Kenya

key figures
- Land area, thousands of km²: 580
- GDP per capita, $ PPP valuation (2006): 1 835
- Life expectancy (2006): 49.6
- Illiteracy rate (2006): 26.4
IN 2005, THE KENYAN ECONOMY, with most sectors recording accelerated growth, sustained the momentum that had started in 2003. Real Gross Domestic Product (GDP) grew by 5.8 per cent in 2005 compared with 4.9 per cent in 2004, and it is estimated at 5 per cent in 2006. This economic growth is expected to be maintained in the medium term.

Despite the increase of government expenditures and the fiscal deficit of 2005/06, the overall fiscal situation is favourable, as the government succeeded in improving its revenue collection and in keeping the fiscal balance at a manageable level. The fiscal policy for the medium term continues to seek increased spending and revenue while containing the budget deficit at 3.5 per cent of GDP. In addition, public expenditures are being restructured from recurrent to development sectors (infrastructure, education, health, etc.) with the goal of attaining 7 to 9 per cent of GDP on development-sector expenditure in the medium term. Controlling recurrent expenditure to free up resources for increased development expenditure should be achieved thanks to selected cuts, such as in the civil-service wage bill, and better management of public finances.

Monetary policy will continue to aim at maintaining inflation below the official 5 per cent level and at preserving stability in the foreign-exchange market. The monetary authority is on track in the area of

**Governance problems persist but reforms are beginning to take hold and the development of the private sector is on course.**

Figure 1 - **Real GDP Growth and Per Capita GDP**
($PPP at current prices)

Source: IMF and National Institute of Statistics data; estimates (e) and projections (p) based on authors' calculations.

http://dx.doi.org/10.1787/355447083017

© ADB/OECD 2007

African Economic Outlook
containing inflationary pressures, although the inflation rate was quite high in 2006, driven basically by food and energy prices. Inflation is expected to ease towards the targets in 2007 and 2008. Interest rates were fairly – and unusually – stable in 2005/2006.

The Kenyan government has sustained its emphasis on development of the private sector and has taken important measures to enhance the investment environment for private-sector activities. These measures include improving infrastructure – such as the road network (which is still a key challenge), the ports, and rail transport – providing reliable and affordable energy, and developing information and telecommunications infrastructure. The government has also strengthened the financial sector, improved public expenditure and financial management, and privatised state-owned enterprises to enhance Kenya’s external competitiveness and reduce pressures on the budget. In addition, it has eased the legal, regulatory and institutional constraints that affected the private sector adversely and delayed the privatisation process.

Constitutional and legal reforms as well as deepening macroeconomic and structural reforms are considered key pillars for attaining the goals of “Kenya Vision 2030” to transform the country into a medium-income country within 25 years. Although the authorities have increased the democratic space significantly since 2002, governance issues are still hampered by the corruption and political manipulation allowed by inadequacies in the legal framework to fight corruption at high levels in the system. This continues to affect the image of the government amongst development partners, and if it is not contained, it could slow down the pace of economic development that the country has recently realised.

**Recent Economic Developments**

Kenya had 5 per cent GDP growth in 2006, compared to 5.8 per cent in 2005, continuing the buoyant growth that had begun in 2003. The key sectors driving this growth were agriculture, construction and building, manufacturing, tourism, and transport and communications. Overall, the economy withstood the impact of higher oil prices rather well.

The economy-wide reform efforts currently underway and the resulting stable macroeconomic environment are expected to generate sufficient momentum for growth to be maintained at about the same rate in both 2007 and 2008 (estimated at 5.3 and 5.1 per cent, respectively).

The implementation of the Economic Recovery Strategy for Wealth and Employment Creation (ERS) will be completed by the end of 2007. In the meantime, the government intends to finalise Kenya Vision 2030, which will be the basis for further policy development. It will be based on three pillars – economic, social, and political – and its ambitious goals are: to maintain sustained 10 per cent annual economic growth for the next 25 years; to build a just and cohesive society enjoying equitable social development in a clear and secure environment; and to build an issue-based, people-centred, result-oriented and accountable democratic political system.

The agricultural sector continues to play a dominant role, contributing significantly to increasing food security, income generation, employment creation and industrial development within the framework of the Investment Programme for the ERS (IP-ERS). The sector accounted for 25 per cent of GDP in 2005 and grew at an annual rate of less than 6 per cent in 2006 compared with 6.8 per cent in 2005. This growth was driven by improved performance in cereals, horticulture and dairy sub-sectors thanks to adequate rainfall in 2005 and 2006, a performance all the more impressive even though a drought affected the livestock sub-sector in some parts of country in 2005.

A number of structural reforms have been implemented since 2003, aimed at improving efficiency and productivity in the coffee, pyrethrum and sugar, and co-operative sub-sectors.

These sector reforms include the review and harmonisation of the legal, institutional and regulatory frameworks. The share of budgetary resources allocated
to the agriculture sector was projected to increase sharply from KES (Kenyan shillings) 18.6 billion (5.3 per cent of total resources) in 2005/06 to KES 33.5 billion (7.3 per cent of total resources) in 2008/09. Other incentives initiated in 2006 to promote productivity in the agricultural sector include zero-rating of tractor tyres, agricultural tractors and semi-trailers for agricultural tractors, as well as transport of unprocessed agricultural and agro-forest produce. Efforts are also being made to strengthen land management and the land-tenure system, support fisheries, forestry and mining, and protect the environment and natural resources.

In 2006, the production of major crops displayed mixed performance. Improved weather conditions in the second half of 2006 moderated the adverse effects of the drought experienced during the first quarter of the year. Tea production declined in 2006 by 16 per cent. However, average tea auction prices increased substantially by almost 40 per cent in 2006 as a consequence of reduced supply and improved quality. Similarly, coffee output was almost at par with production in 2005 while the prices increased by 11.2 per cent.

In the horticultural sector, flower production improved by 5.7 per cent, while fruit and vegetable production for export decreased by 2 per cent and 1.5 per cent respectively in 2006. Export earnings from the sector registered marginal improvement. The 2006/07 budget proposed tax measures to support the horticultural sector and make its products more competitive by shifting the focus towards more fruit production. The sugarcane and milk sub-sectors also registered an improved performance in 2006.

The government has continued to take measures to attain food security. However, these efforts have been undermined by frequent droughts and/or floods. The self-sufficiency ratio (SSR) for maize ranged between 84 per cent and 106.3 per cent between 2000 and 2005. The import-dependency ratio (IDR) for cereals has been on the decline, ranging from 19.5 per cent to 31.5 per cent between 2000 and 2005. The IDR for maize has consistently stood below 20 per cent. This means the country’s production of maize almost meets domestic demand. Maize production has been increasing as a result of the incentive of good prices offered to farmers. It is estimated to have increased from 32 million bags in 2005 to more than 33 million bags in 2006. Most producer prices for the majority of agricultural commodities recorded a gradual increase during the year, supported by a revival of farmers’ institutions such as the Kenya Co-operative Creameries or the Kenya Meat Commission.

The manufacturing sector continued to respond positively to the reforms identified in the 2004-05 IP-ERS. The reforms include trade liberalisation, financial deepening, facilitating the use of technology by improving licensing procedures aimed at expanding growth and employment-generating capacity in the sector. The key growth targets for the sector for the IP-ERS period include: achieving an average growth rate of 8.6 per cent annually; increasing employment in medium and small enterprises; and formalising the informal micro- and small-enterprise (MSE) sector.
The manufacturing sector accounted for 14 per cent of GDP in 2005, up from 9.9 per cent in 2004. In 2005, the sector recorded 5 per cent real growth compared with 4.5 per cent in 2004 as a result of increased domestic, as well as external demand. Factors contributing to growth in the sector included tax exemptions on some imports for intermediate consumption in the 2006/07 budget and enforcement of anti-dumping measures within the East African Community (EAC) and Common Market for Eastern and Southern Africa (COMESA) regions. In 2005, however, output was constrained by increases in production costs subsequent to the rise in oil prices, appreciation of the Kenya shilling resulting in lower export earnings and poor infrastructure.

In 2006, output from the manufacturing sector improved thanks to increased output from key sub-sectors. In 2006, the production of beer and cigarettes increased by 7.4 per cent and 21.3 per cent, respectively.

Consumption of electricity grew by 5.2 per cent in 2006, in line with the increased level of economic activity. The increase in supply to meet this demand reflected good water supply to hydroelectric dams and increased generation from thermal sources.

The government took several measures to improve the business environment and stimulate production in the manufacturing sector. In the 2006/07 budget, it enhanced the tax incentives first introduced in 2003/04, which included duty waivers on capital goods, plants and equipment. In addition, 17 trading licenses were removed in 2005/06, an additional 118 licenses were marked to be eliminated in 2006/07, together with import duties on selected intermediate inputs.

The tourism sector is a major component of the service sector, which accounts for about 50 per cent of GDP and has continued to exhibit rapid growth. This is due in part to measures taken by the government: to foster private-sector partnerships for the development and implementation of a co-ordinated strategy; to attract tourists from a wider range of countries; to diversify tourist attractions; to expand the benefits to the local population; to protect the environment; and to improve quality and standards.

In 2006, combined tourism earnings from international and domestic sub-sectors grew by 20 per cent compared with 24.7 per cent in 2005. International arrivals increased to 1.7 million, up from 1.5 million in 2005 and 1.4 million in 2004. In 2006, tourist arrivals from all markets recorded improvements with significant increases from Asia, America and Europe of 7.9 per cent, 14.8 per cent and 13.7 per cent, respectively. This growth is linked to an improved marketing of tourism in non-traditional markets like

<table>
<thead>
<tr>
<th>Table 1 - Demand Composition (percentage of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
</tr>
<tr>
<td>---</td>
</tr>
<tr>
<td><strong>Gross capital formation</strong></td>
</tr>
<tr>
<td>Public</td>
</tr>
<tr>
<td>Private</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Consumption</strong></td>
</tr>
<tr>
<td>Public</td>
</tr>
<tr>
<td>Private</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>External sector</strong></td>
</tr>
<tr>
<td>Exports</td>
</tr>
<tr>
<td>Imports</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

Source: IMF and National Institute of Statistics data; estimates (e) and projections (p) based on authors’ calculations.

http://dx.doi.org/10.1787/005222256585

African Economic Outlook © AfDB/OECD 2007
China, India, Japan and the local market. Diversification away from traditional tourism products to new ones has also helped improve performance and future prospects in the sector.

The transport and communications sector accounted for 11 per cent of GDP in 2005, recording real growth of 8.3 per cent in the year and making it one of the fastest-growing sectors in the economy. This rapid expansion was maintained in 2006. In the road-transport sub-sector, new motor-vehicle registrations increased by 10 per cent in 2006. In the air-transport sub-sector, a combination of factors, including positive knock-on effects from tourism, caused the incoming passengers through major border ports to rise by 7.5 per cent in 2006, while outgoing passengers increased by 6.2 per cent in the same period. Cargo through the port of Mombasa grew by 5 per cent in 2006. The Government has prioritised expansion through the improvement and maintenance of the road network to support growth placed in the 2006/07 budget, improvement of the business climate and the competitiveness of Kenyan products.

Concessioning of the Kenya railways in November 2006 is expected to improve railway transport, which will facilitate faster movement of cargo through the port of Mombasa. Other measures being taken to improve port efficiency include introducing private-sector participation in container-terminal operations, dredging the channel to accommodate larger vessels and introducing 24-hour operations. In 2006, further reforms were taken to modernise and upgrade air transport at Jomo Kenyatta International Airport, and other airports and airstrips. This is expected to increase the volume of transit passengers with direct flights from North America and Europe, improve general air safety, increase revenue flow and promote tourism.

The telecommunications sub-sector displayed strong performance in 2006 with the number of mobile subscribers estimated to have increased to more than 7 million, up from 5.6 million in 2005. The impressive growth in airtime sales was driven by lower-denomination prepaid cards and expanded network roll-out to rural areas along with aggressive marketing. Safaricom, a mobile provider in which the government is a shareholder, is one of the fastest-growing enterprises in Kenya.

The balance sheet of the state-owned Telkom Kenya, the fixed-line provider, is weak. However, the enterprise has recently put out new products and services. Fixed-line connections increased by more than 8 per cent in 2006 representing a 1 per cent increase in the penetration rate for this sector. Telkom has boosted the performance of its existing network by revamping the data-transfer technology known as Asymmetric Digital Subscriber Line (ADSL), as well as by introducing three different prepaid cards with different tariffs and download speeds. A corporate Voice Over Internet Protocol (VoIP) tariff and an Internet dial-up solution are also now offered amongst other products.

The building-and-construction sector realised real growth of 7.2 per cent in 2005, up from 4 per cent in 2004, and continued to record rapid growth in 2006. Cement production, for example, increased by 6.1 per cent in 2006. This was due in part to strong demand for residential housing in urban areas supported by relatively low and stable interest rates and remittances from abroad. Other factors contributing to the sector’s improved performance are the revival of several stalled public-sector development projects and increased budgetary allocation for road construction and rehabilitation activities.

In collaboration with the government, international enterprises are undertaking oil exploration along the coastal belt, which is divided into blocks held by several oil enterprises. In 2006, equipment arrived in Mombasa for prospective oil drilling off the Lamu Coast, where an Australian drilling enterprise has estimated that there is a 12 per cent chance of striking oil.

The economy experienced several problems in 2006. These included high oil prices, which increased production and transport costs and led to an acceleration of consumer-price inflation, and severe drought that affected the livestock sub-sector adversely,
especially in the arid and semi-arid land (ASAL) areas during the first quarter of the year. Also, during the last quarter of 2006, the country experienced massive floods that displaced both people and livestock in areas prone to flooding, and destroyed roads and bridges in the affected parts of the country. The ravaging floods in the North Eastern and parts of the Coast provinces during the fourth quarter of 2006 led to deaths and infections associated with Rift Valley Fever, as well as the imposition of quarantine and a ban on the slaughtering of livestock in the affected areas. This was followed by immunisation campaigns targeting mainly domestic animals kept by the nomadic communities in these areas.

There was no major regional conflict affecting the country in 2006. The situation in Somalia, however, continued to affect the country through an influx of refugees, new cases of diseases such as polio, which had been eradicated, and an increase in the prevalence of small firearms.

Macroeconomic Policies

In 2006, the government undertook the mid-term review of the 2003-07 ERS to highlight the policy implementations achieved from July 2003 to June 2006. The review also made recommendations on key areas of the economy that need to be addressed in the remaining period of ERS.

Fiscal Policy

Fiscal policy is guided by the Public Expenditure Review (PER) and the medium-term expenditure framework (MTEF). These establish certain ceilings, ring fence core poverty programmes and imply a strong revenue effort. The growth of total expenditures is to be restrained and the composition of expenditures changed to reduce the share of non-productive recurrent expenditures and increase the share of operations-and-maintenance and capital expenditures. In addition, the domestic debt is not to exceed a sustainable level. The medium-term target for domestic debt is 20 per cent of GDP.

The overall budget deficit in 2005/06 was KES 55.2 billion, equivalent to 3.5 per cent of GDP on a commitment basis compared with a surplus of KES 1 billion equivalent to 0.1 per cent of GDP in 2004/05. This deficit mainly reflected the expansionary fiscal policy pursued in 2005/06, which includes a large increase in development spending. The fiscal deficit is projected to decline to 1.4 per cent of GDP by the end of 2007/08.

In 2005/06, revenue collection and receipts from external grants amounted to KES 327.8 billion, under the target of KES 360.7 billion. The shortfall was due in part to problems with the implementation of a new customs computer system, which affected the collection of customs duties. Nevertheless, revenue collection and receipts of external grants increased by 7.6 per cent from 2004/05 as a result of strong economic growth. Fiscal receipts as a percentage of GDP rose from 23.8 in 2003 to 24.2 in 2005.

The public-sector wage bill as a percentage of fiscal receipts was 58.2 per cent in 2005, down from 59.9 per cent in 2004. Efforts are being made to lower it further through the civil-service reform commission. Public investment financed from domestic resources as a percentage of fiscal receipts improved significantly in 2005, rising to 26.8 per cent from 17.3 per cent in 2004. This improvement appears to have been due to the operation of the Constituency Development Fund (CDF), a programme promoting grassroots development across the board. Differences between actual and budgeted expenditures narrowed in 2005/06 compared with 2004/05, indicating improved budgetary management.

Indirect and direct intervention measures have been undertaken to counter the rise of oil prices. One measure was to publish the pump prices of various oil marketers in order to promote consumer awareness and competition. In addition, the state oil enterprise (National Oil Corporation) opened more retail outlets with an aim to increase competition and thus maintain some downward pressure on prices. However, the government has wisely chosen to allow the increase in international oil prices to be fully passed through to domestic prices.
Monetary Policy

Monetary policy is under the responsibility of the Central Bank of Kenya (CBK). It seeks to maintain a rate of inflation that does not exceed that of its trading partners, which was expected to be less than 5 per cent in 2006/07. The measure of inflation, which includes food and oil, rose from 11.9 per cent in June 2005 to 14.6 per cent in November 2006, mainly as a result of increased prices of food and non-alcoholic drinks, and oil. However, the measure of underlying inflation, which excludes food and oil, declined from 8.2 per cent in June 2005 to 4.4 per cent in November 2006. This measure of inflation remained stable in 2006. The Consumer Price Index (CPI) inflation rate is estimated at 14.48 per cent in 2006 but is projected to decline considerably in 2007 and 2008 to stabilise at 3.64 and 3.75 per cent, respectively.

In the year to September 2006, the broad money supply (M3) increased by 17.4 per cent compared with 11.8 per cent in September 2005. This reflected increased credit to the government by the banking system to finance government deficit. Meanwhile, the growth of credit to the private sector slowed for most of the period.

In August 2005, the government established a Monetary Policy Advisory Committee (MPAC) with a mandate to advise the CBK on monetary policy. The MPAC worked with the CBK to develop a framework for the Central Bank Rate (CBR), which replaces the 91-day Treasury Bill (TB) as benchmark rate and was launched in May 2006. The implementation of the CBR within the monetary programme targets the quantity of money. The current CBR is 10 per cent, up from the initial rate of 9.75 per cent. Interest rates remained moderate with the 91-day TB discount rate down from a high 8.68 per cent in April 2005 to a low 6.6 per cent in June 2006.

The Kenya shilling exchange rates remained fairly stable in 2006, strengthening marginally against the US dollar at KES 72 compared to KES 76 in 2005. The shilling is projected to depreciate in the medium term to 74-75 against the US dollar.

The monetary policy for 2006/07 will continue to be directed towards attaining and maintaining underlying inflation below 5 per cent. In line with this goal, M3 is set to grow by 10 per cent by June 2007 while reserve money is also programmed to expand by

---

Table 2 - Public Finances (percentage of GDP)

<table>
<thead>
<tr>
<th></th>
<th>1997/98</th>
<th>2002/03</th>
<th>2003/04</th>
<th>2004/05</th>
<th>2005/06</th>
<th>2006/07(e)</th>
<th>2007/08(p)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue and grants*</td>
<td>21.4</td>
<td>20.8</td>
<td>22.4</td>
<td>22.6</td>
<td>23.0</td>
<td>22.5</td>
<td>22.2</td>
</tr>
<tr>
<td>Tax revenue</td>
<td>18.4</td>
<td>18.1</td>
<td>19.0</td>
<td>19.4</td>
<td>19.0</td>
<td>18.6</td>
<td>18.4</td>
</tr>
<tr>
<td>Grants</td>
<td>0.7</td>
<td>1.4</td>
<td>1.3</td>
<td>1.1</td>
<td>2.2</td>
<td>2.0</td>
<td>1.9</td>
</tr>
<tr>
<td>Total expenditure and net lending*</td>
<td>22.5</td>
<td>24.3</td>
<td>23.3</td>
<td>22.5</td>
<td>26.5</td>
<td>23.7</td>
<td>23.6</td>
</tr>
<tr>
<td>Current expenditure</td>
<td>20.7</td>
<td>20.9</td>
<td>20.0</td>
<td>19.1</td>
<td>20.9</td>
<td>19.3</td>
<td>19.0</td>
</tr>
<tr>
<td>Excluding interest</td>
<td>15.7</td>
<td>17.6</td>
<td>17.6</td>
<td>16.9</td>
<td>18.5</td>
<td>17.0</td>
<td>16.6</td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>4.2</td>
<td>7.8</td>
<td>7.9</td>
<td>7.8</td>
<td>7.3</td>
<td>6.9</td>
<td>6.5</td>
</tr>
<tr>
<td>Interest on public debt</td>
<td>4.9</td>
<td>3.3</td>
<td>2.5</td>
<td>2.3</td>
<td>2.4</td>
<td>2.3</td>
<td>2.3</td>
</tr>
<tr>
<td>Capital expenditure</td>
<td>1.7</td>
<td>3.2</td>
<td>3.2</td>
<td>3.3</td>
<td>5.5</td>
<td>4.4</td>
<td>4.5</td>
</tr>
<tr>
<td>Primary balance</td>
<td>3.8</td>
<td>-0.2</td>
<td>1.5</td>
<td>2.4</td>
<td>-1.0</td>
<td>1.1</td>
<td>0.9</td>
</tr>
<tr>
<td>Overall balance</td>
<td>-1.1</td>
<td>-3.5</td>
<td>-0.9</td>
<td>0.1</td>
<td>-3.5</td>
<td>-1.2</td>
<td>-1.4</td>
</tr>
</tbody>
</table>

a. Only major items are reported.
Source: Domestic authorities’ data; estimates (e) and projections (p) based on authors’ calculations.

http://dx.doi.org/10.1787/028710663648
With the stable low interest rates, growth of domestic credit to the private sector is set to range between 10 per cent and 12 per cent.

**External Position**

The deficit on current account increased to 2.6 per cent of GDP in 2005, compared to 2.2 per cent of GDP in 2004, reflecting in part an increase in the oil bill and moderate growth in non-oil imports, which together exceeded a sizeable increase in export earnings. The deficit is estimated at 2.8 per cent of GDP in 2006 and projected to reach 3.4 per cent in 2007 before easing to 2.4 per cent in 2008. Net earnings from services, which include tourism earnings and unilateral transfers, increased substantially in 2005 but not enough to match the increase in the visible trade deficit.

In 2005, horticulture, tea and coffee continued to be the leading export earners accounting for 49.8 per cent of the total domestic export earnings. Export earnings improved to KES 168.4 billion in January to September 2006, following increased earnings from tea, manufactured goods, horticulture, oil products and coffee exports. The values of tea, coffee and tobacco exports rose by 14.7 per cent, 1.1 per cent and 69.1 per cent, respectively, in January to September 2006, compared with the same period in 2005. While tea and coffee exports fetched higher prices, export prices for some horticulture products declined.

### Table 3 - Current Account (percentage of GDP)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006(e)</th>
<th>2007(p)</th>
<th>2008(p)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade balance</td>
<td>-7.2</td>
<td>-7.6</td>
<td>-10.1</td>
<td>-11.6</td>
<td>-10.1</td>
<td>-8.9</td>
<td>-8.2</td>
</tr>
<tr>
<td>Exports of goods (f.o.b.)</td>
<td>14.4</td>
<td>16.2</td>
<td>16.8</td>
<td>17.3</td>
<td>15.3</td>
<td>15.0</td>
<td>14.6</td>
</tr>
<tr>
<td>Imports of goods (f.o.b.)</td>
<td>21.6</td>
<td>23.8</td>
<td>26.9</td>
<td>28.9</td>
<td>25.4</td>
<td>23.9</td>
<td>22.8</td>
</tr>
<tr>
<td>Services</td>
<td>1.0</td>
<td>3.4</td>
<td>3.8</td>
<td>4.0</td>
<td>3.3</td>
<td>3.1</td>
<td>3.3</td>
</tr>
<tr>
<td>Factor Income</td>
<td>-1.2</td>
<td>-0.6</td>
<td>-0.8</td>
<td>-0.6</td>
<td>-0.5</td>
<td>-0.4</td>
<td>-0.4</td>
</tr>
<tr>
<td>Current transfers</td>
<td>4.1</td>
<td>5.8</td>
<td>4.9</td>
<td>5.5</td>
<td>4.5</td>
<td>2.9</td>
<td>2.9</td>
</tr>
<tr>
<td>Current account balance</td>
<td>-3.4</td>
<td>1.0</td>
<td>-2.2</td>
<td>-2.6</td>
<td>-2.8</td>
<td>-3.4</td>
<td>-2.4</td>
</tr>
</tbody>
</table>

Source: Domestic authorities’ data; estimates (e) and projections (p) based on authors’ calculations.

The import values of crude oil and oil products increased by 12.1 per cent and 7 per cent, respectively, and jointly accounted for 22.7 per cent of the total import expenditure in 2005. Industrial machinery and road motor vehicles accounted for 17 per cent of the total import bill.

The Protocol establishing the East African Customs Union came into force on 1 January 2005. The key objectives of the Customs Union as provided under the Protocol is: to further liberalise intra-regional trade in goods on the basis of mutually beneficial trade arrangements amongst the partner states; to promote efficiency in production within the Community; to increase domestic, cross-border and foreign investment in the Community; and to promote economic development and diversification in industrialisation in the community partner states. To achieve these objectives the partner states undertook to eliminate tariff and non-tariff barriers amongst themselves, simplify and harmonise trade formalities, produce and exchange customs and trade statistics and information, all in order to create the most favourable environment possible for the development of regional trade.

In 2005, capital and financial accounts recorded a net surplus of KES 57 862 million compared with a net surplus of KES 18 964 million in 2004. The increase was attributed to increased long-term loans to the private sector, and capital transfers to the general government.

The government’s aim is to reduce the domestic-debt stock from 22 per cent of GDP in 2003/04 to 20 per cent by 2007/08. In addition, the net present value of external debt was to be contained at around...
27 per cent of GDP for the medium term, thereby leaving the total debt ratio below 50 per cent of GDP. This implies a narrowing of the fiscal deficit (including grants) to about 1 per cent of GDP in 2007/08 from 2.6 per cent of GDP in 2004/05.

The Government has consistently maintained a sound and timely debt-serving policy. Annual debt servicing charges decreased from KES 114.9 billion in 2003/04 to KES 112.2 billion in 2004/05, while receipts on loan repayments and interest registered a substantial increase from KES 719.4 million in June 2004 to KES 1.7 billion in June 2005. External-debt-service payments as a percentage of export of goods and services declined to 6 per cent on 30 June 2005 compared with 7.9 per cent a year earlier. This was due to the effect of a decline in external-debt servicing combined with consistent growth in exports of goods and services in the past five years.

External debt dropped from KES 443.2 billion in June 2004 to KES 434.5 billion in June 2005. The proportion of multilateral creditors in total external debt declined to 59.6 per cent at the end of September 2006. Kenya has not benefited from debt cancellation under the Heavily Indebted Poor Countries Initiative because its level of debt is considered to be sustainable.

**Figure 3 - Stock of Total External Debt (percentage of GDP) and Debt Service (percentage of exports of goods and services)**

![Graph showing the stock of total external debt (percentage of GDP) and debt service (percentage of exports of goods and services) from 2000 to 2008.](http://dx.doi.org/10.1787/105101125116)

**Source:** IMF.

---

**Structural Issues**

**Recent Developments**

To improve accountability and efficiency in the management of public corporations and enhance the role of the private sector as the engine of growth and poverty reduction, the government has initiated a number of reform measures. These include: drafting the Privatisation Bill in 2003, which is currently in parliament; introducing various reforms for restructuring, rationalisation and good corporate governance in public enterprises; identifying candidates for divestiture and privatisation and preparing strategies and programmes for this process; and implementing reforms covering budgeting, financial management,
internal audits and performance contracts for state enterprises. Moreover, 16 state enterprises were put on performance contract, effective from 1 October 2004, and Kenya railway concessioning was completed in December 2006. Prospective reforms include privatising Kenya Ports Authority, including concessioning of container terminals, bulk handling and conventional cargo, concessioning roads and other public works, continuing the liberalisation of the telecommunications sector and initiating the process for the privatisation of Telkom Kenya.

In the financial sector, the role of the state in the economy will be reduced through privatisation and/or restructuring public enterprises and state-owned banks. The Microfinance Bill will be operationalised to improve the supervision of deposit-taking institutions. In addition, reforms in the insurance sector are to be strengthened, and a strategy for development finance institutions is to be developed.

The Governance, Justice, Law and Order Sector reform programme, referred to as GJLOS, is now in an accelerated phase of implementation as a four-year medium-term Strategy ending in June 2009. GJLOS will focus on improving the anti-corruption architecture by enhancing the investigative and prosecutorial capacity of the legislature, as well as by strengthening other institutions in the criminal and civil justice systems. A medium-term anti-corruption strategy with measurable performance indicators is to be implemented. GJLOS will address the systematic enhancement of public-sector integrity and accountability mechanisms in public institutions through the enforcement of codes of conduct and result-driven service charters.

Reforms to strengthen public-expenditure management aim at improving service delivery in the key priority areas of health, education, infrastructure and agriculture. The reforms will focus on: meeting all 16 Public Expenditure Management Assessment and Action Plan (PEMAAP) benchmarks by 2008/09 (on 31 December 2005, only 6 out of 16 benchmarks had been met); reducing the discrepancy between approved budgets and budget outturns; and addressing the main causes of budget reallocations during the course of the year. From 2006/07 onwards, budget reallocations are to be limited to no more than 8 per cent and will be disallowed for new programmes. No reallocations involving core poverty programmes will be tolerated. In addition, a Public Procurement and Disposal Bill has been enacted and efforts are now geared towards operationalising the autonomous Public Procurement Oversight Authority and making sure that it is run efficiently.

Public-service reforms aim to re-establish control over the wage bill, address capacity constraints in key ministries, and promote the creation of a more efficient public service. In this regard, the government has: introduced new wage-setting guidelines for public employees; announced its intention to streamline the terms and conditions of service for top management in the government and state enterprises; taken steps to strengthen capacity at all levels of government, particularly in ministries essential to the realisation of the ERS, such as the Ministry of Finance; and committed to restructure a number of key ministries, including the ministries of Roads and Public Works, Education, Health and Agriculture.

The government identified in its IP-ERS the restoration and expansion of infrastructure (transport, water, energy, telecommunications and information technology) as one of the main pillars and challenges for its economic recovery programme. In this regard, the share of resources going to physical infrastructure is projected to rise from 19.2 per cent in 2005/06 to 21.6 per cent in 2008/09 with priority going to: expanding and improving maintenance of the road network and other public works; increasing access to water resources; and increasing the availability, reliability and affordability of energy.

The challenges facing the sector include expanding the road network; reducing the rehabilitation and maintenance backlog; strengthening road safety and controlling overloading, and expanding private-sector management and financing.

For roads, activities include: formulation of a long-term road-sector strategy and a multi-agency model for
managing responsibilities and financing for all types of roads; rationalisation of the number of agents responsible for rehabilitation, construction and development of urban roads under the Kenya Roads Board Act; completion of a road inventory and condition survey study; reducing the audit backlog for the road-levy fund and improving public information on the use of the fund; establishing a new road-safety authority; enforcing axle load control limits; and launching a national road-safety campaign. Selected targets for the IP-ERS period include rehabilitation of 2815 kilometres under the Roads 2000 Programme, reconstruction of 150 kilometres of trunk roads per annum and the concessioning of up to 1208 kilometres of trunk road during 2004-07.

To ensure efficient and secure air transport, security measures at airports are being improved, the construction of a perimeter fence and the installation of an intrusion-detection system are ongoing, while the refurbishment of the airport and civil-aviation facilities has commenced.

In the telecommunications sub-sector, the government is to make a public offering in 2007 for Safaricom shares, to be traded at the Nairobi Stock Exchange. In addition, Telkom Kenya is also undergoing a major reorganisation aimed at strengthening its balance sheet, by purging it of bad debts amongst other actions. The process of selling two of its loss-making subsidiaries, namely Gilgil Technical Institute and the Kenya College of Communications Technology, was initiated in 2006.

The awarding of a license to an additional operator to operate in both fixed-line and mobile-telephony networks is expected to lower prices and boost competition against the state-owned operator Telkom Kenya, as well as mobile-service providers Safaricom and Celtel. The government also allowed all enterprises in the sector to offer the entire range of telecommunications services.

Further liberalisation, significant investment in an e-government initiative and zero rating of VAT on computer equipment, parts and accessories are expected to boost growth in the sector. To improve service delivery and efficiency in the public sector, the government has established operational information and communications technology units in ministries, installed local area networks in Government buildings and implemented rural telecommunications projects by the Ministry of Information and Communications.

To maintain the competitive edge of the port of Mombasa, its operations are to be privatised while the port itself will remain the property of the state, which began operating 24 hours per day in February 2007. Equipment is to be modernised and a Maritime Sector Policy paper finalised. In addition, two new ferries will be purchased to increase safety.

The authorities have redefined the role of the state from producer to facilitator in order to make the private sector the engine of growth through preparation of a private sector development strategy (PSDS) paper spelling out the reforms needed to enhance efficiency and international competitiveness. The PSDS paper was launched in January 2007. An action plan detailing short- and medium-term measures to improve the investment climate has been finalised, as well as a national export strategy action plan in five key sectors for implementation starting in 2005/06.

A number of measures to strengthen the financial system and create a predictable environment for private-sector development are being implemented. These reforms include: setting up the Bank Restructuring and Privatisation Unit in the Ministry of Finance to develop and implement restructuring reforms for state-owned banks; enacting the Micro Finance and Savings and Credit Co-operatives Bills by parliament; capacity building to fight money laundering and for Combating the Financing of Terrorism (CFT). These latter include: gazetting the National Task Force on Anti-Money Laundering (AML) and CFT in 2003; drafting the AML and Proceeds of Crimes Bill; drafting the Suppression of Terrorism Bill (2003) to criminalise the financing of terrorism; and modernising the financial system with, amongst others, the drafting of a specific bill on Electronic Money Transfer, the amendment of the Banking Act and Central Bank Act to transfer all
regulatory and supervisory roles from the Ministry of Finance to the CBK, and the introduction of a new regulation tightening loan provisioning and classification.

Reforms in the agricultural sector aim to promote productivity growth and lower the costs of agricultural inputs, particularly amongst smallholders and subsistence farmers, who account for an estimated 70 per cent of marketed agricultural production. The reforms include: restructuring and rationalising the network of agricultural-research institutes by consolidating operations into the Kenya Agricultural Research Institute; strengthening the link between farmers' demands, extension provision and the direction of research, and increasing the productivity of public investment; deepening agricultural financial services to ensure that poor farmers have access to credit and insurance; putting in place reforms to improve competition in input distribution and marketing, and enforcing the law against fraudulent practices of input supplies and marketing agents; reducing transport costs through improved rural roads and reduced fuel taxes and electricity costs; improving access to information through strengthened communications; giving support to co-operatives, private investors and other institutions to undertake necessary investments in marketing and value addition; formulating a national land policy to address land use and administration, land tenure, and land delivery systems; reviewing the law of succession to address gender imbalances in land; reassessing food-security policies and introducing pro-poor reforms; amending the Coffee Act to allow growers to sell coffee outside the auction and establishing an agency to operate processing, marketing and input distribution; and supporting plans for the rehabilitation and development of irrigation systems to support the revitalisation of the cotton and rice sectors.

Access to Drinking Water and Sanitation

Kenya is not well-endowed with water resources. Its annual surface-water and ground-water potential is 19.6 million m$^3$ and 0.6 million m$^3$ per year, respectively. This is less than 600 m$^3$ per capita and well below the norm of 1000 m$^3$ per capita, which describes a situation of water scarcity. Factors threatening these water sources include: frequent droughts and floods, which reduce water catchment; rapid population growth, which leads to the destruction of water-catchment areas through land conversion and fragmentation; pollution from chemical pesticides and fertilizers on agricultural land, as well as industrial wastes and raw sewage leaching into surface and ground water.

The government of Kenya created the Ministry of Water and Irrigation (MWI) in 2002 to consolidate the responsibility for the management and development of water resources. Its mandate is to protect, harness and develop the country’s water resources to ensure the availability of high-quality water to all.

The main institutions for the water and sanitation services (WSS) sectors are the MWI, the Water Services and Regulation Board (WRSB), the Water Resources Management Authority (WRMA) and the Water Services Trust Fund (WSTF). Other institutions include the water-services boards, water-services providers and the Water Appeals Board (WAB). These institutions are co-ordinated by the MWI, which has the leadership role for the WSS sector. Water operators are private/commercial enterprises. The role of small and medium-sized organisations for water services in small towns and peri-urban areas is to provide water and sewerage services to users. They connect water users to the trunk lines of the main water system provided by the water-services provider and sell the water to households and other users. The water and sewerage departments within the municipality or local authority have been licensed to operate commercially as water-services providers and as water and sanitation enterprises. The different institutions and operators are regulated under the Water Act of 2002.

In order to address the challenge of managing its water resources to satisfy sectoral demands, Kenya adopted its first National Water Resources Management Strategy (NWRMS) in 2003. The NWRMS provides a clear, accountable and transparent roadmap for assessing, maintaining, enhancing, developing and managing fresh-water resources, using an integrated approach and on a sustainable basis. Extensive investment is needed to remedy the low
level of development of water resources. In addition, it is necessary to reverse catchment degradation and control pollution.

There is no data on the average cost of access to water and sanitation services. However, this information is expected to be provided by the Kenya Integrated Household Budget Survey which was undertaken in 2005/6, the data of which is now being analysed.

At present, the proportion of the population with access to improved drinking-water coverage in Kenya is about 50.9 per cent and the sanitation coverage is 81 per cent. The current water-supply coverage in urban and rural areas is 75.5 per cent and 39.3 per cent, respectively, while sanitation coverage is 94.8 per cent and 76.6 per cent in urban and rural areas, respectively.

The government’s targets to meet the Millennium Development Goals (MDGs) by 2015 as indicated in the ERS are 80 per cent and 96 per cent for nationwide coverage of safe water supply and improved sanitation, respectively. For the urban and rural areas, the water-supply targets are 96 per cent and 66 per cent, respectively, while for sanitation they are 96 per cent and 89 per cent, respectively.

The targets for WSS MDGs were planned and set for each sector by the Ministry of Planning and National Development, which is co-ordinating the monitoring of the MDGs together with a roadmap for their achievement. Depending on the availability of funds for investment in water projects, the planned targets are likely to be achieved. The progress rate in relation to the goals for access to drinking water and sanitation (WSS) is higher compared to other MDGs thanks to the early establishment of an integrated approach to water issues. Moreover, the ongoing rehabilitation of water systems throughout the country has improved the access to water.

The main obstacles and challenges to WSS are inadequate finance and lack of institutional capacity. Problems include: inadequate plants and equipment for borehole drilling and dam construction; ageing WSS schemes of 20-40 years ago that need a complete overhaul; need for more efficiency in the delivery of water services and improvement of revenue collection; difficulties in mobilising resources for the WSTF to implement community schemes; inadequate resources to rehabilitate and expand WSS infrastructure, leading to poor maintenance of these systems; and the demand for services exceeding their design capacity. Most of the water is not accounted for, due to the obsolete and dilapidated state of water infrastructure and to the increasing incidence of illegal abstractions. Resources for the rehabilitation and expansion of water and sewerage infrastructure have been inadequate, and some water mains have been damaged by careless construction practices. Customers have resisted paying for water because of the general lack of accountability in the water sector. This is now beginning to change as the water-services providers continue raising public awareness of the importance of paying for water, and revenue collected by the water-providing enterprises has been increasing.

Reforms are driven by the National Policy on Water Resources Management and Development (1999), the NWRMS of 2003 and the National Water Services Strategy and Investment Plan (2003). The Water Act of 2002 created the legal framework for the implementation of these policies. The key principles of the reform are articulated around the separation of regulatory functions from services delivery, separation of ownership of assets from responsibility for operation and maintenance, the introduction of performance targets and commercial principles, the ring fencing of water-services revenues to allow the collected revenue to be ploughed back and the redeployment of existing staff to the new institutions.

Furthermore, it is government policy to devolve policy implementation to communities, the private sector and sector stakeholders. This approach is detailed in the Strategy for Performance Improvement in the Public Service and in the policy on the reforms and privatisation of public enterprises. In this arrangement, the role of the ministry will be directed at policy formulation, implementation, co-ordination, support in resource mobilisation and regulation. This new thrust is reflected in the Water Sector Strategic Plan.
Currently, MWI gives higher priority to water supply than to sanitation services. The MWI deals with sewerage, bearing in mind that other sanitation issues are being handled by the Ministry of Health. The fear is that if most of the resources are directed towards the provision of water supply while neglecting sanitation services, the environmental-sustainability MDG might not be achieved. Synergies do exist, however, as sanitation services are also provided by other stakeholders, such as the Ministry of Health.

A study is expected to be commenced soon to determine the total amount of investment required for an efficient WSS infrastructure. The major actors in financing the water sector are the government and donors/development partners, mainly through revenues generated from water charges, government budgetary allocations, loans and grants. Multilateral financial institutions give loans and grants to water projects, while the New Partnership for Africa's Development (NEPAD) water and sanitation programme provides technical advice. Multi-stakeholder participation in the WSS sectors is ensured through the Sector Wide Approach to Planning (SWAP). Donor funds increased significantly in 2006 to KES 16.5 billion. The main donors were the Swedish International Development Agency, the Danish International Development Agency, the African Development Bank, the World Bank, the French Development Agency, the Arab Bank for Development in Africa, Japan International Cooperation Agency, and the UN Human Settlement Programme UN-HABITAT.

A number of projects are currently planned, including the Nile River Basin project for Efficient Water Use for Agricultural Production, the ongoing restructuring of the MWI headquarters, and the rehabilitation of water and sewerage in Nairobi, supported in large part by the Africa Water Facility. The government budget for the MWI increased from KES 3 billion in 2001/02 to KES 11 billion in 2006/07, with development expenditure for the water sector increasing from KES 3.2 billion in 2004/05 to KES 6 billion in 2005/06.

Further institutional changes are also needed. A policy on the management of transboundary water resources is wanting but currently being developed in the context of new projects in the planning and of the Nile Basin Initiative. A national WSS monitoring and evaluation mechanism is also lacking. WSS issues are monitored and evaluated by the implementing institutions – the MWI or the Ministry of Health, for instance. Reports are provided regularly and published periodically. There is nonetheless transparency in the award of contracts, with no known political interference in water management.

### Political Context and Human Resources Development

One of the major indications of the determination to pursue good governance has been Kenya’s commitment to the African Peer Review Mechanism. Kenya completed the peer review process at the 5th Summit of the APR Forum in Banjul, the Gambia in June, 2006.

The National Rainbow Coalition (NARC) government promised to deliver the new constitution within 100 days of its taking office, but failed to do so. The draft supported by the government was defeated by the supporters of the opposition party in the 21 November 2005 national referendum, and it appears likely that constitutional reform will not materialise before the next general election.

There was some realignment amongst the political parties after the reconstitution of the cabinet soon after the government lost the constitutional-referendum vote in November 2005. The formation of a Government of National Unity involved part of the original NARC, as well as some members of parliament (MPs) from the opposition parties. MPs from the NARC rebel wing of the Liberal Democratic Party (LDP) were left out of the new governing coalition. NARC-Kenya (NARC-K) was launched on 3 June 2006 with a huge show of power featuring the Vice President and half of the cabinet in attendance. In July 2006, by-elections were occasioned by the death of five MPs in a plane crash. NARC-K won three of the five vacant seats, beating LDP and Kenya African...
National Union (KANU) rivals in an election that some considered a sign of the direction the next general election will take. NARC-K is closely associated with the government, although the president has never declared direct support for the party.

KANU, together with the LDP, had campaigned against the proposed constitution and both have now formed a coalition party, the Orange Democratic Movement Kenya (ODMK), to challenge the current government. Currently, the Political Parties Bill 2006 is awaiting debate in parliament. The bill, if passed, will pave way for political parties to receive funding from the treasury.

In an effort to improve governance and reduce the perception of being a corrupt regime, measures are being taken to strengthen key institutions – including the Office of the Attorney General (AG), The Director of Public Prosecutions, the Judiciary and the Kenya Anti-Corruption Commission (KACC) – that are on the front line of the war on corruption. These measures include: hiring lawyers and special prosecutors from the private sector; reviewing terms and working conditions of the legal staff in the AG’s chamber; increasing the number of judges and anti-corruption courts; and implementing various governance and anti-corruption strategies.

In addition, the national security loan contracts awarded by the Department of Defence have been audited and investigated and the reports tabled by the Controller and Auditor General as well as the Public Accounts Committee. These contracts are also under investigation by the KACC.

The Government continued to improve the delivery of services at the local level as a way of alleviating poverty mainly through the increase of devolved funds. This included the Constituencies Development Fund (CDF), the Local Authorities Transfer Fund (LATF) and the Road Maintenance Fund (RMF), amongst others. In 2006/07, the CDF was increased by almost 40 per cent from the statutory requirement of 2.5 per cent of ordinary revenues to about 3 per cent. Similarly, the LATF and RMF were increased by a comparable 34 per cent and more than 50 per cent, respectively.

Efforts to improve the quality of free primary education are continuing. These include: financial management and accountability in schools; rationalising the deployment of teachers; targeting tuition scholarships to poor and orphaned children; expanding and improving educational facilities countrywide; and providing adequate teaching and learning materials in schools. These measures have resulted in a significant improvement in a number of indicators.

The percentage of primary-school graduates enrolling in secondary school increased from 47 per cent in 2002 to 57 per cent in 2006, and a target of 70 per cent has been set for 2007. The number of students enrolled in universities increased from 71 349 in 2001/02 to 89 979 in the 2005/06 academic year. However, notable problems subside, including the misappropriation of funds by headteachers, inadequate physical infrastructure, a low teacher-pupil ratio and the sustainability of the school feeding programme, especially in ASAL areas.

The authorities continued reorienting policy towards preventive healthcare provision, while ensuring efficiency and effectiveness in healthcare service delivery countrywide. Reforms implemented in 2006/07 include: improving healthcare procurement procedures and accountability systems, as well as strengthening supervision capacity of medical supplies in rural health facilities in order to improve access to drugs and medical supplies. The allocation of resources to the health sector was increased from 8.6 per cent of total government expenditures in 2005/06 to 9.4 per cent in 2006/2007 to promote the achievement of the MDGs.

These resources were used to fund, amongst others, HIV/AIDS interventions, healthcare infrastructure and affordable drugs. The government, in collaboration with non-governmental organisations, set up mobile medical programmes targeting vulnerable groups such as those with disabilities and people living a nomadic life. The government supplements the health budget for anti-retroviral drugs using money provided through the treasury from the Global Fund while the Ministry of Health is responsible for its distribution. The enactment of the Sexual Offences Bill in July 2006
will also help to support the fight against the spread of HIV/AIDS. The HIV and AIDS Protection and Control Act, 2006, was enacted in December 2006. The Act provides for the protection and promotion of public health and for the appropriate treatment, counselling, support and care for persons infected or at risk of HIV and AIDS infection.

The infant-mortality and the under-five-mortality rate are estimated at 77 and 115 per 1,000 live births, respectively. The Kenya Demographic and Health Survey 1998 indicates a wide disparity of under-five mortality across regions, with low mortality in the central part of the country while the rest recorded high mortality rates. Efforts to reduce child mortality have been hampered by a number of factors, including: a decline in levels of immunisation coverage against the six childhood diseases; recurring incidence of hunger and the resultant protein-energy malnutrition amongst children; widespread incidences of malaria, diarrhoea and acute respiratory infections, which mainly have an impact on children; the HIV/AIDS epidemic and related opportunistic infections; low literacy levels and low mothers’ education levels in many parts of the country; inadequate access to sustainable clean-water sources and sanitation facilities; lack of access to health services in many parts of the country; and insufficient resources, including trained health workers, equipment, drugs, etc.

There were a few incidents of polio outbreaks, a disease that was last detected in Kenya more than 22 years ago. This was suspected to be caused by the influx of refugees from the neighbouring countries.

The target of creating at least 500,000 jobs annually has continued to remain a challenge to the government. The economy has been generating an average of 471,000 jobs annually, most of which were in the informal sector. In 2004 and 2005, employment creation was short of targets by 16.6 and 41.1 thousand jobs, respectively. This situation may improve somewhat, following the establishment of a Youth Enterprise Fund established to provide young people with access to credit for starting or up-scaling small or medium-sized enterprises, developing their entrepreneurial skills and/or creating job opportunities.