Manufacturing resilience and sustainability strategy: Priority Policy Toolkit

Executive Summary

September 2020
The COVID-19 pandemic, which was primarily a health crisis, has caused a momentous global economic crisis worse than the global financial crisis of 2008-2009. The International Monetary Fund (IMF) projects that the world economy will grow at an average of -4.9%. The pandemic has devastated balance sheets of households and businesses, and induced strong precautionary behavior with the net effect being reduced consumption. Initial policy responses by countries across the globe were nearly identical and mainly involved expansionary fiscal and monetary policies. The main focus included protecting workers and businesses through tax cuts, loans at low interest rates and paying pending bills such as VAT refunds.

Initial policy prescriptions were premised on the assumption that COVID-19 will be contained in a few months. The reality is different. It is evidently clear that the pandemic’s challenge will be a new normal going forward. Therefore, a post COVID-19 future must be informed by this reality. It is imperative for policymakers to pause and take stock of what it will take to assure robust recovery. In addition, as the government eases lockdowns or even lifts them in the future, policy focus must shift towards supporting sustained recovery. This will require policy measures designed in such a manner as to limit the pain of adjustment while preserving productive jobs and businesses. Effective demand is also pivotal in ensuring speedy recovery.

According to the United Nations Department of Economic and Social Affairs (UNDESA), “the pace and sequence of recovery from the crisis will largely depend on the efficacy of public health and fiscal measures, containing the spread of the virus, minimizing risks of reinfection, protecting jobs and income and restoring consumer confidence.” There is general consensus amongst analysts and policymakers that policies in the post COVID-19 lockdown phase should target four broad thematic areas:

1. The health emergency must continuously be addressed by ensuring adequate supplies of personal protective equipment (PPE) and increasing capacities of hospitals. Sudden surge in reinfections cannot be ruled out. This is also a forward-looking approach because, with climate change, such pandemics cannot be ruled out in the future.

2. Liquidity of businesses should be supported. Demand will likely be subdued for an extended period of time even if the pandemic is finally contained.

3. Mechanisms should be created to ensure that links between businesses and workers are maintained even if workers are not engaged at all. This will allow a quick restart once businesses resume full operations. This can be in the form of an insurance scheme.

4. The crisis can be viewed as an opportunity by both the government and businesses. For government, it is an opportunity to rethink the current economic model with a view to aligning it to the “new world” that the pandemic is creating. In particular, the need to diversify and exploit emerging opportunities such as component manufacturing, development of agro-industry value chains, and shortening of supply-chains. This is also important to reduce exposure to external shocks. For businesses, they have to retool and reconfigure business models based on the emerging realities. Businesses will require government support. Clearly, fiscal space is required and must be created.
The global outbreak of the COVID-19 pandemic has resulted in an economic downturn as countries continue to grapple with the adverse health and economic effects of the pandemic. The pandemic has led to a contraction of the global manufacturing output due to reduced consumer demand and global supply chain disruptions as countries put in measures to contain the spread of the coronavirus.

In Kenya, the pandemic has had far reaching implications in the manufacturing sector as reflected in the survey on ‘The impact of Covid-19 on the manufacturing sector in Kenya’ conducted by the Kenya Association of Manufacturers (KAM) in collaboration with KPMG. From the survey findings, manufacturers experienced a significant reduction in output, increased liquidity and logistics challenges, and a reduction of their workforce. The impact was felt more among Micro, Small and Medium Enterprises (MSMEs) compared to large enterprises.

Against this backdrop, a policy toolkit has been developed to aid in charting forward the growth, development, and resilience of the manufacturing sector to attain the 15% contribution to Kenya’s Gross Domestic Product (GDP) as envisioned by the Big Four Agenda. The toolkit highlights overarching interventions needed to aid in the recovery of the manufacturing sector and economy, as businesses try to navigate different challenges brought about by the pandemic. The interventions include:

— Flattening the COVID-19 epidemic curve to slow down the spread of the coronavirus.
— Nurturing nascent and emergent business opportunities uncovered by the COVID-19 pandemic.
— Adopting a “do-no-harm” principle by government while intervening in the market by conducting a regulatory audit with the aim of creating a supportive regulatory environment in Kenya as well as deferring any tax policies that will increase the burden to taxpayers.
— Supporting Small and Medium Enterprises (SME) development through provision of affordable credit.
— Increasing the resilience of the manufacturing sector by ensuring long term policy stability, improving the ease of doing business and developing regional value chains to minimize exposure from external shocks.
— Setting up an unemployment insurance fund to pay benefits to covered workers who become involuntarily unemployed and meet specified eligibility requirements, to cushion them in times of unemployment.
— Creating fiscal space by rationalizing government expenditure through operationalization of the public investment management guidelines.

By taking these and other robust actions into account, stakeholders in the manufacturing sector will be in a position to better build business resilience plans and policies, prioritize their workers, monitor potential pain points, and implement measures to stay resilient during this crisis and beyond.
**Introduction**

The advancement of globalization ushered in a new era of manufacturing with much of the industrial production pattern shifting to global value chains. This has led to the emergence of China, the US, and Europe as core global value chain hubs as reflected in their contribution to the global Manufacturing Value Added (MVA) as shown in Table 1.

The COVID-19 pandemic has resulted in value chain disruptions as factories worldwide have curtailed production and/or shut down to contain the spread of the virus leading to a reduction in global manufacturing output.

**Global context**

Global manufacturing has experienced a reduction with output declining by 6.9% (Q4 2019 – Q1 2020).1 The reduction in global outputs is largely attributed to lockdown regulations that were put in place to contain the transmission of COVID-19, US-China trade tension, and uncertainties around Brexit. China experienced the biggest drop in manufacturing outputs of 18.1% between Q4 2019 to Q1 2020.

Similarly, other regions have witnessed a decline in their manufacturing output with Africa registering only a slight drop of 0.4% between Q4 2019 and Q1 2020. However, it is worth noting that the drop does not capture the full impact that the COVID-19 pandemic has had on the sector, which was more felt in Q2 2020. Manufacturing output in East Asian economies rose marginally by 0.7% compared to Q4 2019.

<table>
<thead>
<tr>
<th>Share in world MVA (2015)</th>
<th>Compared to Q4, 2019</th>
<th>Compared to Q1, 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>100</td>
<td>-6.9</td>
</tr>
<tr>
<td>Industrialized Economies</td>
<td>56.5</td>
<td>-1.4</td>
</tr>
<tr>
<td>North America</td>
<td>19.4</td>
<td>-1.7</td>
</tr>
<tr>
<td>Europe</td>
<td>22.4</td>
<td>-2.6</td>
</tr>
<tr>
<td>East Asia</td>
<td>13.4</td>
<td>0.7</td>
</tr>
<tr>
<td>China</td>
<td>27.7</td>
<td>-18.1</td>
</tr>
<tr>
<td>Africa</td>
<td>1.4</td>
<td>-0.4</td>
</tr>
<tr>
<td>Asia &amp; Pacific</td>
<td>7.6</td>
<td>-2.5</td>
</tr>
<tr>
<td>Latin America</td>
<td>4.8</td>
<td>-2.5</td>
</tr>
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Kenyan context

Manufacturing sector contribution to Kenya’s Gross Domestic Product (GDP) has been on a declining trend, dropping from 11% in 2012 to 7.5% in 2019 as shown in Figure 1. However, value added by the sector has increased from Ksh. 469 billion in 2012 to Ksh. 734 billion in 2019. The increase in value addition has been largely supported by activities in agro-processing.

The value of manufactured exports has remained constant over the recent period as the sector’s output increased. In turn, the value of manufactured exports as a share of manufacturing output has been declining from a high of 37% in 2012 to 23% in 2018 as shown in Figure 2. This indicates that a large portion of the manufactured goods is consumed in the domestic market. The declining trend contrasts with a projected increase in value of manufactured exports as a share of manufacturing output from 23% in 2017 to 36% in 2018 and ultimately 55% in 2022 as per the National Export Development and Promotion Strategy\(^2\).

Figure 1: Trend in value added in the manufacturing sector and sector’s contribution to GDP, 2012-2019

\(^2\) http://www.trade.go.ke/sites/default/files/NEDPS_Integrated_Strategy_1.pdf

According to the KAM-KPMG survey\(^3\) conducted in May 2020, 53% of the surveyed manufacturers were operating below 50% production capacity during the COVID-19 period as compared to 8% of respondents that were operating below 50% production capacity before COVID-19. This was due to temporary shutdown of production plants or reduction in operational capacity given the reduced demand for goods and services during the crisis.

Persisting challenges affecting manufacturing sector and emerging issues from COVID-19 pandemic

Persisting challenges

1. Continued uncertainty about the future economic environment because of increasing transmission of the coronavirus. Consequently, manufacturers are still facing low domestic demand for their products and reduced risk appetite of commercial banks to offer credit to manufacturers.

2. Unpredictable policies from the Government particularly on taxation as evidenced in the Tax Laws Amendment Act 2020 and the Finance Act 2020, for example, introduction of minimum tax, 14% VAT on plant and machinery, staggering of the investment deduction, removal of pharmaceutical products from VAT zero rate status to VAT exemption, and withdrawal of the electricity rebate program, among others.

3. Slow responsiveness from regulatory agencies in approving innovations from local manufacturers. For example, lack of standards for medical ventilators has hindered commercialization of innovations, and undermined manufacturers’ efforts to diversify production.

4. Slow implementation of interventions already pronounced by the Government, for example, operationalization of the Buy-Kenya-Build-Kenya (BKBK) strategy and the SME credit guarantee scheme.

5. Unfair/unlevel playing field between locally manufactured goods and imported ones.

6. Low productivity.

7. Lack of procurement of locally manufactured products by the government and, in some cases, preference for imported products. For example, procurement of PPEs for the public healthcare system.

Emerging opportunities

In the midst of the COVID-19 pandemic, manufacturers within KAM membership noted the following opportunities:

1. Manufacture and supply of medical equipment, for example, protective personal equipment.

2. Investments in adopting new technology, for example, computer hardware, internet connectivity, home and office furniture.

3. Increased attention to developing local value chains to reduce dependence on imports including component manufacturing in automotive, electronics, pharmaceutical and plastics.

Conclusion and overarching policy interventions

The initial policy interventions were based on the assumption that the novel COVID-19 pandemic was a short-term disturbance, but it is increasingly becoming evident that living with the virus is the new normal. Policy interventions adopted by countries have been almost identical and only differing in magnitude/size. Widespread lockdowns were initiated to contain the virus followed by measures to protect vulnerable workers and businesses through a mix of monetary and fiscal policies. Kenya has been incrementally easing lockdown measures thus policy interventions should be geared towards supporting recovery. There is also broad consensus by analysts that normalcy cannot return until the pandemic is defeated. More precisely, containing the pandemic is a stimulus program in its own right. The virus is a major cause of uncertainty. Failure to reduce uncertainty will induce more precautionary saving behaviour by households, businesses will hold on to their investments due to anxiety about the future, while banks may lack creditworthy borrowers and therefore hold on to their excess liquidity. This will directly affect overall consumption and reduce demand for manufactured goods. Flattening the COVID-19 pandemic curve to slow down the spread of the coronavirus is the key determinant of the speed of economic recovery.
<table>
<thead>
<tr>
<th>Proposed intervention</th>
<th>Comments</th>
<th>Key stakeholder group</th>
<th>Time horizon</th>
</tr>
</thead>
</table>
| **Flattening the curve** | - The two levels of government should enhance the capacity of health facilities to conduct COVID-19 tests, and public health officials to undertake contact tracing expeditiously to reduce the transmission rate in the country.  
- Map-out high-risk areas that can aid the spread of the virus and intervene as appropriate.  
- Reduce COVID-19 related compliance cost to facilitate manufacturing production locally. | - Ministry of Health  
- County Governments | Short term (3-6 months) |
| **Circular Economy** | - Localize and implement SDG Goal no. 12 on Responsible Production and Consumption under the circular economy.  
- National Environment Management Authority  
- KAM | Medium term (6-12months) |
| **Nurturing nascent and emergent business opportunities uncovered by COVID-19 pandemic** | - Enforce the BKBK strategy to encourage consumers to buy locally manufactured products.  
- Fully operationalise the BKBK monitoring and evaluation framework i.e. periodic reporting of BKBK strategy implementation progress by MDAs.  
- Provide surgical masks and alcohol-based hand sanitizers to schools when they reopen.  
- Enhance capacity for KEBS to develop standards for new inventions/innovations by manufacturers.  
- Exploit component manufacturing opportunities in pharmaceuticals, plastics, machinery, and expansion of an array of parts produced in the automotive sectors and electronic sectors. | - Ministry of Industrialisation, Trade and Enterprise Development | Medium term (6-12months) |
| **Support to SMEs** | - Operationalise the SME credit guarantee scheme.  
- Operationalization of the Ksh. 712 million SME fund proposed in the National Budget Statement 2020. | - The National Treasury and Planning  
- Ministry of Industrialisation, Trade and Enterprise Development  
- Micro, Small & Enterprise Authority  
- Commercial banks | Medium term (6-12months) |
<table>
<thead>
<tr>
<th>Adopt a “do-no-harm” principle while intervening in the market</th>
<th>Delete tax provisions that will increase the burden to taxpayers.</th>
<th>Reverse punitive tax policies as contained in the Tax Laws Amendment Act 2020 and Finance Act 2020. Specifically, the 1% minimum tax; VAT exemptions on pharmaceutical products; 14% VAT on plant, machinery, and spare parts; deferring the staggering of investment deductions on plant and machinery; VAT on transfer of a business as a going concern; and withdrawal of the 30% electricity rebate program.</th>
<th>The National Treasury and Planning</th>
<th>Ministry of Industrialisation, Trade and Enterprise Development</th>
<th>KRA</th>
<th>Relevant government regulators</th>
<th>Long term (more than 12months)</th>
</tr>
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<tr>
<td>Increase resilience of the manufacturing sector and ease of doing business</td>
<td>Ensure long-term policy stability, particularly on taxation. A policy on taxation is required to ensure certainty and predictability.</td>
<td>Develop selected domestic and regional value-chains to minimise exposure to external shocks.</td>
<td>Ensure an effective legislative and institutional framework to support research and development.</td>
<td>Review policies at county and national level to ensure they improve the business environment and investment climate.</td>
<td>National Government</td>
<td>County Governments</td>
<td>The National Treasury and Planning</td>
</tr>
<tr>
<td>Unemployment Insurance Program for workers</td>
<td>Set up an unemployment insurance fund to pay benefits to covered workers who become involuntarily unemployed and meet specified eligibility requirements, to cushion them in times of unemployment. The insurance program may be designed in two ways: 1. allow workers to work part-time or 2. allow workers to remain formally with the business even if not working at all to ensure quick resumption of activity once normalcy returns.</td>
<td>Ministry of Labour &amp; Social Services</td>
<td>The National Treasury and Planning</td>
<td>Long term (more than 12months)</td>
<td></td>
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<td>Fiscal consolidation</td>
<td>Operationalize the public investment management (PIM) guidelines to ensure that only economically viable public projects are funded through the budget. This will ensure value for money.</td>
<td>The National Treasury and Planning</td>
<td>Long term (more than 12months)</td>
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