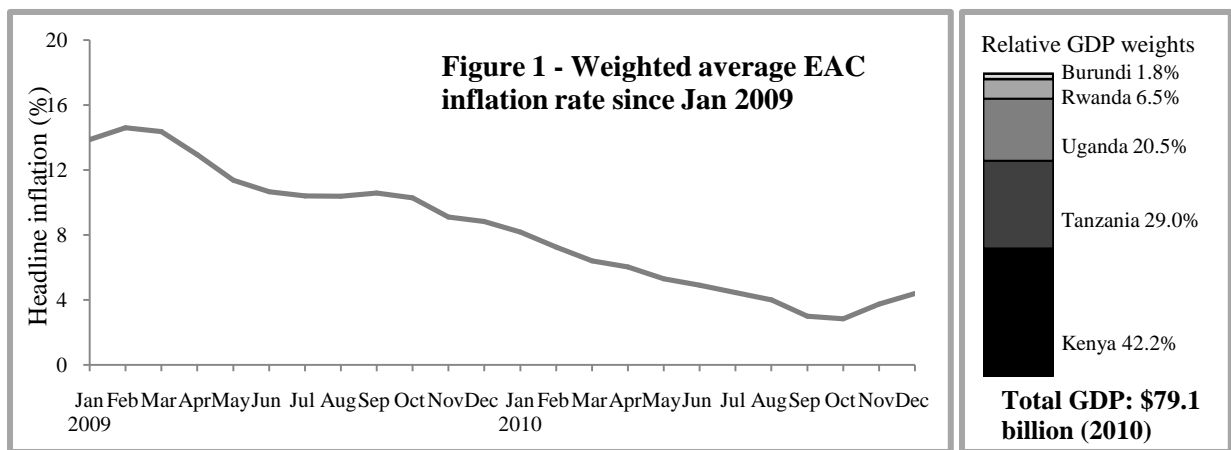


Inflation in the East African Community

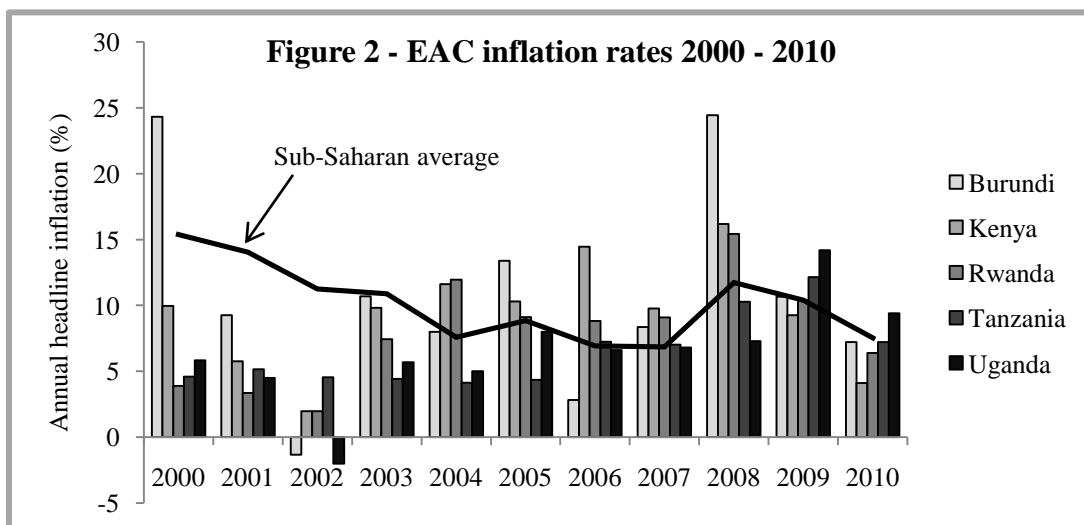
January 2011

1. Introduction

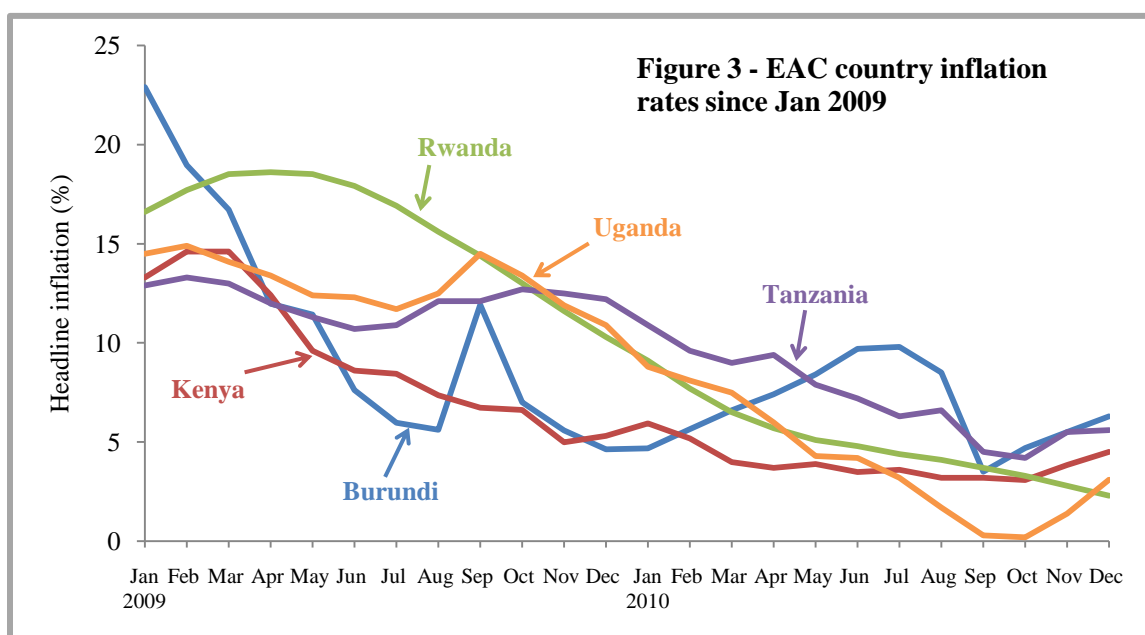
After seven consecutive quarters of declining inflation, prices in the EAC region began to rise more quickly over the last quarter of 2010. In December 2010, the weighted average headline rate for the region was 4.4 percent. This is down from the recent peak of 14.6 percent in February 2009, but up from 3.0 percent in September 2010.



The reasons for the previous high inflation are numerous and have been covered in detail in previous reports. The primary cause had been the global commodity price spikes of 2008 that drove up food and fuel prices. Poor regional weather conditions (drought) and the after effects of the global financial crisis also contributed to a jump in inflation in 2008 both in the EAC and across Sub-Saharan Africa. Inflation has since begun to decline once again.



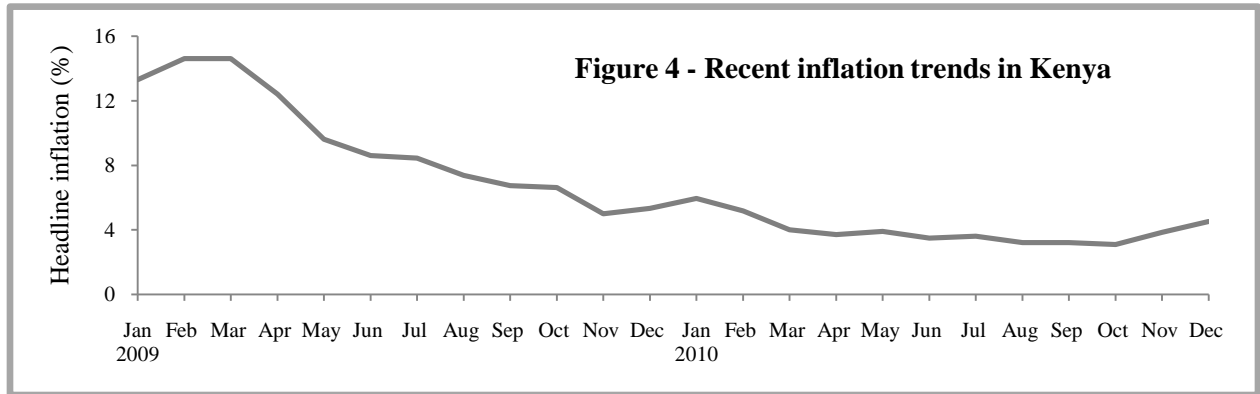
An individual country level analysis shows how each of the EAC member states managed declining inflation during 2009 and 2010. All countries started 2009 with double digit inflation and all ended 2010 with a rate of less than 6.5 percent. The three largest economies in the region – Kenya, Tanzania and Uganda – all experienced a gradual decline followed by a slight upswing in inflation in the last quarter. In Rwanda, inflation continued to decline gradually over seven quarters. Burundi remained the outlier for the region as headline inflation increased for the first half of 2010, dipped to 3.5 percent in September then rose to 6.3 percent by December.



	Mar-09	Jun-09	Sep-09	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
Burundi	16.7	7.6	11.9	4.6	4.7	5.6	6.6	7.4	8.4	9.7	9.8	8.5	3.5	4.7	5.5	6.3
Kenya	14.6	8.6	6.7	5.3	6.0	5.2	4.0	3.7	3.9	3.2	3.6	3.2	3.2	3.1	3.8	4.5
Rwanda	18.5	17.9	14.4	10.3	9.1	7.7	6.5	5.7	5.1	5.0	4.4	4.1	3.7	3.3	2.8	2.3
Tanzania	13.0	10.7	12.1	12.2	10.9	9.6	9.0	9.4	7.9	7.2	6.3	6.6	4.5	4.2	5.5	5.6
Uganda	14.1	12.3	14.5	10.9	8.9	8.1	7.5	5.9	4.3	4.4	3.2	1.7	0.3	0.2	1.4	3.1

2. Country-specific analyses

2.1 Kenya



Over the past quarter, inflation in Kenya began to increase again after having been on a downward trend for most of 2010. At the end of the year, headline inflation in East Africa's largest economy stood at 4.5 percent.

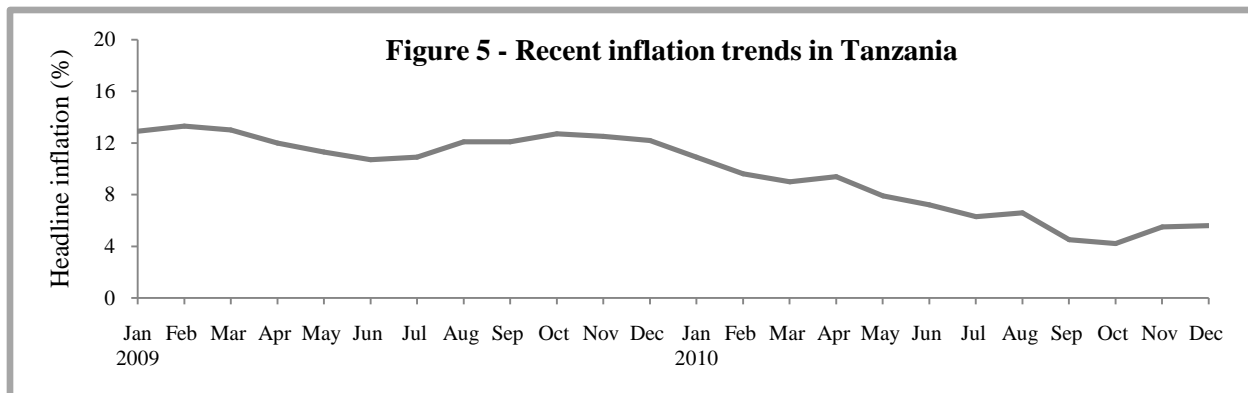
Inflation had previously fallen from a peak of 31.5 percent in May 2008 due to a gradual recovery from temporary price shocks associated with post-election violence, drought and high international commodity prices.

In recent months, inflationary pressure has been caused by increasing food and fuel prices. As food crop prices have edged up on international markets, domestic prices have also been forced up by the twin factors of dry weather (which restricts supply) and the holiday season (which expands demand).

Prices of food and non-alcoholic beverages, which comprise 36 percent of the CPI basket, were 7.8 percent higher in December 2010 than in December 2009. The increases were particularly pronounced for beef, milk and cooking fat. Similarly, increased prices of fuels such as kerosene and cooking gas had both a direct effect (by edging up the Housing, Water, Electricity, Gas and Other Fuels index) and an indirect effect (through increased transportation and business costs).

The impact of price wars in the telecommunications market continues to be seen. The communications index in December 2010 was down 23.4 percent on the same stage in 2009.

2.2 Tanzania



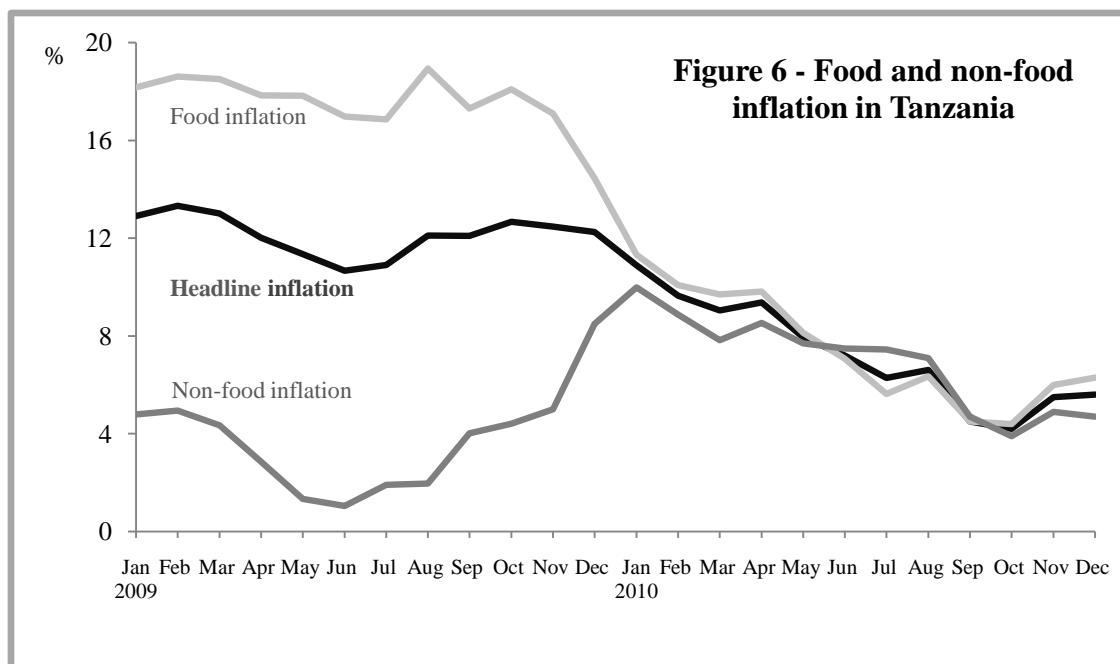
As of November 2010, headline inflation in Tanzania was once again above the target 5 percent level. After having fallen from 12.2 percent in December 2009 to 4.2 percent in October 2010, there was an upturn in the last two months of the year to 5.6 percent in December.

Tanzania altered the way that inflation was measured from October 2010. Inflation is now averaged using a geometric mean approach, in line with the techniques recently introduced in Kenya, Uganda and Rwanda. The rebased National Consumer Price Index (NCPI) now includes both rural and urban households (the previous measure was urban-only) and gives a lower weighting to food items.

OLD INDEX	
Food	55.9
Transportation	9.7
Fuel, Power and Water	8.5
Drinks and Tobacco	6.9
Clothing and Footwear	6.4
Education	2.6
Personal Care & Health	2.2
Household Operation & Maintenance	2.1
Furniture & Household Equipment	2.1
Miscellaneous Goods & Services	1.4
Rents	1.4
Recreation & Entertainment	0.8
TOTAL	100

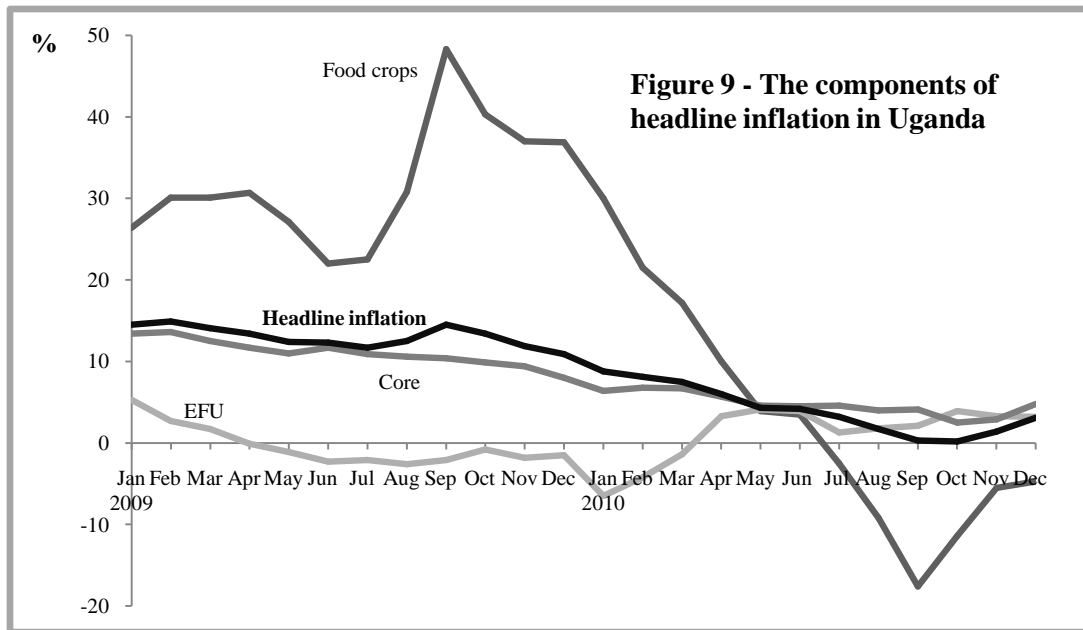
NEW INDEX	
Food and Non Alcoholic Beverages	47.8
Transport	9.5
Housing, Water, Electricity, Gas and Other Fuel	9.2
Clothing and Footwear	6.7
Furnishing, Housing Equipment and Maintenance	6.7
Restaurants and hotels	6.4
Miscellaneous goods and services	4.5
Alcoholic and Tobacco	3.3
Communication	2.1
Education	1.7
Recreation and Culture	1.3
Health	0.9
TOTAL	100

Although the importance of food prices in the inflation basket has decreased slightly, these remain the driving force behind changes in the NCPI. Food inflation in December 2010 was 6.3 percent, compared to 4.7 percent for non-food items.



Over the past quarter, the declines in both food and non-food price inflation have been arrested and prices have begun to increase again at a slightly faster rate. Food and non-food prices appear to be still moving largely on track with each other, although the rate of inflation in food prices remains slightly above that of non-food items.

All indicators suggest that inflation is likely to remain on its upward trajectory in the coming months. The failure of the short rains at the end of 2010 meant that harvests were poor countrywide and a lack of food supply will build inflationary pressure. Even under the new inflation-measurement regime, food products make up a far greater proportion of the CPI bundle than in Kenya and Uganda, and so Tanzanian headline inflation will be more exposed to these likely price rises. The effect can already be seen; the food and non-alcoholic beverage index increased by 2.6 percent in December alone. In addition, the pass through of increased energy costs to transport and utilities will place upward pressure on inflation.



The General Election, to be held in Uganda in February 2011, will potentially create some inflationary pressures in the country. Government spending traditionally increases around the time of an election which will create upward pressure on inflation. In addition, increased demand for dollars will place downward pressure (depreciation) on the exchange rate.

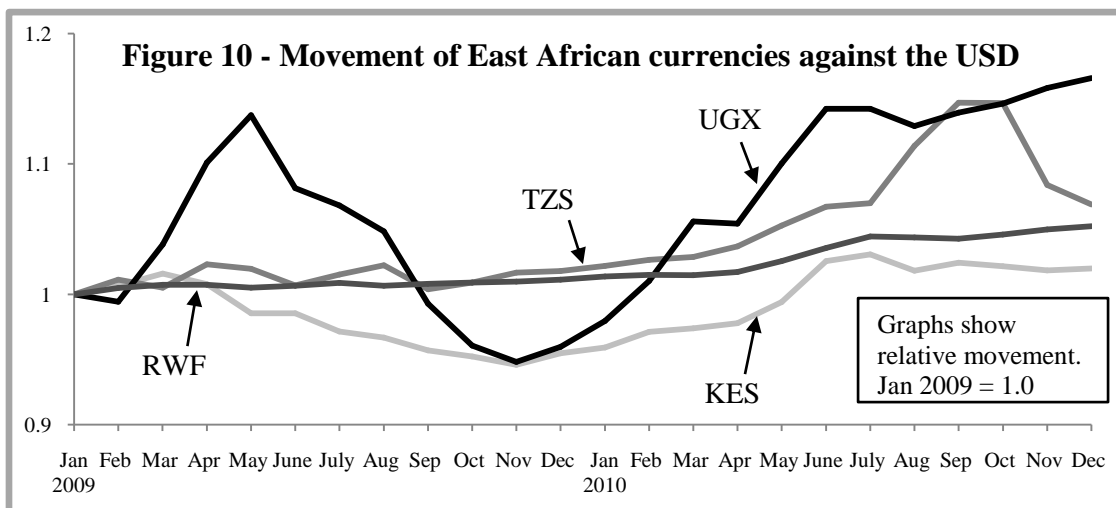
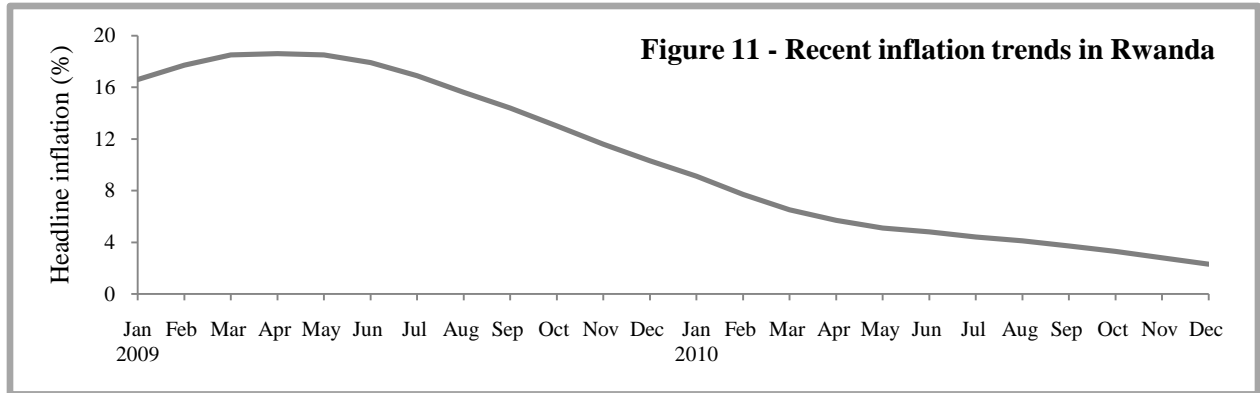


Figure 10 shows how over the last two years, the Ugandan Shilling has depreciated more against the dollar than any of the other three major regional currencies. It is unlikely that much more pressure can be released through the exchange rate, and hence inflation and/or interest rates would have to rise.

2.4 Rwanda

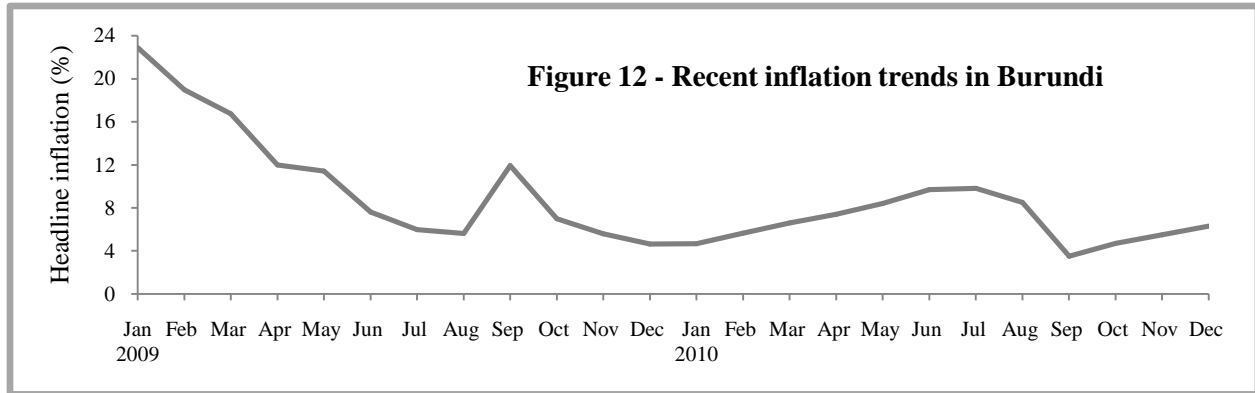


Rwandan inflation continued on its downward trajectory over the quarter, reaching 2.3 percent in December 2010. The general index of prices was down 2.5 percent over the quarter and 6.5 percent for 2010.

The declining prices were mainly seen in the food and non-alcoholic beverages sector, which accounts for 54.2 percent of the CPI basket. Prices of vegetables were 12.7 percent lower in December 2010 than three months earlier (though this is largely a reaction to the 13 percent increases seen in the previous quarter). Bread and cereals prices were also well down over the year. Good agricultural performance and favourable weather conditions for most of the year were the major force behind these price declines, as increased supply drove down prices in the markets. Increased regional integration also helped, as prices of imports from the EAC region fell.

In addition to the region-wide supply side pressures on inflation over the coming year (poor weather conditions and fuel price increases), Rwanda is also likely to see a rebound in demand-pull inflation. This is because the sustained low inflation environment has encouraged a relaxed monetary policy aimed at promoting employment and growth. Broad money is expected to increase by 13.8 percent in 2011 against 12.9 percent in 2010. This will help deepen the financial sector but is also likely to be inflationary. The headline rate is expected to rise to 4 percent by the end of Q1 2011.

2.5 Burundi¹



Over the past quarter, inflation in East Africa's smallest economy has again started to increase, from 3.5 percent in September to 6.3 percent in December 2010. Headline inflation in Burundi, which previously peaked at 26 percent in 2008, fell steadily over 2009 to 4.6 percent in December 2009. Since then, it crept up again over the first half of 2010 before a steep decline in the third quarter on the back of lower housing, water and energy costs.

The main driver of the recent rise in inflation in Burundi has been increased fuel prices which have been passed through to higher transport costs. The transport index, though only 5.3 percent of the CPI basket, rose by 4.2 percent in the year to December 2010.

The housing, water and energy index also rose significantly over the quarter, also reflecting the increase in fuel prices.

3. Regional inflation outlook

A number of leading indicators suggest that inflation in EAC countries will increase over the course of 2011.

3.1 Regional weather patterns

The failure of the short rains in November and December across the East Africa region is already showing in the December inflation figures and will be more pronounced in the New Year. A worse than expected harvest in the new year will restrict the supply of food crops to the markets, drive up prices for primary goods and be passed through to manufactured products.

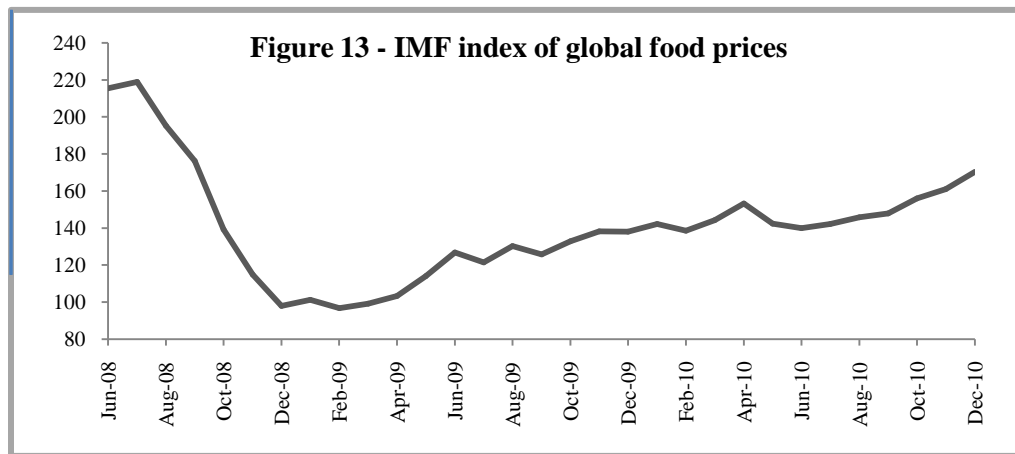
With the increased economic integration within the East Africa region, localised weather problems can potentially have regional effects. The opening of a common market means that trade, and particularly food crops, flow more freely across the region. The effect of a food

¹ Inflation measures for Burundi should be at best be seen as best guesses. The expenditure weights in the CPI come from a 1991 household expenditure survey and have not been updated since. The survey only covers Bujumbura and so agricultural data is inadequate. No producer price index is compiled.

shortage is therefore likely to be less pronounced in the immediate area but more pronounced in the surrounding regions; the inflationary pressure is spread over a wider area.

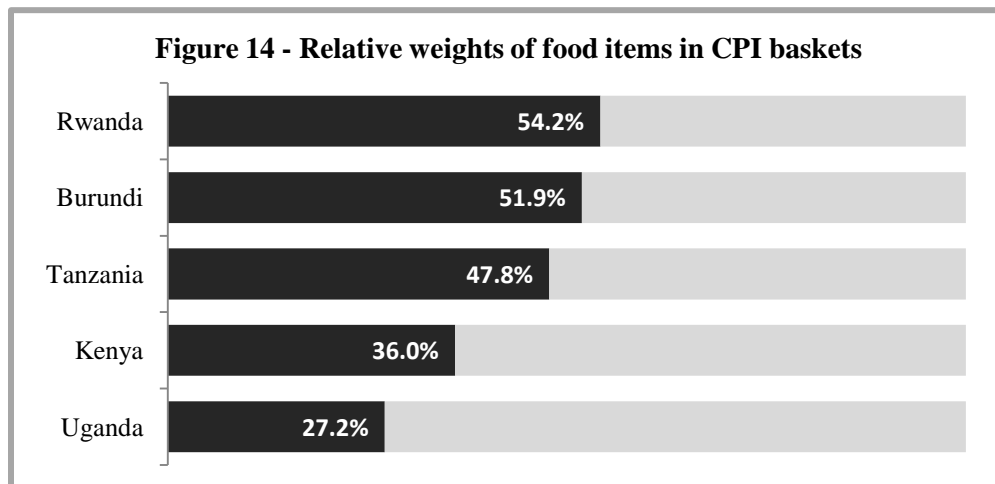
3.2 Global food prices

Global food prices have crept up over the past two years after a steep decline that followed the price spike seen in mid-2008. Prices in December 2010 were at their highest point since September 2008.



This trend has roots both on the demand and the supply side. A rapidly growing global population is demanding ever-increasing amounts of food, a phenomenon driven by a growing appetite for meat products in developing countries. Supply side shocks, such as recent natural disasters in Russia, Pakistan and Australia, can cause supply-side price spikes that have lasting effects.

It is possible to see the high importance of food price rises in EAC inflation by looking at the relative importance of food items in the CPI baskets.

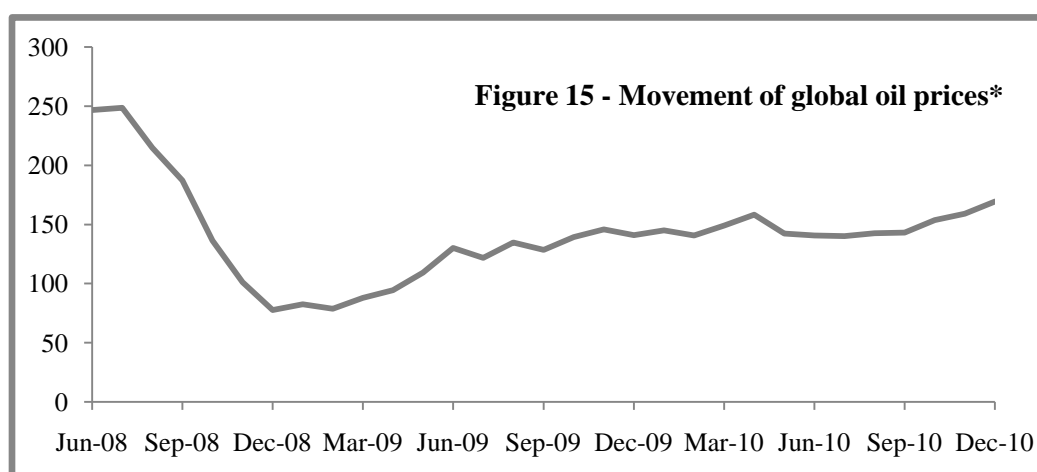


Uganda attaches the least weight to food items when assessing CPI, giving around a quarter of the basket to food items. In Burundi and Rwanda the proportion is more than half.² CPI baskets with high weights for food items are highly responsive to increases in global food prices, which is indicative of a causative relationship between global food prices and inflation in EAC countries.

3.3 Oil prices

Rising oil prices have also had significant impact inflation, primarily by raising transport and manufacturing costs.

After global oil prices rose steadily to a peak in mid-2008, prices plummeted as the credit crunch began to bite. Prices gradually rose again through 2009 before levelling off for the first three quarters of 2010. The index as of December 2010 was more than double the level at December 2008 and 20 percent higher than in December 2009.



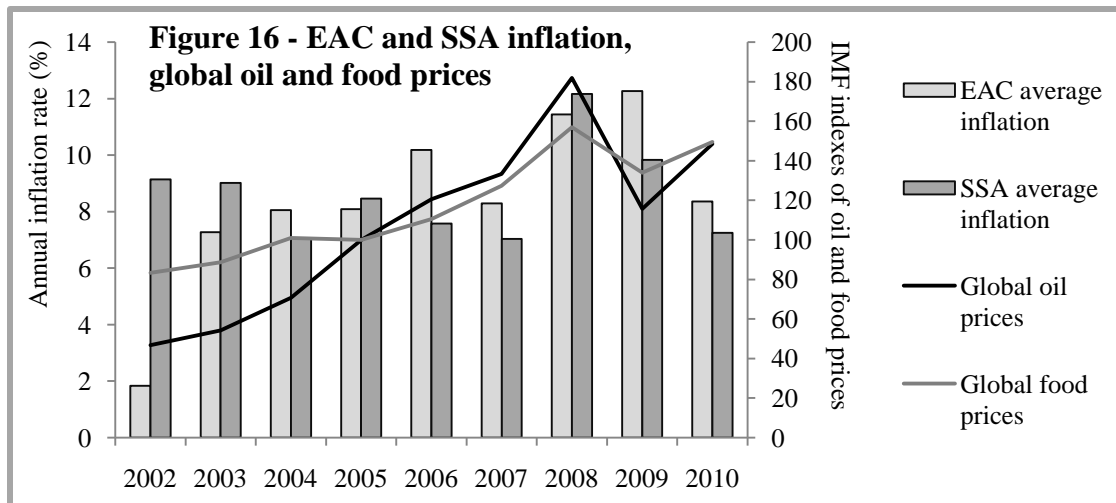
*IMF index averaging U.K. Brent (light), Dubai (medium), and West Texas Intermediate (heavy) oil, equally weighted (US dollars per barrel)

A rise in oil prices has both short term and long term effects on inflation. In the short run, increased fuel prices push up CPI and create an upward spiral in prices and wages. Over the longer term, second round effects become significant. As increased oil prices eat into consumers' disposable incomes, profits fall, growth falls and inflationary pressures ease.

Fluctuations in oil prices also pass through to inflation via the exchange rate: if a domestic currency has to depreciate to compensate for higher oil prices, exports will become cheaper and imports more expensive leading to further inflationary pressure.

The impact of commodity price rises over the past few years can be seen in figure 14 below.

² Full details of CPI weights can be found in the appendix to this paper



It is clear that the increases in global commodity prices in the years up to the 2008 peak helped to pull up inflation both in the EAC and Sub-Saharan Africa as a whole. As oil and food prices bounced back in 2010, the pass through to inflation rates in EAC countries (which are net importers) is likely to be seen throughout 2011.

4. Conclusion

Inflation is on the rise across the region. Over the past quarter, two EAC economies (Burundi and Tanzania) edged above the 5 percent level for headline inflation. This is significant because 5 percent is the threshold set for access to the proposed East African Monetary Union (EAMU). Single digit inflation has been fundamental to the rapid economic growth achieved in East Africa over the past two decades. It is therefore critical that inflationary pressures aren't allowed to force prices out of control.

Inflation in the region fell throughout most of 2010 largely as a natural response to the spike in inflation caused by global commodity prices, the global financial crisis and poor regional weather conditions in 2008 and 2009. It is likely that the full effects of these crises have now been felt. Price increases over the past quarter reflect a gradual incline in global food and commodity prices which pass through to a significant proportion of CPI baskets across all countries in the region. The failure of the short rains has had some impact on the data but the effect will be stronger in the New Year, particularly if the much-needed long rains fail to materialise in March 2011.

The external environment will also affect the performance of inflation in the region. Inflation is on the rise in developing Asia, which is an increasingly important trading partner for East Africa. Increased prices in China will pass through to inflation in East Africa through rising prices of imported goods. Similarly, while economic activity in the EU (East Africa's largest export market) remains subdued, a pickup in the speed of recovery will also put pressure on local prices.

APPENDIX – Relative weights in CPI baskets

Burundi	
Food	51.9
Clothing	5.3
Accommodation and heating	27.0
Household items	4.9
Health	2.0
Transport and communication	5.3
Education	1.9
Other goods and services	1.7
	100

Rwanda	
Food and non-alcoholic beverages	54.2
Alcoholic beverages and tobacco	3.6
Clothing and footwear	3.6
Housing, water, electricity, gas and other fuels	15.9
Furnishing, household equipment and maintenance	3.4
Health	1.3
Transport	6.9
Communication	1.3
Recreation and culture	1.6
Education	2.0
Restaurants and hotels	3.4
Miscellaneous goods and services	2.9
	100

Uganda	
Food	27.2
Beverages and tobacco	4.7
Clothing and footwear	4.4
Rent, Fuel and utilities	14.8
Household and personal goods	4.5
Transport and communication	12.8
Education	14.7
Health, entertainment & others	16.8
	100

Kenya	
Food & Non-Alcoholic Beverages	36.0
Alcoholic Beverages, Tobacco & Narcotics	2.1
Clothing & Footwear	7.4
Housing, Water, Electricity, Gas and other Fuels	18.3
Furnishings, Household Equipment and Maintenance	6.2
Health	3.1
Transport	8.7
Communication	3.8
Recreation & Culture	2.3
Education	3.1
Restaurant & Hotels	4.5
Miscellaneous Goods & Services	4.5
	100

Tanzania	
Food and Non Alcoholic Beverages	47.8
Alcoholic and Tobacco	3.3
Clothing and Footwear	6.7
Housing, Water, Electricity, Gas and Other Fuel	9.2
Furnishing, Housing Equipment and Routine Maintenance of the House	6.7
Health	0.9
Transport	9.5
Communication	2.1
Recreation and Culture	1.3
Education	1.7
Restaurants and hotels	6.4
Miscellaneous goods and services	4.5
	100