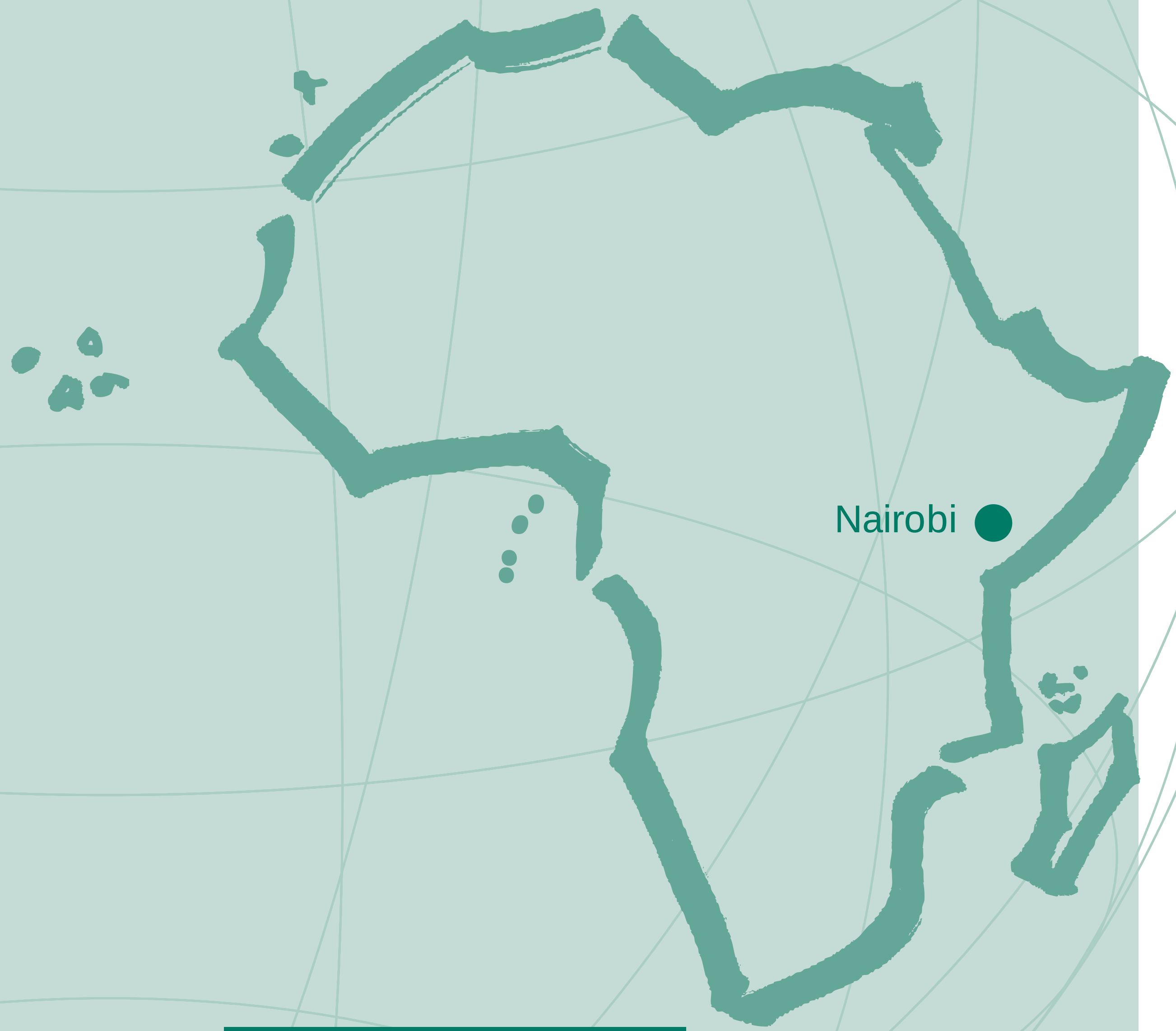
Kenya



key figures

- Land area, thousands of km² 580
- Population, thousands (2004) 32 420
- GDP per capita, $ (2003) 449
- Life expectancy (2000-2005) 44.6
- Illiteracy rate (2004) 14

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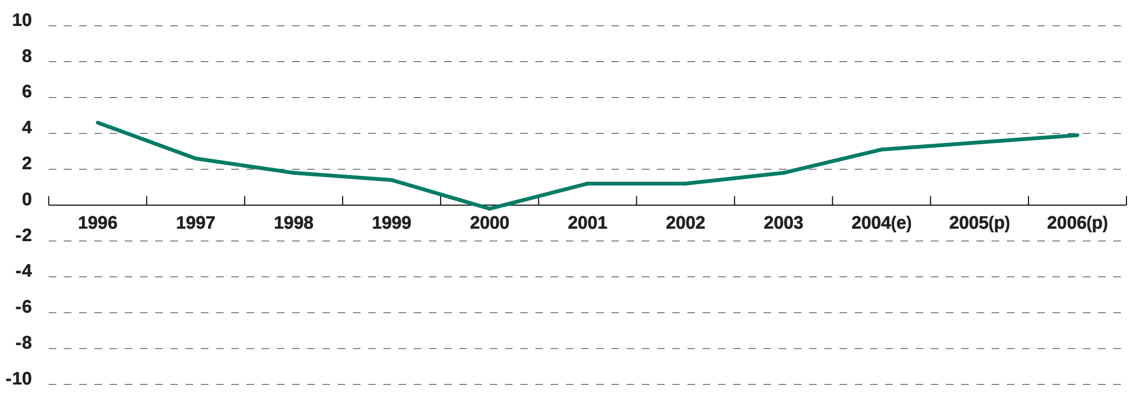
Kenya

SINCE 2003, KENYA HAS MADE significant progress in reversing its poor economic performance of the preceding decade. Following a protracted recession, a modest rebound in economic activity has got underway: fiscal performance has strengthened under the IMF-supported programme approved in November 2003, and some steps have been taken towards improving governance. In the political sphere, progress has been made towards reaching a broad consensus on the elements of a new constitution. However, inflation has accelerated sharply in recent months, there have been delays in implementing reforms in public expenditure and the financial sector, and poverty alleviation has been hampered by delays in initiating social programmes and weak donor support. The main challenge for Kenya is to accelerate broad-based growth to help reduce poverty and improve the delivery of public services, while securing fiscal discipline and restoring price stability. With these objectives in mind, the authorities plan to further improve revenue collection, contain the wage bill and reorient public expenditure in favour of essential social and economic outlays, tighten monetary policy, broaden and accelerate structural reforms (including the privatisation programme), pursue their strategy of good governance, and promote increased donor support. To foster private sector activity and improve Kenya's competitiveness, the government strategy includes efforts to improve the current regulatory environment in order to reduce the cost of doing business. Micro-financing is being considered as a possible way of meeting the financing problems of the country's sizeable SME sector.

Economic recovery appears underway but accelerated broad-based growth is needed to reduce poverty and improve public service delivery.

Figure 1 - Real GDP Growth



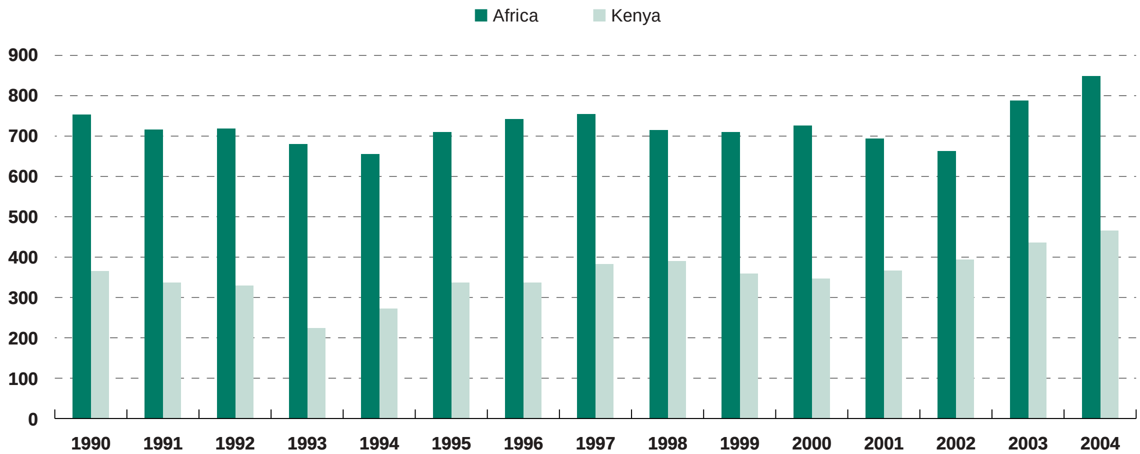
Source: Domestic authorities data; estimates (e) and projections (p) based on authors' calculations.

Recent Economic Performance

The Kenyan government is implementing an Economic Recovery Strategy to promote strong economic growth and increase employment. The programme for 2003/04–2005/06 aims at creating opportunities for productive employment through the rebuilding of sound governance structures, addressing the country's major macroeconomic vulnerabilities - particularly its weak budgetary position, large domestic debt and distressed financial system -, and reforming the parastatal sector, the labour market and the trade system to foster a more competitive private sector.

The Kenyan economy is starting to recover from what has been one of the country's longest recessions.

Figure 2 - GDP Per Capita in Kenya and in Africa (current $)



Source: IMF.

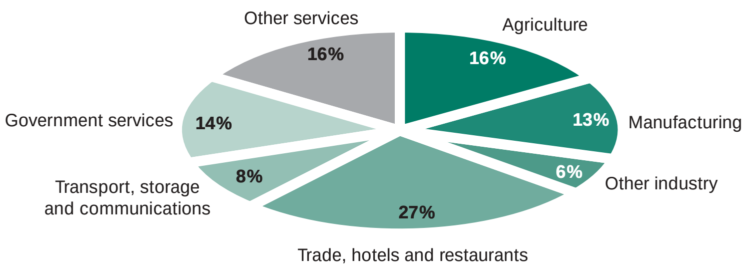
In 2003/04 real GDP grew by 3.1 per cent up from 1.8 per cent in the previous year. These first steps towards recovery have, however, been narrowly based: growth has been driven by an upturn in the tertiary sector, while primary sector output has been adversely affected by drought. Economic growth is expected to reach 3.5 per cent in 2004/05, and is projected to rise to 3.9 per cent in 2005/06, based on a broad-based performance in almost all sectors.

The performance of the agricultural sector - like that of the rest of the economy - remains below potential as a result of a number of factors. First, the sector has suffered from drought since 2000. In addition to this, the terms of trade have deteriorated owing to increases in agricultural input prices coupled with lower prices offered for agricultural produce. In 2004, the government initiated the Strategy for Revitalisation of Agriculture (SRA) to improve the contributions of the sector. In the context of the SRA, a sector-wide Kenya Agricultural Productivity Project (KAPP) was introduced to support essential activities such as research and extension services to farmers. Erratic input price movement continues to affect investment, production and profitability in the agricultural sector: finding a way of dealing with this problem would be an immediately effective way of improving agricultural output. The current instability in this area relates to the serious governance issues in the agricultural input market and requires reforms to enhance competition in input distribution and marketing.

Kenyan manufacturing appears to be responding positively to the domestic incentives introduced in 2003. Output growth in the manufacturing sector rose by 1.4 per cent in 2003, and is estimated to have expanded by 1.8 per cent in 2004 on the strength of the agro processing industries, dairy production, fish processing, fats and oils, as well as drugs and medicines, perfumes and toiletries. Key factors that have contributed to the improving performance include tax exemptions for the majority of inputs and the enforcement of anti-dumping measures to protect local industry. However, the expansion of manufacturing output remains constrained by low domestic consumer demand, high energy cost, and the recent depreciation of the Kenyan shilling. The textile industry in particular appeared unprepared for the challenge of the new WTO regulation that permits unrestricted textile exports following the expiry of the Multi-Fibre Arrangement at end-2004. The government has attempted to help the industry by introducing improvements in the administration of tax incentives aimed at encouraging trade in new, cheap and quality clothing to boost the local industry. The government has also increased vigilance to avert inflows of counterfeit and sub-standard goods that compete with local manufactures.

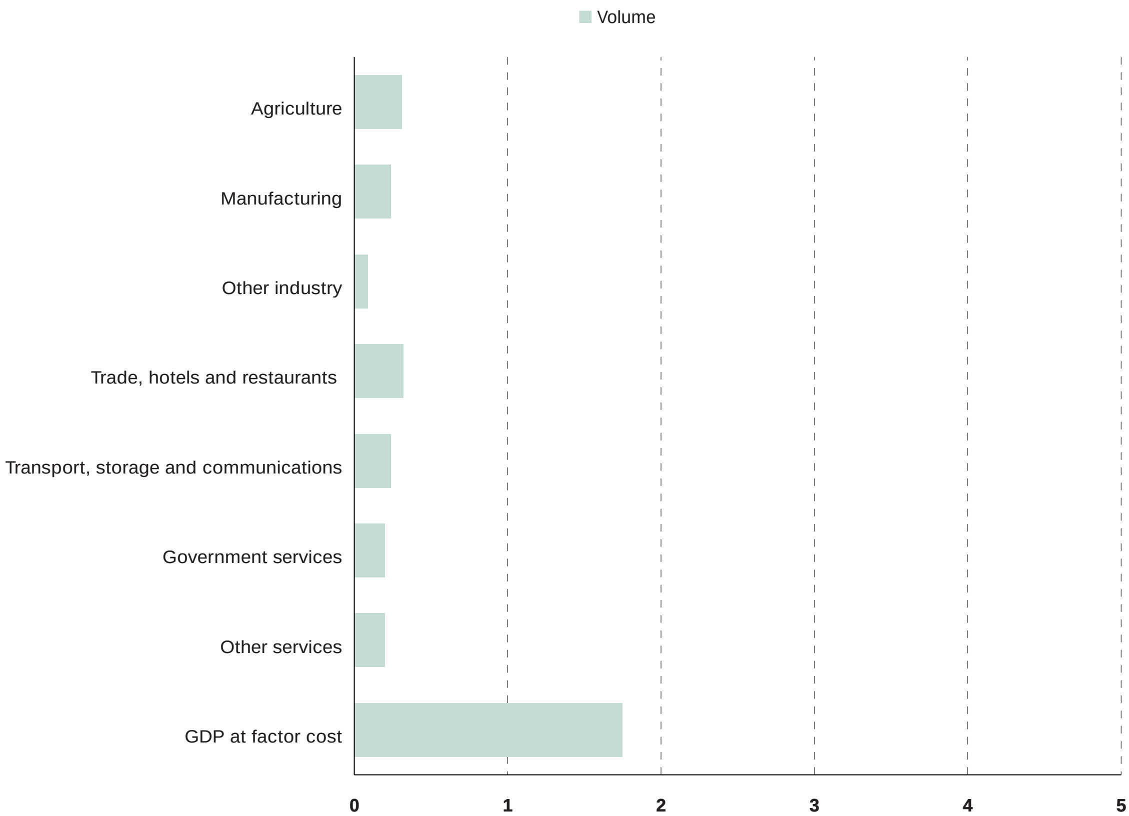
The service sector remains dominant and accounted for about 56 per cent of GDP in 2003. The tourism sector, which had hitherto driven growth in the service

Figure 3 - GDP by Sector in 2003 (percentage)



Source: Authors' estimates based on domestic authorities' data.

Figure 4 - Sectoral Contribution to GDP Growth in 2003 (percentage)



Source: Authors' estimates based on domestic authorities' data.

sector, suffered in 2003 from a decrease in the number of visitors to Kenya, following negative travel advice by the United States of what they perceived as high security risks in the country. Tourism earnings, however, recorded an improvement in that year. The tourist trade continued to struggle to regain lost ground in 2004 by promoting domestic and conference tourism. According to preliminary estimates, tourist receipts increased by an estimated 22 per cent in 2004. Although it is expected that earnings from tourism will continue to rise in 2005, there are concerns regarding the falling numbers of tourists to Kenya. The government expects that the removal of the travel advisories by the United States, along with continued efforts to improve security at the major holiday centres, will bring the tourists back to Kenya.

Indicators of the transport and communication sector continued to show increased activity for almost all sub-sectors. The recent boom in telecommunications was sustained as the number of companies licensed to offer services in telephone connections and internet services continued to rise. Landline phone capacity and mobile phone connections increased significantly, the latter following the introduction of "Simu ya Jamil" (community phone) mobile pay phones to the market in 2003. The regional operator, Bell Western, which was licensed in 2003 to offer on line service, also began operations in 2004.

Kenya's economic performance remains characterised by low and declining savings that lead to poor domestic capital formation. In 2003, gross capital formation fell to its lowest level in several years. Gross capital formation picked up in 2004, with further strengthening on the horizon. However, Kenya's capital formation performance remains below that of several other African countries. Determined efforts to speed up reforms will be required if domestic savings are to be improved as economic activity picks up, and to enhance the inflow of foreign savings for domestic investment.

Table 1 - Demand Composition (percentage of GDP)

	1996	2001	2002	2003	2004(e)	2005(p)	2006(p)
Gross capital formation	**20.3**	**14.6**	**13.4**	**12.9**	**13.7**	**14.7**	**15.4**
Public	3.6	5.1	4.6	4.4	4.4	4.7	5.2
Private	16.8	9.5	8.7	8.5	9.3	10.0	10.2
Consumption	**84.0**	**94.9**	**92.1**	**91.7**	**89.2**	**89.8**	**89.8**
Public	16.0	19.2	19.1	17.9	17.6	18.3	18.5
Private	68.0	75.7	72.9	73.8	71.7	71.5	71.3
External sector	**-4.3**	**-9.5**	**-5.4**	**-4.6**	**-2.9**	**-4.5**	**-5.2**
Exports	32.6	26.6	26.0	24.9	27.1	26.8	25.3
Imports	-36.9	-36.2	-31.4	-29.5	-29.9	-31.3	-30.5

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

Macroeconomic Policies

Fiscal Policy

The fiscal challenge facing the Kenyan government is to re-establish fiscal sustainability while reorienting the budget toward poverty reduction programmes and development expenditure. In recent years, fiscal operations recorded a declining trend in the ratio of revenue to GDP (from 29 per cent in 1995/96 to 21.7 per cent in 2001/02), while expenditure on debt service and wages remained stable. This situation created serious policy conflicts, with resources allocated to development and social expenditure being squeezed out, resulting in deteriorating public service delivery. In addition, the state's high borrowing requirement resulted in a rapidly increasing public debt – which exceeded 50 per cent of GDP by 2002 – and the government incurring substantial arrears.

In FY 2003/04, fiscal performance strengthened in the framework of the Poverty Reduction and Growth Facility (PRGF) programme agreed with the IMF in November 2003. This performance reflected a strong total revenue collection, which increased to 22.8 per cent of GDP in 2003/04, as measures were taken to rebuild the credibility and improve the capacity of the Kenya Revenue Authority, and to reform the customs administration. In parallel, the management of recurrent expenditure was tightened. Furthermore, Kenya received Houston rescheduling terms from Paris Club creditors in January 2004 despite its IDA-only country status.

Table 2 - Public Finances[a] (percentage of GDP)

	1995/96	2000/01	2001/02	2002/03	2003/04	2004/05(p)	2005/06(p)
Total Revenue and grants[b]	**30.4**	**25.3**	**21.7**	**22.1**	**22.8**	**23.0**	**22.5**
Tax revenue	24.8	19.5	17.6	17.5	17.7	17.8	17.9
Grants	1.2	1.5	1.3	1.5	1.9	1.9	1.4
Total expenditure and net lending[b]	**30.4**	**25.3**	**24.1**	**24.1**	**24.4**	**25.3**	**25.4**
Current expenditure	24.5	21.1	21.2	20.8	20.4	21.4	21.2
Excluding interest	*17.0*	*18.2*	*18.0*	*17.4*	*17.4*	*18.2*	*18.8*
Wages and salaries	5.0	8.6	8.9	8.7	8.7	8.6	8.6
Interest	7.5	2.9	3.2	3.5	3.1	3.2	2.4
Capital expenditure	5.3	3.9	2.8	3.3	3.9	3.9	4.2
Primary balance	**7.6**	**3.0**	**0.8**	**1.4**	**1.4**	**0.9**	**-0.5**
Overall balance	**0.1**	**0.0**	**-2.4**	**-2.0**	**-1.7**	**-2.3**	**-2.9**

a: Fiscal year begins 1 July.
b: Only major items reported.
Source: Domestic authorities' data; projections (p) based on authors' calculations.

In view of the slow resumption of donor budgetary assistance, the authorities revised their initial budget for 2004/05, allowing for a more modest expansion in poverty reduction programmes and development expenditure, while increasing domestic borrowing to 2.5 per cent of GDP. The authorities intend to pursue their efforts to improve revenue performance in 2004/05 despite the adverse effect expected from the introduction of the Common External Tariff (CET) by the East African Community (EAC) on 1 January 2005, and to restructure expenditure to permit increased allocations for roads, health and agriculture. The authorities plan to address the problem of budget rigidity through a new wage-setting mechanism for public employees linking wage awards to revenue growth.

The overall fiscal deficit declined from 2 per cent of GDP in 2002/03 to 1.7 per cent in 2003/04; it is expected to rise slightly to 2.3 per cent of GDP in 2004/05 and again to 2.9 per cent of GDP in 2005/06.

Monetary Policy

Kenya's monetary policy is aimed at achieving domestic price level stability. The monetary authorities' success in controlling movement in monetary aggregates in the course of 2001 and 2002 contributed to keeping inflation low. This achievement was reversed in 2003 as banking credit to the government drove a substantial increase in monetary aggregates: broad money supply (M3) increased by 13 per cent, compared with 10 per cent in 2002. The attempt by the Central Bank of Kenya to rein in the growth of money supply (M3) in 2004 to 8 per cent appears to have been unsuccessful, as monetary expansion was estimated at 12.6 per cent during the 12-month period through to September 2004.

The loosening of monetary policy, together with the increase in oil price and drought-related shortages of food commodities, has led to an increase in inflation. The annual average rate of inflation rose markedly from 2 per cent in 2002 to 9.8 per cent in 2003, and jumped to an estimated 11.1 per cent in 2004. The government has allowed both oil and food prices to adjust fully to the increase in imports prices, with appropriate safety nets to protect the poor. The prices of gasoline and kerosene (the major source of lighting and cooking energy for about 80 per cent of the population) were raised by 22.7 per cent and 33 per cent, respectively, between October 2003 and October 2004. The outlook for inflation is moderation as food production is expected to improve and monetary conditions to be less expansionary. The annual average rate of inflation is projected to decrease to 6.2 per cent in 2005 and to 5.4 per cent in 2006.

Interest rates have not risen in pace with inflation, resulting in negative interest rates, as banks' reserve requirement was lowered from 10 per cent to 6 per cent in July 2003. The rate on the benchmark 91-day

Treasury bills averaged 1.41 per cent at end-December 2003 and 2.75 per cent at end-September 2004.

Kenya maintains a flexible exchange rate system to complement its trade reforms and to ensure an appropriate structure of economic incentives for producers. In 2003/04, the Kenya shilling depreciated by 8.2 per cent in real terms. The depreciation reflected increased foreign currency demand associated with the lax monetary policy, high oil prices, and to an extent, speculative pressures following delayed donor inflows.

External Position

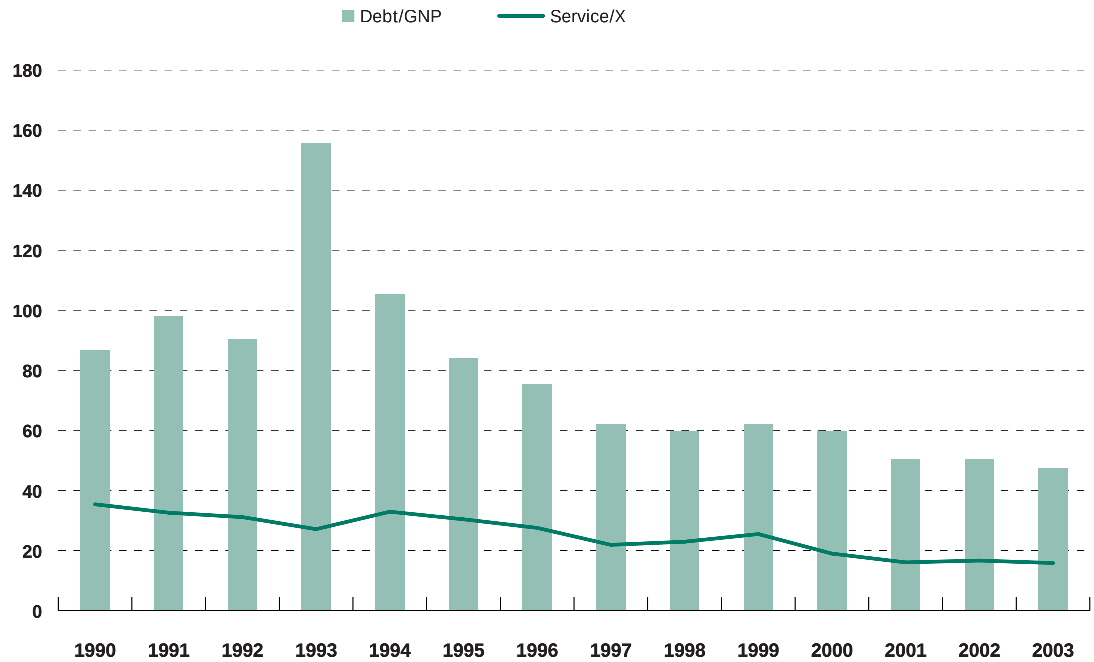
Kenya maintains a liberalised external trade system, although there are some import controls based on health, environmental and security concerns. In addition imports are subject to a pre-shipment inspection for quality, quantity and price. The country's trade policy is increasingly oriented towards regional integration, with the focus of the integration being on COMESA (Common Market for Eastern and Southern Africa), and the EAC (East African Community), which now

Table 3 - Current Account (percentage of GDP)

	1996	2001	2002	2003	2004(e)	2005(p)	2006(p)
Trade balance	-5.6	-12.0	-8.2	-7.9	-8.6	-10.2	-10.4
Exports of goods (f.o.b)	22.5	16.9	17.7	16.9	16.8	16.6	15.6
Imports of goods (f.o.b)	-28.1	-29.0	-25.8	-24.8	-25.5	-26.7	-26.0
Services	1.1	2.5	2.7	3.3			
Factor income	-2.4	-1.1	-1.2	-0.6			
Current transfers	4.8	7.2	5.2	5.7			
Current account balance	**-2.1**	**-3.4**	**-1.5**	**0.5**			

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

Figure 5 - Stock of Total External Debt (percentage of GNP) and Debt Service (percentage of exports)



Source: World Bank.

account for most of Kenya's trade within Africa. The EAC Customs Union, which came into force on 1 January 2005, lowered Kenya's maximum tariff rate from 35 per cent to 25 per cent.

Kenya's external accounts position has remained fragile in spite of improvement in the terms of trade in 2003, which reversed the deterioration of the preceding four years. The contraction in the trade deficit in 2003 that led to an improvement in the current account was reversed in 2004 as a result of higher imports (in value terms), notably petroleum products and food items. Tea and horticulture together accounted for about 50 per cent of total export earnings in 2004. The external accounts position may be expected to deteriorate as the trade deficit widens in 2005 and 2006.

Kenya's external debt is low and remains on a declining trend. It stood at $5 billion at end-2003. Multilateral organisations continued to be the leading creditors, accounting for 62 per cent of the total debt, while bilateral creditors accounted for 32.2 per cent. The remaining 5.8 per cent of the total debt was owed to commercial banks. Japan and France were the leading bilateral creditors, while the International Development Association (IDA) and the African Development Bank – Kenya's leading development partners for many years – were the dominant multilateral creditors. The total debt was equivalent to 35 per cent of GDP in 2003 (80 per cent in 1996), well below the thresholds of the enhanced HIPC Initiative. The debt service ratio has also declined from 24 per cent in 1996 to 22 per cent in 2003. Other key debt ratios and debt service burden indicators are also relatively low and Kenya's external debt is sustainable. As mentioned above, Kenya rescheduled its debt with Paris Club creditors in January 2004 and it settled the modest amount of non-rescheduled arrears to Paris Club creditors by November 2004. The authorities have undertaken an audit of Kenya's external commercial contracts for governance reasons.

Structural Issues

Despite the structural reforms undertaken since the 1990s to diversify the economy and attract investment, the lack of necessary infrastructure and the current regulatory and legal framework are still imposing a significant burden on private business activity and thereby hindering faster growth. The private sector is facing problems of security, a lack of harmonisation of government procedures and widespread corruption.

Kenya's privatisation programme, which has been ongoing since 1992, has made some limited progress. The privatisation process suffered a major setback when the Privatisation and Sale of Assets Bill was not enacted as planned in 2003. In the course of the following year the government put together a privatisation programme. This plan targets a number of commercial public enterprises in the agricultural, tourism and financial sectors for privatisation or management contracts, as well as major parastatals including Telcom Kenya, KenGen, KPA, and Kenya Railways Corporation. The programme also sets out the government's intention to sell its shares in the Kenya Commercial Bank. However, the privatisation process requires the enactment of the necessary legislation, which is still pending before the Parliament.

In spite of the financial sector reforms pursued in the past, Kenya's financial system is still ailing. Its weaknesses include: *i)* high level of Non-Performing Loans (NPLs) arising from political lending from public sector banks, insider or connected lending, and pervasive legal problems in enforcing creditor rights; *ii)* under-capitalisation, which leaves banks vulnerable to negative shocks; *iii)* low or negative profitability and high costs, despite large intermediation margins, with spreads between lending and deposit rates of about 13 percentage points; *iv)* weak banking supervision; and *v)* a fragmented legal framework for insolvency and creditor rights, with outdated insolvency laws.

The government has started addressing the existing problems in the financial system. Reforms were introduced in 2003 to improve governance in the banking industry by enabling the central bank to access information on bank interests and other charges. In 2004, the government introduced a comprehensive Financial Sector Reform Strategy that calls for major changes to the Banking Act, including the transfer of operational and licensing powers from the Minister to the Central Bank. In accordance with the Basel Accord, significant shareholders would be subject to vetting by the Central Bank. The introduction of the so-called "In Duplum" rule would safeguard the interests of borrowers by introducing a cap on interests charged on non-performing loans. Also in 2004, the government sought to enhance corporate governance in the banking sector by *i)* requiring the continuous vetting of the chief executive, directors and significant shareholders of banks and financial entities prior to assuming responsibilities; and *ii)* restricting lending to any one shareholder to no more than 25 per cent of the core capital.

Kenya has a sizeable SME sector that the government is attempting to promote. SMEs encompass businesses employing up to 50 workers. The sector was estimated to employ about 3.2 million people and contributed about 18 per cent of total GDP in 2003. Earlier government policies aimed at promoting the SMEs were based on welfare considerations: SMEs were regarded as potential generators of employment, vehicles for achieving balanced regional growth and as counterweights to the concentration of economic power by larger firms. This contributed to keeping the SME sector in Kenya weak and uncompetitive.

Although the problems faced by SMEs in Kenya vary by sector, limited access to financing is a problem that is experienced across the board. In spite of Kenya's relatively large financial services sector, only about 10 per cent of the population is estimated to have access to banking services. The bulk of the poor, who mostly live in the rural areas, have no access to formal financial services. Consequently, small entrepreneurs start their business by investing their own savings and/or using funds obtained from relatives or friends. This might be supplemented by loans from informal lenders or by credit from suppliers. It is only after the business has been operating for some time, usually as a micro-enterprise or on a small scale, that any attempt is made to seek financing from a bank for further development and expansion.

The main reason why commercial banks are reluctant to lend to the SMEs is that this type of business seldom has any credit history or marketable assets to use as collateral. Bank lending to SMEs is usually done after on-site inspections - which may also include house visits - to assess what tangible assets the client owns. Thereafter, loans are awarded on an incremental basis and the client keeps getting more once the previous loan has been successfully repaid.

There are a large number of micro-finance institutions involved in providing financial services to people with low incomes, as well as to SMEs. There exist about 4 000 Saving and Credit Co-operative Societies (SACCOs). SACCOs are member-based institutions found both in the rural and urban areas of Kenya: members have to save a fixed amount in order to qualify for SACCO credit which can be used for starting up or promoting an existing business. While SACCOs are an important provider of financial services for rural SMEs, one major weakness has been their limited outreach capacity in areas without a major cash crop. This includes the greater part of marginal areas in Kenya where the bulk of the poor live. SACCOs can also guarantee loans from the Co-operative Bank of Kenya for one or several of their members operating as an SME. In addition to the SACCOs, there are about 1 million rotating and accumulating savings and credit associations (ROSCAs and ASCRAs), which are a form of "merry-go-round". They mostly provide goods or capital to their members for starting or enhancing businesses. Finally, there are about 130 other micro-finance organisations recorded by the Central Bureau of Statistics.

Micro-finance institutions face major obstacles in their operations, including the lack of a mechanism to track and recover loans, a lack of co-ordination, a lack of commitment from the borrowers, and the use of counterfeit documents as collateral. Furthermore, they suffer - as do the commercial banks - from the lack of a supportive judicial system and effective administration of property rights.

Political and Social Context

Since the political transition in December 2002, which brought the National Rainbow Coalition to power, Kenya's participatory democracy and political pluralism has appeared to be stable and working well. However, differences within the ruling government, with roots in the pre-election formation of the Coalition, have surfaced of late. This division is holding up progress towards the New Constitution of Kenya.

The government has shown commitment to maintaining the rule of law, peace and security. In this regard, the capacity and co-ordination of public safety and law and order institutions have been strengthened. The efficiency of the judiciary has also been improved; more judicial officers have been appointed and the law courts are being rehabilitated. In order to free the courts of petty cases, in 2004 the government drew up plans to establish small claims courts. The government now has an anti-corruption strategy, which involves civil society. The Kenya Anti Corruption Commission (KACC), which came into being in its present form in 2003 after the enactment of the Anti Corruption and Economic Crimes Bill, has responsibility for investigating and prosecuting in corruption and economic crimes cases. There is now an office of a permanent secretary in charge of ethics and governance who reports directly to the president. In addition there is the Kenya Human Rights Commission (KHRC), which is now quite vocal on matters of governance in Kenya.

The operations of institutions set up to safeguard good governance are backed up by key pieces of legislation. Following the enactment of the Public Officers Ethics Bill - which provides a code of conduct for all public officers, including Members of Parliament, the executive and the judiciary - in mid-2003, mechanisms were instituted for implementing the Act. All public officials, including members of the judiciary, executive, and legislature, were required to complete declarations of their assets and those of their families by December 2003, and the information declared therein will be made public. An independent Anti-Corruption Commission was established in 2004 to investigate alleged cases of corruption. In addition to this, reforms to the judicial system were made which included the dismissal of corrupt judges. In spite of these efforts, there is a perception that the political resolve to fight corruption is rather uncertain.

The government has increased funding for pro-poor social services especially in health and education. The share of government health expenditure in total expenditure increased to 5.3 per cent in 2004 from 5 per cent in 2003. Nonetheless, the 2003 Kenya Demographic and Health Survey (2003 KDHS) shows that the health situation remains dire. The infant mortality rate (77 deaths per 1000 live births) and under-five mortality rate (115 deaths per 1000 live births) are very high, as are pregnancy-related deaths (14 per cent of all deaths of women aged 15-49), possibly due to the high proportion of deliveries that take place without the assistance of professional medical personnel. Total Fertility Rate (TFR), which declined between the 1960s and the 1990s, seems to have started rising again since 1998. This represents a major demographic challenge for a country that already has one of the fastest growing population rates in Africa. Domestic violence also appears to be an important issue.

The spread of HIV/AIDS continues to represent a major challenge to the health system although the HIV prevalence rate has slowed down. The infection rate among females is higher than among males.

Government expenditure on education, which rose sharply to 21.4 per cent of total expenditure in 2003, fell to 20.8 per cent the following year. The introduction in 2003 of free primary education enabled over one million children who previously received no formal education to enrol in primary school. However, the "hard-to-reach" group of youngsters that includes street children, orphans and those with HIV/AIDS, require specific measures if the country is to achieve its education for all objective. The increase in primary school enrolment will need to be followed by improvements in the higher levels of the education system.