhere in Sub-Saharan Africa.

Environmental and social management

Ecotourism is 'defined as responsible travel to natural areas that conserves the environment and improves the wellbeing of local people' (Cheung, 2012).

Community engagement with tourism has been sought through a variety of methods. As well as parks providing employment for local people, there are revenue-sharing arrangements whereby 25% of park fees are paid to local authorities for the use and benefit of local communities. However, there have been comments that the speed and form of funds distribution are not satisfactory and need further improvement. This includes programmes that address the impact of conservation, such as compensation programmes for livestock losses to protected predators (Bruyere et al., 2009; Cheung, 2012).

The establishment of conservation and management programmes has improved conservation. However, more needs to be done if tourism is to be further developed without damage to the natural environment that is its key attraction – for example by promoting parks beyond the top seven where the majority of visitors are concentrated.

This could also be encouraged through use of visitor quotas for overused parks. Such quotas can be quantitative or managed through high visa or park fees. The latter have been used successfully in, for example, Bhutan and Rwanda, and have led to increased revenues as well as reduced visitor numbers (Cheung, 2012).

3.5.5. Conclusions

The indirect and induced effects of tourism in Kenya are greater than the direct effects, suggesting it is important to understand how the sector affects the rest of the economy before making any judgements on its success.

Kenya's tourism has a fundamental comparative advantage – the beautiful natural environment that has successfully attracted many tourists to the country. Further development and diversification strategies are needed to grow the industry while also optimising gain to the national economy and managing negative benefits, especially environmental degradation.

The contribution that the sector could potentially make to structural transformation is high – especially because of the potential to provide low-skill employment and to create spillover benefits such as infrastructure development and backward linkages.

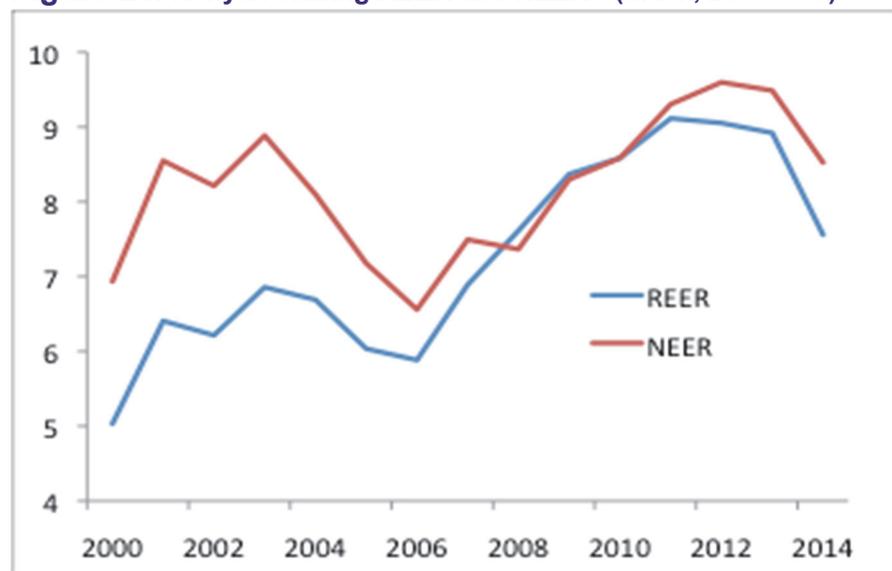
3.6 Services and Kenya's real effective exchange rate

The above sectoral sections discuss direct, indirect and induced effects. However, as argued in Section 2.3, we also need to consider the international linkages and examine the effects of exchange rate shifts brought about by services development. The Kenyan shilling (KES) REER appreciation has multiple links with the country's services sector. There is some evidence that a stronger REER has been driven by the services sector. The distributional effects of a stronger exchange rate are likely to be felt by domestic investors and producers of non-tradable goods and services (Frieden, 1991). In Kenya, although minimal risk has been identified in its banks (IMF, 2014a), banking sector inflows and rising corporate credit are likely to benefit further from an appreciating exchange rate. This has also been the case for Kenya's transport sector.

In this section, we examine the REER appreciation of the KES, the degree to which it has been driven by services sector developments and the extent to which it has coincided with Kenya's largely stagnant manufacturing sector. We also explore the degree to which the KES REER has diverged from its long-term equilibrium values.

The KES REER has increased significantly. The index appreciated by 50% from 2000 to 2014 according to our Consumer Price Index (CPI)-based REER calculations,⁴¹ with a 22% rise in the nominal exchange rate calculated over the same period (Figure 21). The increase has owed to rises in both relative prices and the nominative effective exchange rate (NEER). As with other emerging and developing country currencies, the latter has been a reflection of multiple factors, including capital inflows into Kenya as a consequence of global investors' search for yield, including heightened risk appetite by the global investor base (BIS, 2015).

Figure 21. Kenyan shilling REER and NEER * (Index, 2000=100)



Note: *Relative consumer price ratios are calculated using CPIs.

Source: WDI, ODI.

3.6.1. Kenya's real effective exchange rate

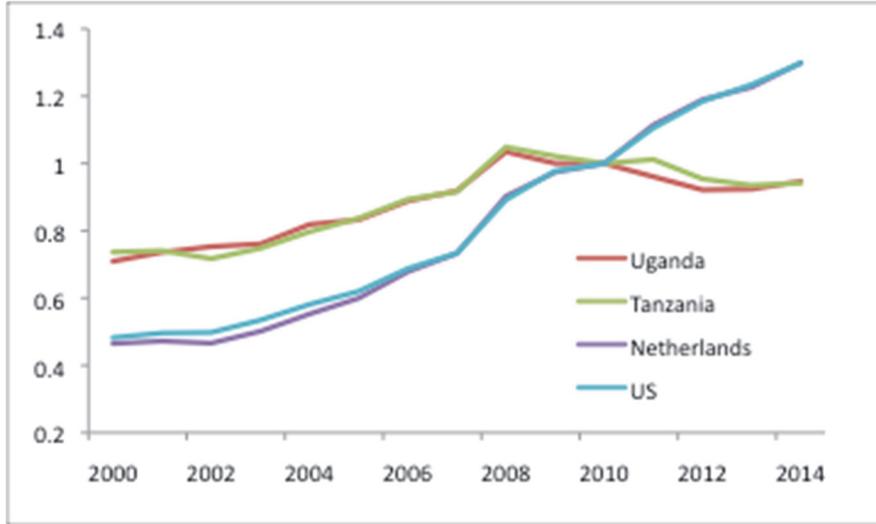
Drivers of Kenya's domestic price dynamics

Kenya's domestic inflation has boosted the REER. Its long-run inflation has been driven by significant monetary and credit expansion (Durevall and Sjo, 2012; IMF, 2012b) that has been driven by its financial services sector. Electronic financial services have contributed to money growth and heightened inflation expectations, strengthening the REER. Financial innovations, such as electronic money through M-PESA and the establishment of new currency centres, have increased the velocity of money and currency circulation (BIS, 2011; Mbiti and Weil, 2011). The M-PESA system, which provides mobile banking to 70% of Kenya's adult population, has an estimated velocity of three to four times higher than the velocity of other components of money and is likely to have boosted inflation expectations, leading to a monetary policy that could inadvertently be too loose (AfDB, 2011).

The detailed splits of the KES REER reveal that the Kenyan economy has seen a generalised increase in its price level. Notably, within its four major export markets, there is a divergence in relative price developments between developing (Uganda and Tanzania) and developed trade partners (US and the Netherlands). Kenya has seen a significant erosion of competitiveness against the US, Japan, the UK and Sweden, which are still fighting disinflation and deflation. This contrasts with more moderate price rises relative to neighbouring Sub-Saharan African countries (Figures 22 and 23).

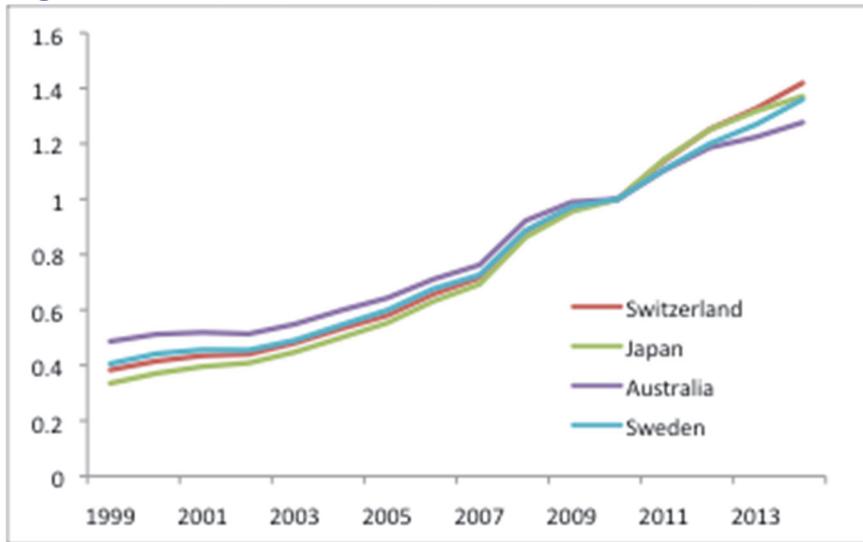
⁴¹ Our estimate for the KES REER is based on trade weights from Kenya's top 25 export markets, taken from the International Monetary Fund (IMF) Direction of Trade Statistics.

Figure 22. Kenya's price developments vs. its top four trading partners*



Note: *Relative consumer price ratios are calculated using CPIs.
Source: WDI, ODI.

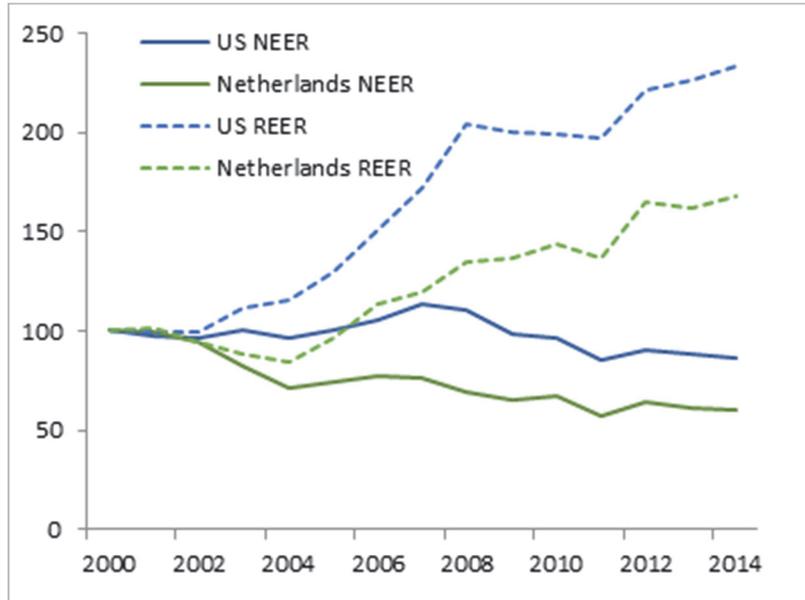
Figure 23. Kenya's price developments relative to developed countries*



Note: *Relative consumer price ratios are calculated using CPIs.
Source: WDI, ODI.

These divergent price trends have meant that, although Kenya's REER has increased, nominal exchange rate dynamics have not followed suit. In fact, the KES NEER has depreciated against the US and the Netherlands, while its REER has increased (Figure 24). In contrast, the KES REER and NEER have appreciated (though to varying degrees) against its Sub-Saharan export markets, particularly Uganda and Tanzania (Figure 25).

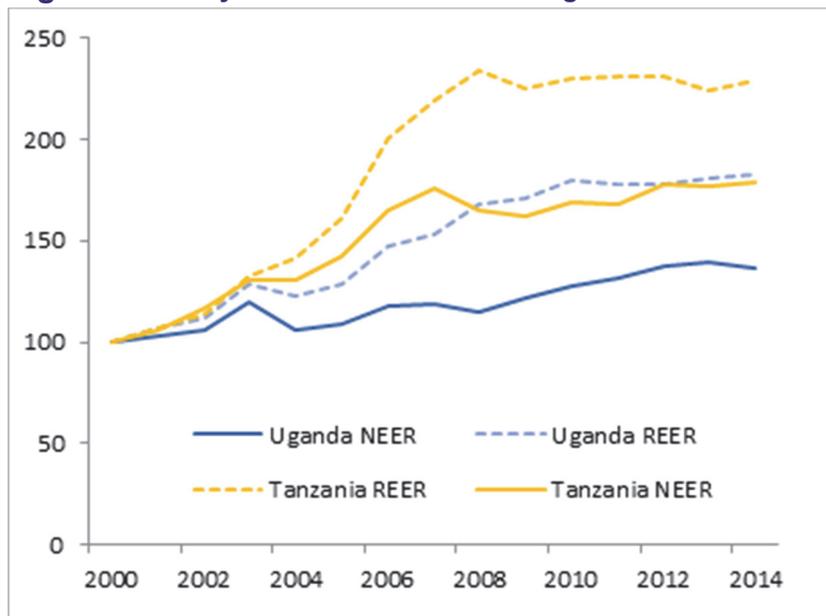
Figure 24. Kenya's REER and NEER vs. the US and the Netherlands* (Index, 2000=100)



Note: *REERs are calculated using CPIs.

Source: WDI, ODI.

Figure 25. Kenya's REER and NEER vs. Uganda and Tanzania* (Index, 2000=100)



Note: *REERs are calculated using CPIs.

Source: WDI, ODI.

3.6.2. Kenya's REER and its services sector

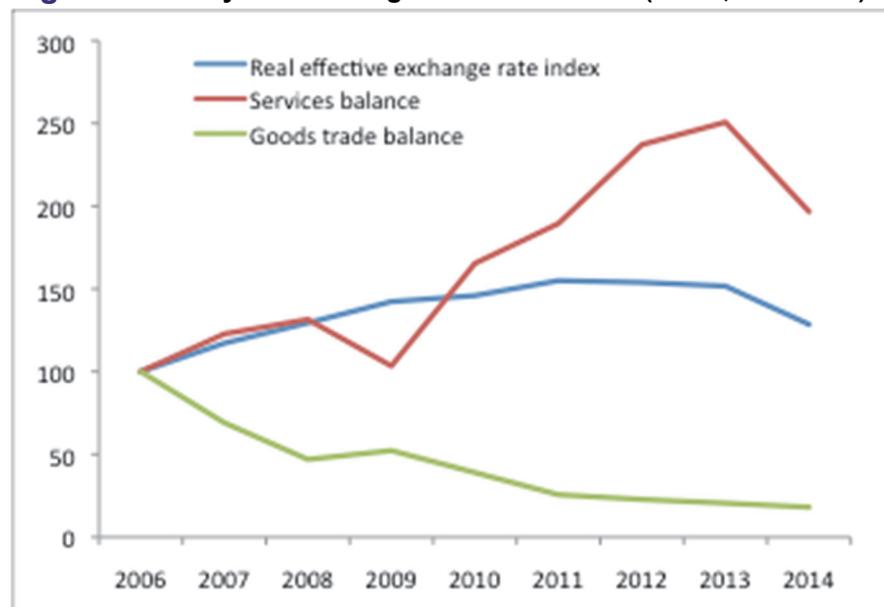
Links between trade in services and KES REER

In this section, we look at whether KES appreciation (and associated imbalances) has been driven by the expansion of external trade in services. We then examine whether Kenya's stronger currency has come at the expense of its manufacturing sector. An examination of Kenya's national and external accounts is indicative of an uneven domestic economy and burgeoning imbalances in its external sector. What is more, exchange rate volatility is deemed to be the biggest risk to its debt sustainability (IMF, 2012b).

Kenya's external accounts suggest there has been a clear deterioration in the economy's external position, particularly in its current account deficit. The data also highlight that the deterioration in the

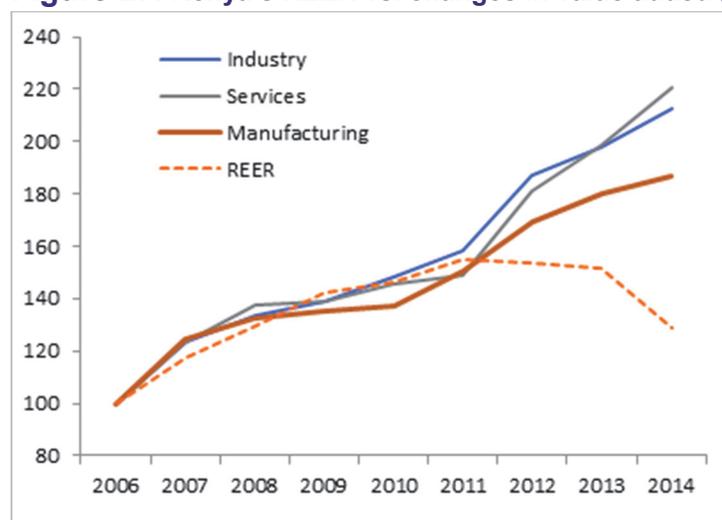
goods trade balance has been driven by a sustained rise in manufacturing imports. This contrasts with developments in trade in services. The appreciation of the REER has coincided with this divergence from 2006 to 2008 but has since seen it become more pronounced (Figure 26) and has coincided with a lack of momentum in value added in manufacturing (Figure 27).

Figure 26. Kenya's trade in goods and services (Index, 2006=100)



Source: WDI, ODI.

Figure 27. Kenya's REER vs. changes in value added (Index, 2000=100)



Source: WDI, ODI.

The concomitant appreciation of the exchange rate with the expansion of the services sector has been conspicuous in the literature. Eichengreen and Gupta (2012) distinguish between traditional services (transport, tourism, financial services and insurance) and modern services (telecommunications, information technology and related services) and find that the effect of real exchange rate changes on exports of modern services is 30-50% larger. They find this in a sample of 66 developing and developed economies and speculate that the currency impact for modern service exports is strongest (compared with merchandise and traditional services exports) because there is lower import penetration and a lower fixed cost of entry. This makes for a higher price elasticity of exports.

Links between trade in manufacturing and KES REER

The underperformance of the manufacturing sector has coincided with the large appreciation of the REER, at least until 2012. This suggests the appreciation and the volatility of the KES (in addition to

other determinants) negatively impacted Kenya’s competitiveness and could have come at the expense of its manufacturing and agricultural exports (Chege Mwangi et al., 2014; Kiptui, 2008; Musyoki et al., 2012). However, as Kiptui (2008) notes, the empirical evidence for Kenya is scant. The link between manufacturing and an uncompetitive exchange rate is not surprising or new – a poorly managed exchange rate can hamper growth; as Rodrik (2007) argues, avoiding overvaluation of a currency is one of the most robust imperatives that can be gleaned from the diverse experience with economic growth around the world. This suggests that some rebalancing would be beneficial (of course there are many other possible reasons behind manufacturing performance).

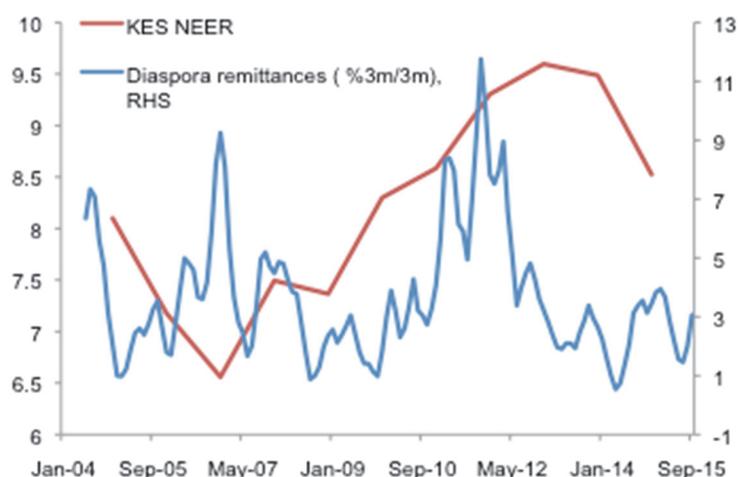
The culprit behind Kenya’s stagnant manufacturing sector could be the KES, but it is unlikely to be the only one. The recent drop in the REER reflects the NEER rather than a competitive shift in relative prices. One could conclude that long-term policies aimed at competitiveness and investment finance, rather than weakening the currency, would be preferable. Okado (2013) finds evidence that increases in manufacturing sector productivity would have an appreciable impact on Kenya’s manufacturing exports. Hausmann et al. (2004) find that fundamental economic reform (such as investment and openness to trade) make the difference between sustained and unsustainable growth accelerations. This advice is applicable to both Kenya and east Africa. Both show little discernible sign of industrialisation (AfDB, 2014).

Links between Kenya’s capital inflows and KES REER

As we highlight in Figure 8, capital inflows are an important determinant of a country’s exchange rate path and this channel is relevant for Kenya. Its FDI flows have largely been oriented to its service sector, particularly in greenfield investments in telecommunications (UNCTAD, 2015). However, Kenya’s FDI inflows have been curiously low compared with those of its neighbours, Uganda and Tanzania, with a reported 99.5% of its companies locally owned (AfDB, 2013); the high cost of capital and the weakness in the exchange rate have typically been cited as obstacles. Portfolio investment has constituted a significant inflow, both through in the domestic stock market and in foreign participation in sovereign bond issuance (Mwega, 2009)

It is difficult to determine the impact of Kenya’s other inflows on KES appreciation, largely because the inflows themselves are hard to measure. Diaspora remittance data published by the central bank show a faint link with the KES (Figure 28) at least during its appreciation between 2007 and 2014. Anecdotally, there is also evidence that proceeds of piracy in Somalia are laundered through investments in Kenya’s (and other regional economies’) real estate, transportation and hotel services, boosting domestic activity accordingly. However, there is little or no information to support a causal link between piracy and increased real estate prices, and remittances from the Diaspora have been far more influential in bolstering house prices (World Bank et al., 2013).

Figure 28. Kenya’s NEER and its remittance flows



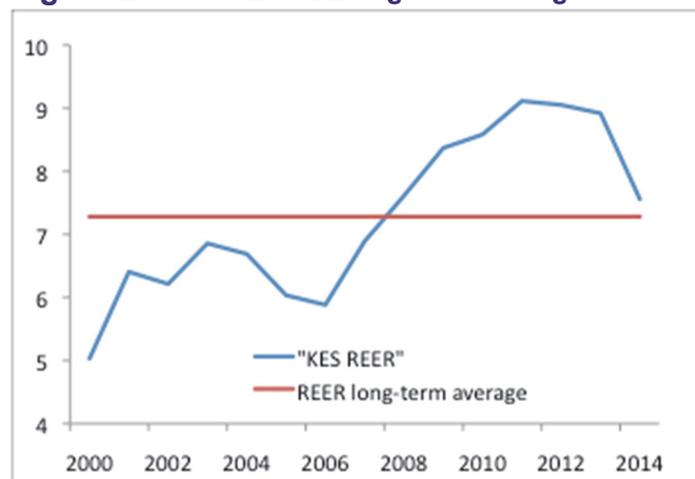
Source: Central Bank of Kenya.

3.6.3. Assessing the KES equilibrium value

Although the KES RER has appreciated significantly since 2000, its 16% decline over the 2013-2014 period, and its 16% decline in 2015 alone, suggests any overvaluation, or misalignment from its equilibrium value, is now smaller. A snapshot of the KES REER time series plotted against its long-term (10-year) average suggests some reversion to its longer-term average has taken place (Figure 29).

The realignment of the KES with its long-term value is consistent with the recent analysis by IMF that the KES is no longer overvalued. Earlier this year, the IMF announced that, at 5-10%, the overvaluation of the KES against the US dollar is moderate (Reuters Africa, 2015). It recommended in Kenya's recent Article IV consultation further rate rises to safeguard against further currency depreciation (IMF, 2014a).

Figure 29. The KES REER against its long-term value*



Note: *REERs are calculated using CPIs.

Source: WDI, ODI.

Although the KES REER now seems to be in line with its long-term average, it is still elevated relative to 2000. This could be problematic in light of Kenya's largely stagnant manufacturing sector. In this context, a key question is not only whether the current level of the KES reflects an overvaluation but also whether the KES equilibrium value itself has increased and constitutes a new equilibrium by economic fundamentals (but which hampers manufacturing).

There are a number of ways to gauge equilibrium exchange rates; key among these is the fundamental equilibrium exchange rate (FEER) approach (Wren-Lewis and Driver, 1998). The FEER estimate for the KES is the level of the exchange rate consistent with Kenya's economy maintaining both internal and external balance. Internal balance is defined as the economy growing at its potential growth rate and external balance is characterised by a sustainable current account.⁴² FEER calculations yield the KES adjustment necessary to return the economy to macroeconomic balance, in particular to return the cyclically adjusted current account deficit to its sustainable target.

The deterioration in Kenya's portfolio flows suggests the KES FEER and REER are both shifting lower. This owes to the fact that FEER estimates are sensitive both to changes in how the sustainable current account is defined and to the sensitivity of the sustainable current account target to changes in capital flows (Papadavid, 2013; Wren-Lewis and Driver, 1998). Factors pushing down the KES REER include the following:

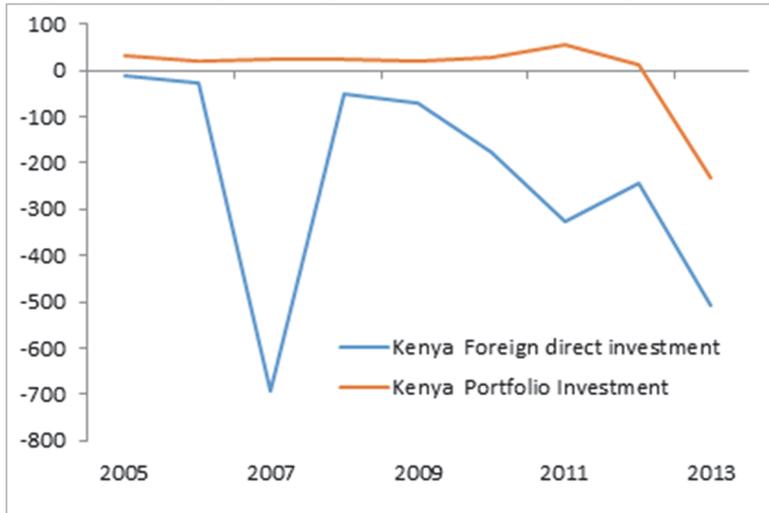
- The KES NEER is expected to depreciate further, resulting in a lower REER for the KES. The KES is an example of a currency that is a key transmission mechanism for cross-border financial shocks,

⁴² External equilibrium can be defined in multiple ways depending on the valuation framework employed. Here, we define it as having an underlying current account deficit that is funded by sustainable trend capital inflows. The external balance approach defines it as having a current account trajectory that is consistent with a stable net foreign asset position (Wren-Lewis and Driver, 1998).

similar to other emerging and developing market currencies (BIS, 2015). Shocks, such as a change in US monetary policy, can lead to shifts in capital flows and the KES undershooting.

- Continued portfolio investment and FDI outflows (Figure 30) will disturb Kenya's net foreign assets position in a sustained fashion, pushing both the KES REER and FEER trajectory lower. Outflows will trigger a larger-than-sustainable current account deficit, inducing both a KES overvaluation and a lower profile for the KES FEER.

Figure 30. Kenya's net portfolio and FDI flows (US\$ millions)



Source: WDI.

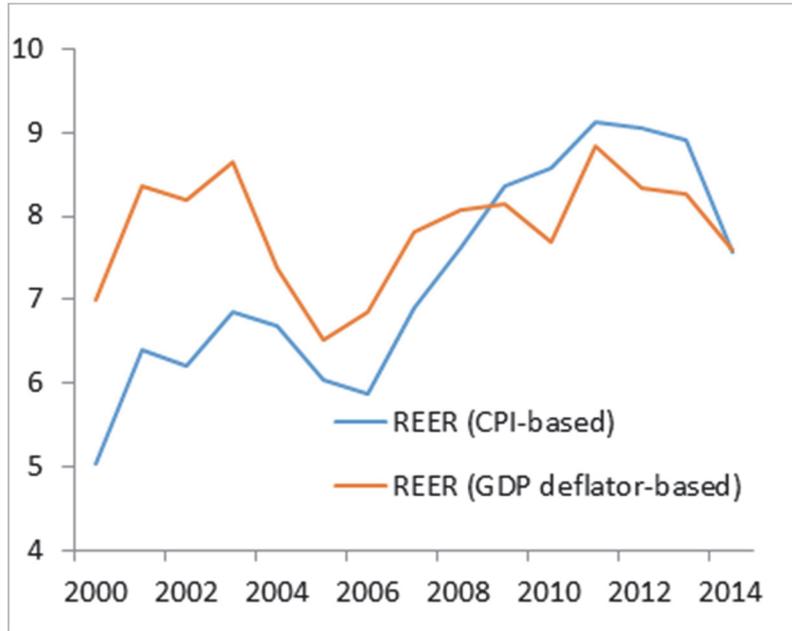
A lower REER trajectory could temporarily reduce Kenya's manufacturing trade deficit (via reduced imports and increased exports). However, the recent decline in the REER is unlikely to alleviate the Dutch disease-type effects that may have limited manufacturing sector growth. This is likely to be the case because:

- Rising borrowing costs will offset a weaker KES. With US interest rates expected to rise, the cost of borrowing in emerging and developing economies, including Kenya's, is likely to follow suit (Sinha, 2013); the Central Bank of Kenya has already increased its policy rate by 300 basis points to stabilise the KES.⁴³ Higher borrowing costs will hurt manufacturing enterprise and offset the impact of a weaker KES.
- A decline in the NEER, rather than a decline in relative prices, has accounted for the drop in the KES REER. Our calculations show the only significant price declines have been against Ethiopia (and to a lesser extent Burundi). The detailed splits of Kenya's CPI⁴⁴ also show broad-based increases (save for in the transport sector) contrasting with moderate inflation pressures in developed country trading partners. Relative trends in domestic GDP deflators also show limited declines in Kenya's prices, except when compared with its Sub-Saharan trading partners (particularly Burundi, Ethiopia and Uganda). Both CPI-based and GDP deflator-based REER calculations show a similar trend (Figure 31).
- A depreciating KES is helpful but not sufficient in stimulating Kenya's manufacturing sector. Increased cost competitiveness through declines in the KES need to be used as a complement to other policies that will generate broader competitiveness impacts (Turner and Van't dack, 1993) such as promoting innovation in Kenya's manufacturing sector.

⁴³ See <https://www.centralbank.go.ke/index.php/monetary-policy>

⁴⁴ See <http://www.knbs.or.ke>

Figure 31. Kenya's CPI-based and GDP deflator-based REER



Source: WDI, ODI.

3.6.4. Conclusion

Kenya's REER appreciated by a substantial 50% from 2000 to 2014, which has now been partly reversed by the 16% depreciation in 2015. Strong growth in services, particularly in Kenya's financial and transport sector, could have been an important driver. The expansion of Kenya's financial services sector has, in part, fuelled an inflationary expansion of money and credit, boosting the REER. Capital inflows have also played a role, particularly in greenfield FDI and remittances from the diaspora.

The KES does not look to be overvalued, given that it is now line with its long-term average. However, the significant factor to consider is that past KES strength has coincided with a stagnant manufacturing sector, and little growth in manufacturing exports. Although the evidence is not conclusive, it is likely that KES strength is one of multiple factors behind Kenya's lagging manufacturing sector. Past KES REER strength also coincided with a growing external imbalance driven by manufacturing imports.

Further KES depreciation will bring cost competitiveness. And yet a deeper adjustment in relative prices *vis-à-vis* its major trading partners (particularly relative to developed countries) is more urgent to restore competitiveness. This relative price adjustment has not been present in the data, with the NEER decline accounting for the drop in the REER. The public sector wage bill has been a key source of price pressure (IMF, 2014a), as have housing, health, utilities and food prices, according to the Kenya National Bureau of Statistics. This will limit scope to rebalance growth to include manufacturing.

3.7 Conclusion: the role of services in Kenya

In this concluding sector we bring together the analysis of the various services sectors in Kenya using the framework outlined in Section 2.3.⁴⁵

Table 8 shows that the services sectors in Kenya have different impacts on economic transformation, and that both direct and indirect effects matter. The direct impact in terms of jobs, exports or GDP is often limited, involving trade-offs (e.g. large export effects but few jobs created). A sector with a large contribution to GDP and exports (e.g. finance) has few direct job effects (and mainly for skilled workers) and may have negative effects through increased exchange rate appreciation. The ICT sector has relatively few direct effects on exports and jobs, but there are important effects on the whole economy through innovation and upgrading. The transport sector has a large contribution to GDP, but that in itself

⁴⁵ Separately we draw out a number of policy suggestions in the executive summary of this report.

masks the improvements that can be made (e.g. more efficient air and port services) for the sector to have a greater impact on the wider economy.

There are three main conclusions. First, it is important to consider different ways of assessing the role of services sectors in economic transformation, as focusing on direct impacts on productivity or jobs fails to appreciate the sometimes very important key long-term, indirect contributions of the sector. On the other hand, potentially large indirect effects may not tackle the jobs challenge in the short run. Different sectors can lead to very different effects solving different objectives.

Second, it is not enough to establish the different types of effects. The really important issue is how to improve the impact of the services sectors through appropriate policy. None of the important indirect effects is inevitable, and they depend on complementary policies and institutions. Building on services for promoting economic transformation would require complementary policies. Each of the above sections has provided a number of policy suggestions.

Third, there are important interactions among services sectors. An efficient and large financial sector requires an efficient and large ICT sector. Tourism depends on efficient transport. Therefore, it is important to address coordination failures in the development of service sectors.

Finally, Section 3.6 considered the links between service sector development, exchange rate dynamic and the goods sector. The Kenyan shilling has appreciated in real terms owing to cost pressures and the recent devaluation has led to a realignment of the shilling. However, some of the damage in the form of a weak manufacturing trade performance has been visible. The loss of manufacturing capacity may well have long-term consequences. In the future, it is important to hold the costs in check and this includes monitoring how services exports affect exchange rates and prices.

Table 8. The effects of selected services on economic transformation in Kenya

Sector	Direct effects			Indirect effects (static and dynamic)	Induced / productivity effects	Policy implications
	Jobs	Exports	GDP			
Tourism	4.1% of employment	Important export revenues	4.8% of GDP in 2013 according to WTTC Accommodation and restaurant is 1.4% of GDP	Very important. Total effect of sector is 12.1% of GDP and 10.6% of employment	Limited, but positive linkages with flower exports through air transport	Maximising gains from employment, e.g. through training; diversifying the sector; environmental and social management
Finance	Important esp. for skilled workers, but job intensity amongst the lowest of Kenya's sectors	Major source of exports and capital inflows	Financial and insurance services 7.4% of GDP; major growing sectors	Backward linkages to ICT sector	Important Dutch disease effects through exports and increased FDI	Need to improve real sector impact of financial hubs; complementary policies include macro-prudential regulation, labour market development, tax and subsidy rules
Information and communication	Important esp. for skilled workers	Potentially a major source of exports and capital inflows	Information and communication is 1.6% of GDP, but problems with data	Mostly forward linkages	Important productivity effects, e.g. m-Pesa	Need to improve entrepreneurship throughout economy to embrace effects of ICT, skills development, SME programmes, use of public procurement, geographical dispersion
Transport and storage	Potentially important (e.g. truck drivers)		Transport and storage is 8.3% of GDP	Port development and value chains	Important for economy wide productivity (corridor approach) Transport services could improve considerably	Improve competition in logistics services

4. Conclusions – what is the future of a service driven economic transformation?

Services have long been ignored in the debate on economic transformation. The theoretical literature dating back to Adam Smith featured an anti-services view of economic development. The empirical literature on growth in developing countries has also paid relatively little emphasis on services until recently.

The neglect of services is remarkable given that they clearly constitute an increasing share in GDP and employment. Perhaps part of the problem was that services used to be seen as following economic transformation, with demand increasing as incomes rise and services seen as being endogenous to a country's structural position. This paper, on the other hand, is urging a supply-side view, whereby services can lead economic transformation, through direct and/or indirect effects, depending on the services sector. There is a lot of evidence to support this view, but it is important to differentiate among services sectors.

An up-to-date view of services considers their role in creating indirect and second-order productivity effects. For example, ICT and financial services make companies more productive, safeguarding jobs, and have been an engine behind developing country growth. Other services, such as tourism, create a lot of jobs. This view is very different from an undifferentiated static view in which some services sectors are seen as productive, creating few jobs (Rodrik, 2015a) and therefore provide no new way forward. In fact, value chains of agriculture and manufacturing products only really develop once services are being developed, suggesting we need to look somewhere entirely different when considering the role of services in economic transformation: how services productivity affects manufacturing and agriculture productivity. We have provided some references in this regard but more needs to be done.

Our work has provided further insights into this, generally, as well as more specifically in the case of Kenya. Generally, we have shown how services are an increasing share in value addition in exports, suggesting services are directly important for economic transformation. In the case of Kenya, we have shown how different services contribute differently to growth and jobs. The traditional view would be to exclude ICT or financial services from consideration on the grounds that they are not sufficiently job-creating, but in a more correct way we would take into account how services could be promoted to increase linkages with manufacturing or agriculture, through for example better transport or financial services, and this in turn safeguards jobs elsewhere.

A proper account of the role of the services sector should consider the links between services sector development, exchange rate dynamic and the goods sector. The Kenyan shilling has appreciated in real terms owing to cost pressures and the recent devaluation has led to realignment. However, some of the damage in the form of a weak manufacturing trade performance has been visible. The loss of manufacturing capacity may well have long-term consequences. In the future, it is important to hold the costs in check, and this includes monitoring how services exports affect exchange rates and prices.

This analysis has the following implications. We need to:

- Examine the role of services in economic transformation in greater depth;
- Differentiate among services sectors and different assessment channels, including direct, indirect and productivity effects, and exchange rate impacts;
- Revisit the manufacturing–services distinction and re-examine the link between services and other sectors in a more disaggregated manner.

Neglecting a sector in the development process can hold back growth. Balanced growth, achieved by emphasising linkages among sectors, is, after all, a good idea.

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