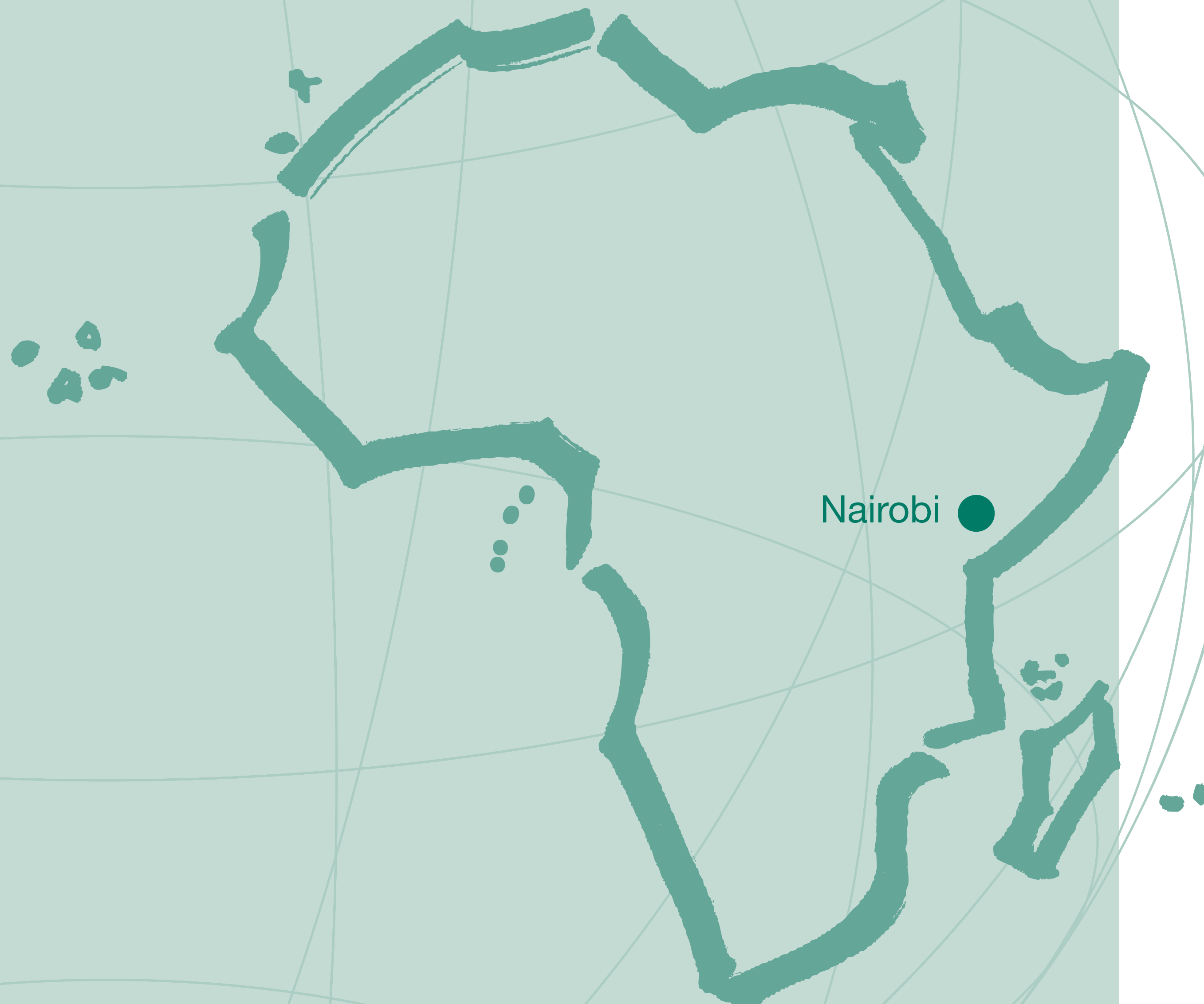
Kenya



key figures

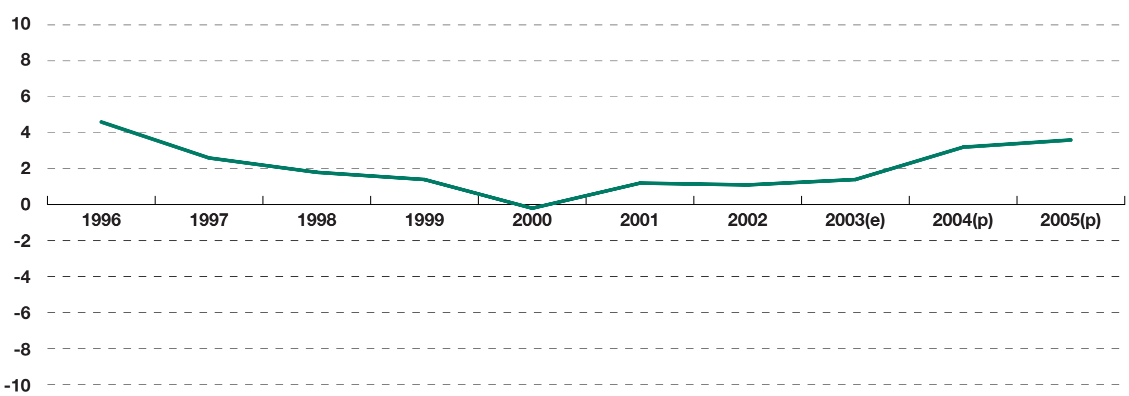
• Land area, thousands of km^2	580
• Population, thousands (2002)	31 540
• GDP per capita, $ (2002)	390
• Life expectancy (2000-2005)	44.6
• Illiteracy rate (2002)	15.8

Kenya

THE RECENT ECONOMIC PERFORMANCE OF KENYA has been well below potential due to a combination of factors including structural bottlenecks and slow pace of reform, low international commodity prices, and governance-related problems. In 2003, while the inauguration of a new government appeared to signal a turn for the better, economic growth remained tame at only 1.4 per cent. Growth had been similarly low in 2002 at 1.1 per cent. The rather poor growth performance in 2002 and 2003 was accompanied by deteriorating economic fundamentals including a huge domestic debt, a worsening fiscal deficit and rising inflation. Under an Economic Recovery Strategy launched in June 2003, economic policy has been reoriented to stimulate growth. The government has also begun to pay attention to the country's governance-related problems by taking important positive steps towards solving the institutional governance issues that have stood between Kenya and major international donors in the past. Economic and other reforms are being reinforced by participatory democracy and political pluralism, which since the political transition in 2002 appear to be stable and working well. Also, the government is taking steps to improve the energy supply situation, which remains crucial to the country's development objectives. The measures being pursued since 2003 ought to reflect an improved economic performance. Real GDP growth is projected to rise to 3.2 per cent in 2004 and further to 3.6 per cent in 2005, as Kenya derives increased financial flows from donors, as well as from exports. The renewed growth performance is likely to be accompanied by improvements in other macroeconomic fundamentals: the government's fiscal deficit should contract, the rate of inflation subside and external payments improve. Nonetheless, the recent poor economic performance has culminated in declining income per head and daunting social problems. These are reflected in increasing poverty, aggravated by unemployment, and relatively low health standards, as well as an education system characterised by non-enrolment, high dropout and low completion rates, which will require special attention as economic activity improves.

The government has begun to pay attention to governance-related problems that have discouraged major international donors in the past.

Figure 1 - **Real GDP Growth**

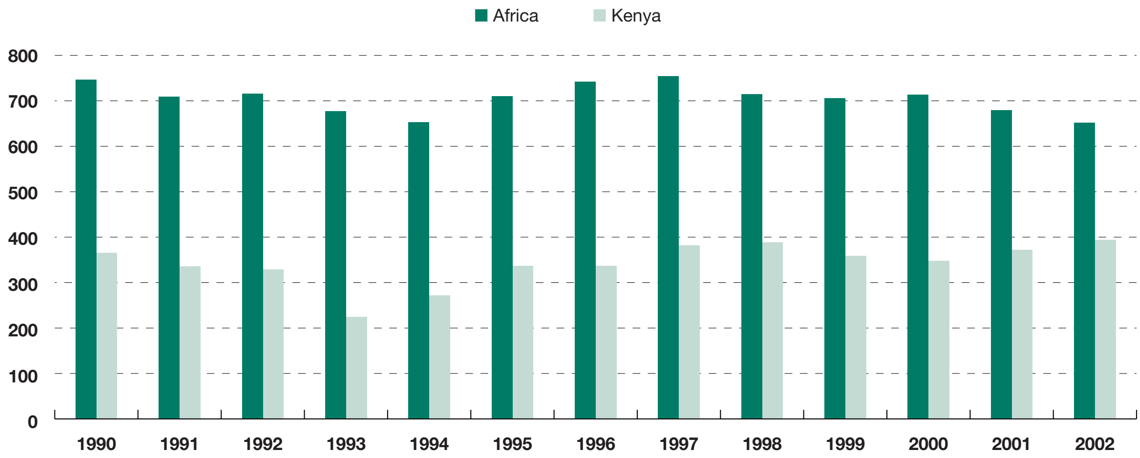


Source: IMF and domestic authorities' data; projections based on authors' calculations.

Recent Economic Developments

The economic performance of Kenya has been well below potential in recent years. In an attempt to turn the tide, the National Rainbow Coalition (NARC) administration that took office on 30 December 2002 embarked on reforms aimed at jumpstarting the economy in order to create additional jobs, improve

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



Source: IMF.

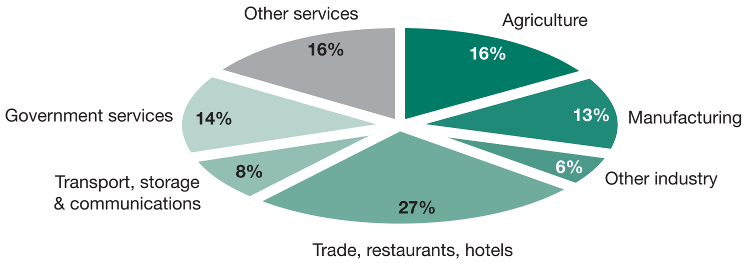
governance, and reduce poverty levels. In June 2003, the government put in place an Economic Recovery Strategy (ERS) for 2003-2007, which, as part of broader reform agenda, aims to create opportunities for productive employment. This is to be achieved by rebuilding sound governance structures, addressing the country's main macroeconomic vulnerabilities – particularly the weak budgetary position, large domestic debt, and strained financial system – and reforming the parastatal sector, labour markets and the trade system to foster a more competitive private sector. Several macroeconomic targets were set for the period, including an annual growth rate of 4.7 per cent; raising the domestic investment rate to an annual average of 17.7 per cent; raising the annual savings rate to 15.8 per cent; annual export growth to an average of 5.8 per cent; and reducing government consumption to about 14 per cent of GDP.

The achievement of these targets would allow Kenya to reverse declining per capita income and start reducing the country's pervasive poverty.

In 2002, economic growth remained very low, at only 1.1 per cent. Also, in spite of some signs of recovery in 2003, growth remained rather low at an estimated 1.4 per cent. Several factors have contributed to this tame level of growth. These include governance-related problems that have contributed to Kenya's being denied international financial assistance. While the smooth transfer of political power at the end of 2002 generated considerable goodwill from the international community, the resumption of international financial assistance was too low to boost growth, although towards the end of 2003 international donors signalled their intention to resume normal flows to Kenya. Other factors that have contributed to the dismal growth performance include the slow pace of reforms, the poor state of infrastructure, and low international commodity prices, especially for Kenya's agricultural exports. The outlook on economic growth is positive, with real GDP growth projected to rise to 3.2 per cent in 2004 and further to 3.6 per cent in 2005. The expansion in economic activity is expected to follow increased financial flows, firstly from donors, as Kenya maintains its governance-related reforms, and secondly from increased exportations, particularly coffee exports.

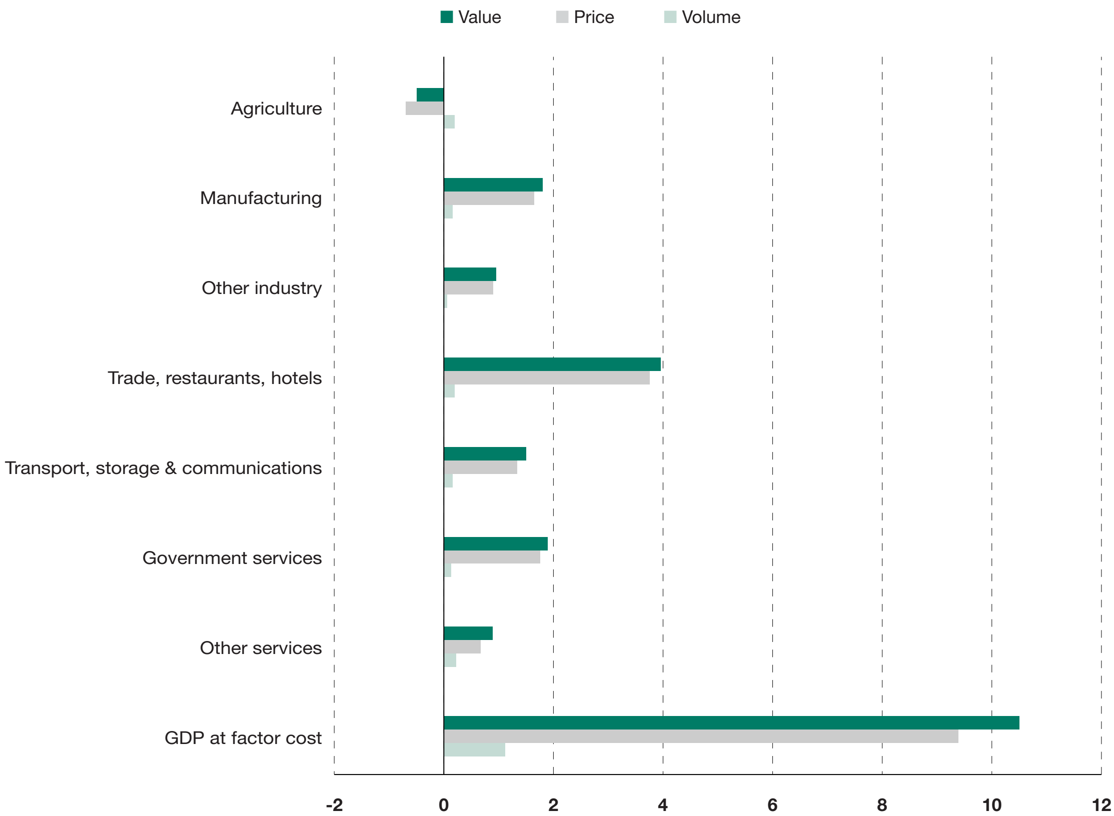
The sluggish economic growth until 2003 has been reflected in all major sectors of the economy. The agricultural sector grew only 0.7 per cent in 2002, with available estimates indicating only a slight recovery to 1.3 per cent in 2003. The sector's growth has suffered from high input prices, low global prices for exported commodities, and mixed weather conditions. In particular, the production of major cereals, maize and wheat, as well as the export commodities coffee and tea, have been adversely affected. Maize output went down from 30 million bags in 2001 to 26 million bags in 2002

Figure 3 - GDP by Sector in 2002



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

Figure 4 - Sectoral Contribution to GDP Growth in 2002



Source: Authors' estimates based on IMF data.

although there was an excess supply of maize on the market in 2002 as a result of the large stock carried over from the previous year. In 2003, about 23 million bags of maize were harvested, representing a reduction of about 10 per cent on the previous year's level. Wheat output fell significantly from 81.5 thousand tons in 2001 to 60.1 thousand tons in 2002. The output of maize and wheat also suffered from the competition of duty-free and tax-free imports. This practice consistently drove producer prices below remunerative levels and undermined farmers' incomes, while discouraging local production. Since the beginning of 2003/04, the government has made concerted efforts to improve economic incentives in favour of food crop farmers, notably through the revocation of the right of all traders to import certain commodities free of duties and taxes, unless these commodities are listed as duty free in the tariffs system. With regard to cash crop production, the output of coffee has continued to suffer from low international commodity prices. As a result, the coffee auction price in Kenya has fallen from an average of Kshs400 ($5.00) in 1997/98 to the 2002/03 level of Kshs120 ($1.50) per kilo. This drop has been exacerbated by management problems that have plagued the industry for many years, with the result that some farmers have neglected their crops, while others have abandoned them altogether. Coffee output in the 2001/02 crop season of 48 000 tons was less than half the output of 100.7 thousand tons realised in the preceding season.

The output of coffee, however, strongly picked up in 2003, with an increase of nearly 50 per cent during the first 8 months of the year. This increase was due to good weather conditions, the elimination of taxes on coffee inputs, and improved crop husbandry motivated by better governance in the sub-sector, which can be attributed to the liberalisation of the coffee market in the late 1990s. Tea output has also suffered on account of poor weather conditions and low global prices. Output of tea fell from 294.6 thousand tons in 2001 to 287.1 thousand tons in 2002. In the first half of 2003, tea output declined further by 3.3 per cent, reflecting delays in the onset of rains in the tea-growing areas. On a positive note, cotton production continues to recover, due to the opportunities offered by the African Growth and Opportunity Act (AGOA) and direct support provided by government.

The manufacturing sector has continued to recover after the adverse effects of the 2000 drought. The sector maintained its 13 per cent share of GDP in 2002, with a growth rate of 1.2 per cent in 2002. During the first part of 2003, growth in the manufacturing sector was estimated to remain at 1.2 per cent. The improving performance has followed the reduction of import duties on most raw materials and industrial intermediates since July 2002, and the increased availability of electricity and water. Also, market expansion brought about by AGOA, COMESA and the EAC trade arrangements has contributed to the resurgence of manufacturing activities. The additional tax incentives introduced in the fiscal year 2003/04 are expected to enhance industrial performance further. Specifically, these measures include duty waivers on capital goods and plant and equipment for investment, the removal of excise duties on locally assembled motor vehicles, the reduction in excise duties on fuel oils, and the increase of investment allowance from 60 per cent to 100 per cent. The high cost of electricity – a particular concern to the manufacturing sector in recent years – is also expected to decline following the zero-rating of bulk electricity imports from Uganda, the reduction of the excise duty on fuel oils by 50 per cent and duty waivers on equipment and machinery used in electricity generation.

The sugar industry in particular has seen a significant upsurge, registering a 31 per cent increase in 2002. Also, all other agro-processing industries recorded positive growth in 2002. Beverages and tobacco showed a growth rate of 4.9 per cent, while textiles and clothing recorded 3.4 per cent growth on account of AGOA.

Within the services sector, tourism, low in 2002, took a turn for the better in 2003. In 2002, in spite of the concerted effort by the authorities to market 'Destination Kenya', tourism activity remained low, largely due to the terrorist attack in Mombasa and the general insecurity in the country. Although the number of arrivals slightly increased in 2002, tourism earnings dropped by 10.4 per cent due to a decline in American and British tourists, who usually spend the most. In 2003, the number of tourists arriving in Kenya continued to increase, with a 13.9 per cent increase recorded in the first part of the year. Also, earnings from tourism showed an increase of 34 per cent in the first 8 months of 2003. This has been attributed to the success of renewed efforts to market Kenya's tourism potential, in the wake of security concerns, adverse travel advice by the British and US governments, and increased competition from other destinations with competitive packages, such as South Africa, Egypt and the Indian Ocean islands. The image of Kenya abroad as a destination of choice by holiday makers also improved following the peaceful general elections and the smooth political transition in December 2002.

Within the services sector, the transport, storage and communication sub-sectors have also continued to show positive growth. Most of this has been in mobile phone services, which have continued to grow significantly every year since liberalisation in 2000. The sub-sector expanded by 2 per cent in 2002 and by a further 3 per cent in the first 8 months of 2003. In 2002, demand for mobile phones in Kenya increased to over one million, representing an increase of 69.6 per cent over the previous year, and by June 2003 the demand for mobile phones had reached 1.6 million, following the government's licensing of an additional mobile service provider.

Kenya's economic performance remains characterised by low and declining savings that lead to poor domestic capital formation. In 2002, gross capital formation fell to its lowest level in several years. However, in 2002 the pattern of investment changed with a substantial increase in investment in manufacturing for export. Capital formation remained low in 2003, albeit slightly improved on 2002, due to an increase in public investment. The pattern of low capital formation in the Kenyan economy is expected to be maintained in 2004 and 2005, requiring the government to make determined efforts to increase domestic savings as economic activity improves.

Table 1 - **Demand Composition** (percentage of GDP)

	1995	2000	2001	2002	2003(e)	2004(p)	2005(p)
Gross capital formation	**21.8**	**15.4**	**14.5**	**13.6**	**14.0**	**14.1**	**14.4**
Public	4.3	5.5	5.1	4.8	5.3	5.4	5.5
Private	17.5	9.8	9.4	8.8	8.6	8.7	8.9
Consumption	**84.1**	**94.1**	**96.8**	**90.5**	**88.4**	**87.4**	**86.5**
Public	14.8	17.5	19.1	19.0	18.6	18.3	18.1
Private	69.3	76.6	77.7	71.5	69.9	69.1	68.5
External sector	**-5.9**	**-9.4**	**-11.3**	**-4.1**	**-2.4**	**-1.6**	**-1.0**
Exports	32.8	26.6	26.5	26.5	26.7	27.2	28.1
Imports	-38.7	-36.0	-37.9	-30.6	-29.1	-28.8	-29.1

Source: IMF data; projections based on authors' calculations.

Macroeconomic Policy

Fiscal and Monetary Policy

Within its broad Economic Recovery Strategy (ERS), the government's fiscal policy objective is to spend to stimulate growth, and to provide tax and other incentives to producers. However, the recent expansionary fiscal policy has worsened the fiscal deficit. High domestic debt remains a major challenge for fiscal stability, having resulted from the government's need to finance its deficits entirely from domestic sources. Domestic debt has risen sharply to represent an estimated 11.4 per cent of GDP in 2002/03. In addition, the government has bills and liabilities pending. Net servicing charges on domestic debt almost doubled between 2001/02 and 2002/03. Under the ERS Kenya expects a significant expansion in donor assistance, which would facilitate a reduction in the domestic debt. Such a reduction would reduce interest payment thereby freeing up budgetary resources for priority poverty spending. The overall budget deficit increased to 4.9 per cent of GDP in 2002/03 from 3.1 per cent of GDP in the preceding year. This reflected under-performance in tax revenue associated with lower than expected economic growth. It also reflected delays in structural reforms, particularly in the programmed privatisation of Telcom Kenya Ltd. and Kenya Re-insurance. The deficit can also be attributed to additional expenditure on free primary education in public schools and salary adjustments for public servants. The government expects to maintain an expansionary fiscal programme under the ERS, particularly to serve the needs of the education and health services. However, it is anticipated that the budget outcome will improve in 2003/04 thanks to an increase in grants, with the overall budget deficit projected to fall to 3.7 per cent of GDP before increasing to 4.4 per cent of GDP in 2004/05.

In 2002/03, total government revenue was 23.2 per cent of GDP. Government receipts from taxation increased from 17.5 per cent of GDP in 2001/02 to 18.6 per cent in 2002/03. The increase was attributed to continuing efforts by the Kenya Revenue Authority (KRA) to strengthen its tax administration. Income tax and VAT, the rates of which are relatively high, have continued to dominate tax revenue, contributing about 70 per cent of the total. The 2003/04 budget lowered the standard VAT from 18 per cent to 16 per cent. Although this reduction was not expected to affect the structure of government revenue, early indications in 2003/04 are that VAT receipts have fallen significantly below the amounts collected in the similar period in 2002/03. The government's receipts of external grants also increased in 2002/03, reflecting the international goodwill towards Kenya following the successful political transition in 2002.

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

	1995/96	1999/2000	2000/01	2001/02	2002/03(e)	2003/04(p)	2004/05(p)
Total revenue and grants[b]	**30.2**	**24.5**	**24.0**	**20.9**	**23.2**	**24.8**	**24.7**
Tax revenue	25.1	20.4	19.8	17.5	18.6	19.2	19.2
Grants	1.3	0.6	1.1	0.6	1.4	2.4	2.2
Total expenditure and net lending[b]	**31.8**	**22.8**	**25.5**	**23.9**	**28.1**	**28.5**	**29.2**
Current expenditure	24.8	20.1	21.5	21.1	23.8	24.1	24.5
Excluding Interest	*17.5*	*16.3*	*18.6*	*17.9*	*20.0*	*20.0*	*20.3*
Wages and salaries	5.3	4.6	4.4	4.3	4.4	4.7	4.4
Interest	7.3	3.8	2.9	3.2	3.8	4.1	4.2
Capital expenditure	6.6	2.5	3.7	2.8	4.3	4.3	4.6
Primary balance	**5.8**	**5.5**	**1.4**	**0.2**	**-1.1**	**0.4**	**-0.3**
Overall balance	**-1.6**	**1.7**	**-1.5**	**-3.1**	**-4.9**	**-3.7**	**-4.4**

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

In 2002/03 total government expenditure increased to 28.1 per cent of GDP, from 23.9 per cent in the preceding year. This reflected the priorities of the new government, which placed extra emphasis on financing education and pursuing good governance. In particular, the wage bill rose to constitute about 30 per cent of current expenditure and about 4.4 per cent of GDP, as a result of increases in public servants' wages and salaries in 2002/03. Further increases were registered in 2003/04, raising concerns that the share of wages and salaries in Kenya will be considerably higher than in neighbouring countries. Capital expenditure also increased sharply to 4.3 per cent of GDP in 2002/03 from 2.8 per cent the year before. The increase reflected a renewed emphasis on rehabilitation of physical infrastructure and public assets as a basis for economic recovery. In line with the objectives of refurbishing the social services and capital infrastructure of the country, the government envisages expenditure in 2003/04 to be driven primarily by increased public outlays on education, operations and maintenance, and capital spending. However, while the 2003/04 expenditure programme appears to indicate a reorientation towards poverty reduction, it remains imperative for the government to improve public expenditure management.

Kenya has exercised prudence in its monetary policy, keeping movements in monetary aggregates stable and inflation low. In doing so, however, it has contributed to poor economic growth by crowding out the private sector. In addition, the lending practices of commercial banks have revealed poor risk assessment, leading to high non-performing loan portfolios. The government's ERS expects monetary policy to change and play a critical role in economic development. In line with this objective, within the broad ERS, money supply was targeted to reach 7 per cent in 2003. In its implementation of monetary policy, the Bank of Kenya relies on traditional monetary policy instruments, namely Open Market Operations (OMOs) – including Repurchase Agreements (REPOs) – reserve ratio facilities and discount facilities. The growth of the money supply has, however, remained above set targets. In 2002, broad money supply M3X – the money supply aggregate which the central bank uses to establish intermediate targets for monetary policy – increased by about 10 per cent. In the year to August 2003 M3X expanded by 8.9 per cent. This growth was supported by a 9 per cent expansion in net domestic assets (NDA) and 8.5 per cent increase in net foreign assets (NFA) of the banking system. Movement in NFA in 2003 continued to reflect investor preference to hold foreign currency, which in the election year 2002 had been substantially higher due to cautious investors. The growth in NDA stems largely from domestic credit to government, which, in the year to August 2003, increased by 8.9 per cent to follow an increase of 13 per cent in 2002. During the same period, the government collected about 78 per cent of total credit from the banking system. However, it is worth noting that credit to the private sector increased by 6 per cent in 2002, reversing the decline of 6 per cent in 2001. Credit to the private sector expanded by a further 2.8 per cent in the year to August 2003.

Kenya has been successful in maintaining low and stable inflation. Underlying inflation, which excludes prices of food and energy products, remained at 2 per cent in 2002 and rose only moderately to 2.6 per cent by October 2003. The average rate of inflation was similarly low and stable in 2002, at 2 per cent compared with 5.8 per cent in the preceding year. However, the average rate of inflation rose sharply, reaching 9 per cent in October 2003 as a result of increases in prices of basic foods. It is expected that inflation will remain at the historically low level of 3.3 per cent in both 2004 and 2005.

In general interest rates have been on a downward trend over the past two years. The average rate on the 91-day Treasury bill dropped from 11.01 per cent in December 2001 to 8.38 per cent in December 2002, and further to about 1.46 per cent in December 2003. This has been due to excess liquidity in the domestic money market, occasioned by limited demand for investment funds due to the prevailing low economic activity. In addition, the government has pursued a deliberate policy of reducing the volume of short maturity domestic debt in preference for longer maturity. Principal money market interest rates have moved downwards in tandem with the decline in the 91-day Treasury bill rate. However, the underlying feature of the interest rate regime remains the large spread between bank lending and deposit rates. The average lending rates of commercial banks declined from 18.3 per cent at the end of 2002 to 14.1 per cent in November 2003, while the average deposit rate dropped from 4.7 per cent to 3.1 per cent over the same period.

The performance of the Kenyan shilling against major international currencies has remained mixed. The nominal effective exchange rate of the shilling fell by about 9 per cent during 2002. In the year to July 2003, the shilling strengthened against the US dollar, gaining about 2 per cent, while it weakened against other major currencies, notably the pound sterling, the euro and the yen. The gains made against the US dollar in the domestic market in 2003 were mainly attributed to positive sentiments that were predominantly hinged on the prospects of good governance by the new government and the likelihood of external aid being resumed. These gains have been further enhanced by the depreciation of the US dollar against all other major currencies. In real terms, the shilling appreciated by 3.4 per cent in the year to July 2003, compared with a depreciation of 1.1 per cent in the year to July 2002, which implied loss in competitiveness for Kenyan exporters.

External Position

Kenya maintains a liberalised external trade system. The country's trade policy has increasingly become oriented towards the pursuit of regional trade integration, primarily through its membership of COMESA and the EAC). The EAC member states (Kenya, Uganda and Tanzania) signed the protocol establishing the EAC Customs Union on 2 March 2004. The ratification of the protocol is expected to take place in July 2004, paving the way for a new tariff structure. The trade agreement was, however, watered down to accommodate differences between the member states. On the issue of the common external tariff (CET), Uganda unilaterally adopted a 20 per cent tax rate for finished goods while Kenya and Tanzania stuck to the more protectionist 25 per cent. This agreement marked a departure from the original protocol that envisaged a 0- 10- 25 CET tax regime for the regional trading bloc, with zero being the rate for raw materials, 10 per cent being the rate for intermediate goods, and finished goods being taxed at 25 per cent. Kenya's recent trade policy has changed its trading partners – in 2002, the larger proportion of its trade within Africa was with COMESA and EAC partners.

Kenya's external payments position improved in 2002, in a significant contrast from earlier years. In 2002, exports that had previously performed badly grew substantially, while the level of imports fell significantly, due to weaker demand in a slow domestic economy. Consequently, the trade deficit that had been widening since 1996 narrowed from the equivalent of 14.5 per cent of GDP in 2001 to 8.1 per cent in 2002. This helped the current account move from a deficit of 5 per cent of GDP in 2001 to a small surplus of 0.5 per cent of GDP in 2002. In 2002, total export receipts increased by 14.7 per cent, with tea, horticulture and coffee jointly accounting for 52.7 per cent of the total export earnings. The improvement in export earnings in 2002 was accounted for mainly by horticulture, as earnings from tea stagnated and those from coffee fell by about 12.3 per cent. Earnings from horticulture increased by about 42.8 per cent in 2002 as against the decline of 6.5 per cent the year before. Other notable increases in export earnings were in tobacco products, articles of plastic, sugar confectionery and animals and vegetable oils. Total import value declined by 11.2 per cent in 2002. Imported crude petroleum and refined petroleum products dropped by 23.2 per cent and 15.2 per cent respectively. Similarly, imports of iron and steel and industrial machinery decreased by 7.1 per cent and 32.8 per cent respectively. Positive trends in the trade balance in 2002 appeared to be reversed in 2003. In the year to August 2003, the current account deficit had widened to about 1.4 per cent of GDP, following deterioration in the trade account as a result of a 14.7 per cent rise in the value of imports, which more than offset a 13.2 per cent increase in the value of exports. The external account is expected to stabilise in 2004 and 2005, as a result of increased exports, leading to an improved current account balance.

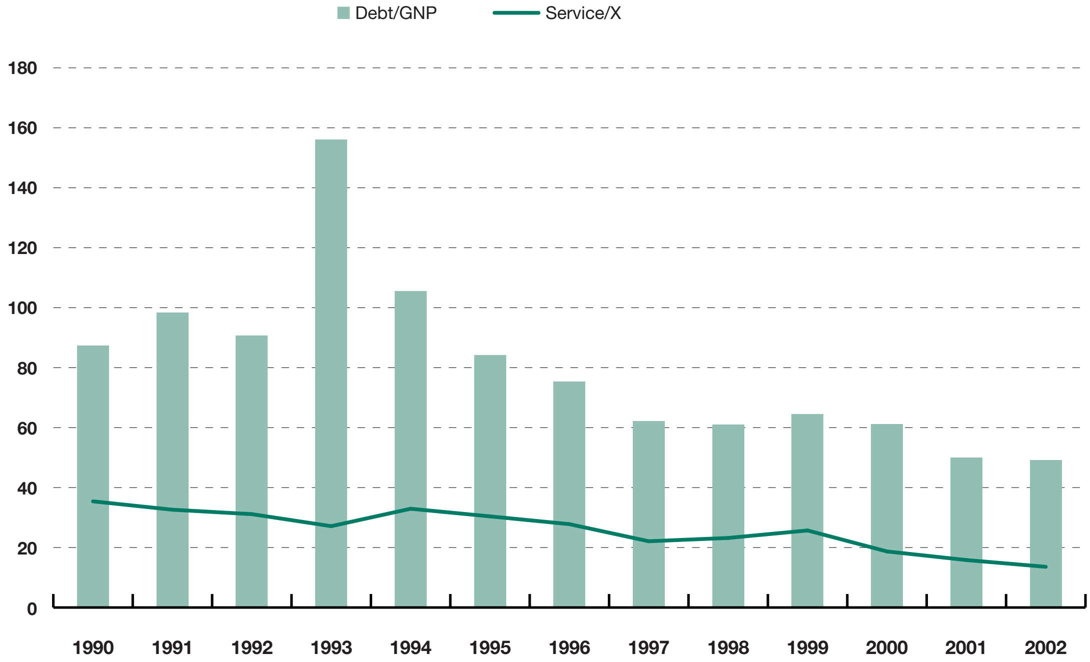
Table 3 - **Current Account** (percentage of GDP)

	1995	2000	2001	2002	2003(e)	2004(p)	2005(p)
Trade balance	-8.2	-12.1	-14.5	-8.1	-8.5	-8.0	-7.8
Exports of goods (f.o.b.)	21.3	17.0	16.8	17.6	16.0	16.1	16.5
Imports of goods (f.o.b.)	-29.5	-29.1	-31.3	-25.7	-24.4	-24.1	-24.4
Services	1.7	2.6	3.2	4.0			
Factor income	-3.5	-1.3	-0.8	-0.5			
Current transfers	4.4	8.8	7.2	5.1			
Current account balance	**-5.6**	**-1.9**	**-5.0**	**0.5**			

Source: Domestic authorities' data; projections based on authors' calculations.

Kenya's total external debt declined by 2 per cent to stand at $4.78 billion at the end of 2002. Multilateral organisations continued to be the leading creditors, accounting for 62 per cent of total debt, while bilateral creditors accounted for 32.2 per cent. The remaining 5.8 per cent was owed to commercial banks. Japan and France remained the leading bilateral creditors, while the IDA and the African Development Bank, Kenya's leading development partners for many years, were the dominant multilateral creditors. Total external debt was equivalent to 49.2 per cent of GNP in 2002, in line with a downward trend from about 75.4 per cent of GNP in 1996 to 61.1per cent of GNP in 2001. The debt service ratio has also declined from about 27.8 per cent in 1996 to 13.6 per cent in 2002. Other key debt ratios and debt service burden indicators are also relatively low and by HIPC initiative criteria, Kenya's external debt is sustainable.

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

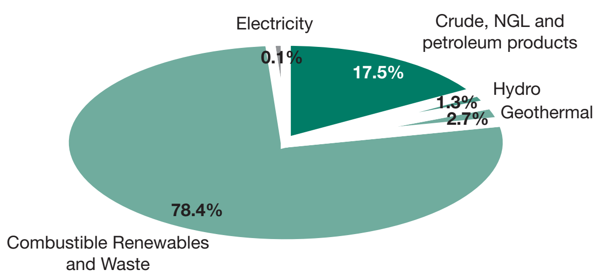


Source: World Bank.

Structural Issues

Kenya has undertaken structural reforms since 1990 in its continuing effort to diversify the economy and attract investment. Earlier reforms included the liberalisation of commodity prices, interest rates and exchange rates, the abolition of import licensing and of the exchange control, and rationalisation of the import tariff structure. A Civil Service Reform Programme has seen the downsizing of the number of core civil servants from 239 000 in 1995 to 193 000 in 2002. However, governance-related problems have deterred investment and, as a result, stifled growth. Kenya's major energy supply sources are biomass, petroleum, hydropower, geothermal power and, to a limited extent, wind and solar power. The country has no commercially exploitable oil and coal deposits and has to depend on imports to meet its commercial energy requirements. There is, however, unconfirmed potential of oil deposits.

Figure 6 - **Structure of Domestic Energy Supply in 2001**



Source: International Energy Agency.

Biomass is Kenya's main source of energy, contributing up to 80 per cent of Kenya's final energy demand, according to a 2002 survey undertaken by the Ministry of Energy. However, there is a lack of accurate data regarding the use of biomass and its environmental impact. By the year 2005, biomass contribution is projected to be about 66 per cent. In the household, agricultural and industrial sectors, biomass supplies are estimated at 93, 89 and 45 per cent respectively. Most of the supply comes in the form of firewood, charcoal or agricultural waste. Most Kenyans use firewood or charcoal for cooking and this is having a visible impact on Kenya's dry land savannah and forests, especially in fragile ecosystems and near refugee camps. There are indications of negative impacts on water catchment areas, as well as reduced water access and capacity for hydro electricity generation. There has been no overall policy on biomass from previous governments and laws that have been applied were both incoherent and not enforced. It has, for example, been illegal to produce charcoal but legal to sell it in Kenya.

A ready supply of commercial energy is vital to Kenya's ambition to become an industrialised nation by the year 2025. The mismanagement of the energy supply and the resulting unreliability and high costs have led to great losses for Kenyan businesses. Problems emanating from energy supply have continued to make Kenyan goods uncompetitive in both local and international markets, as producers have begun generating their own supplies.

Installed electricity capacity is some 1 094 MW, the largest proportion (64 per cent) of which, produced principally by the State-owned Kenya Electricity Generating Company, comes from hydropower stations at dams along the upper Tana River, as well as from the Turkwel Gorge Dam in the west. Diesel and geothermal power stations and electricity imported from Uganda make up the rest of the supply. The Kenyan government plans to diversify power-generation in a bid to reduce the adverse effects of drought on supply. To this end, it has allowed Independent Power Producers (IPPs) since 1998. However, IPPs feel that they have not been offered a fair price for electricity under power purchase agreements (PPAs), and the existing legal and regulatory framework has acted as a hindrance to the development of reliable, secure and diversified supplies of electricity.

As part of Kenya's drive to reduce its dependence on imported power from Uganda, the government has initiated plans to connect its national power grid from Nairobi to Tanzania through Arusha in northeastern Tanzania. The long-term plan reportedly also includes connecting the power grid to Zambia via Tanzania, covering a distance of 3 000 kilometres. The government signed an agreement to this effect in 2003. The Kenyan government further plans to expand the storage capacity of the Masinga Dam, so that hydroelectric generation from the dam can be guaranteed for longer periods. Kenya plans to install six geothermal power plants with a combined capacity of 3 894 MW, while also exploring wind and solar options. The town of Marsabit in northern Kenya has been identified as a possible location for a wind-powered electricity generation plant.

The electricity distribution sub-sector has been under severe strain in terms of security of supply – huge losses (about 20.5 per cent) are experienced through the grid, there are frequent interruptions in electricity supply, the Kenya Power and Lighting Company (KPLC) faces difficulties in financing investment, including for maintenance. Consumers in Kenya also experience high customer tariffs, partly due to unpaid bills by large consumers.

Although the electricity sector is now liberalised, creating an "enabling environment" by changing the legal framework remains crucial. In particular, the Electricity Regulatory Board (ERB) needs to be strengthened so as to make it independent, transparent and impartial, and so avoid political interference regarding PPAs with IPPs. Besides, the monopoly of the KPLC on power distribution needs to be reviewed.

A major issue in the energy supply situation in the country is the lack of progress that has been made regarding electrification of rural areas and access to electricity in urban slums. It is estimated that less than 5 per cent of the rural population has access to electricity. The Rural Electrification Programme and associated Fund set up almost 30 years ago have failed. It is now recognised that the programme needs to be overhauled and renewed. The current cross-subsidy in favour of rural electrification (based on a levy of 5 per cent on electricity bills) has failed due to corruption. The government's strategy for tackling the rural energy access issue includes the following measures:

- reviewing and renewing the rural electrification programmes to attract partners including donors, private sector, consumers and communities;
- opening up the programme for the promotion of off-grid solutions;
- ensuring that the programme is transparent, accountable and meets its aims.

Along with its neighbours, Uganda and Tanzania, Kenya is heavily dependent on imported petroleum, which constitutes approximately 75 per cent of the commercial energy required to facilitate economic growth and development in the country. The three East African countries are working together to promote investment opportunities in petroleum exploration in the region. Though modest exploration for oil has taken place in Kenya, recent seismic tests have revealed that the coastal region may have high potential for natural gas.

Kenya Pipeline Company Ltd (KPC) transports approximately 90 per cent of the petroleum products consumed in Kenya's domestic market. As the owner and operator of the only refined petroleum products pipeline in East Africa, KPC is also the dominant player in the regional energy sector, exporting to Uganda, Tanzania, Rwanda, Burundi, the Democratic Republic of Congo and Sudan.

The government is in the process of formulating a National Energy Policy Paper, in order to prepare a comprehensive reform programme in the energy sector, including amendments to the Electric Power Act 1997, a complete auditing of the use of public funds in the sector, privatisation of state-run companies, and the promotion of renewable sources of energy, notably for the rural and urban poor.

The government's process of reducing its role in commercial activities through its privatisation programme, which has been going since 1992, has made some progress, though there remains a long way to go. As of mid-2003, a total of 207 non-strategic commercial enterprises had been privatised and 33 strategic corporations restructured. The new administration is reorienting the privatisation programme in order to allow for wider participation and consultation with stakeholders. The government has prepared a privatisation bill (2003) to provide the legal framework for privatisation of the remaining public enterprises. The major enterprises yet to be sold include Kenya Telcom, Kenya Power and Lighting Company (KPLC), Kenya Ports Authority (KPA), Kenya railways and Kenya Commercial Bank (KCB). A Privatisation Commission will be set up under the privatisation bill to oversee and implement the Programme.

Financial sector reforms undertaken have led to a well-diversified sector, with 43 commercial banks, 2 non-bank financial institutions, 2 mortgage finance companies, 4 building societies and 48 foreign exchange bureaux as at June 2003. However, only two foreign banks, Barclays and Standard Chartered, and two parastatal banks, Kenya Commercial Bank and National Bank of Kenya, dominate the banking sector, controlling about 60 per cent of total assets. Besides, the performance of the banking sector continues to be constrained by *i)* non-performing loans (NPLs) and poor asset quality; *ii)* absence of effective competition, which has led to wide interest spread; *iii)* absence of strong and vibrant institutions for long term capital; and *iv)* a legal system characterised by long delays in the determination of commercial disputes and enforcement of contracts. The share of non-performing loans (NPLs) in total loans was 29.4 per cent in May 2003. Kenya's current climate of low Treasury bill interest rates, when set against the large NPL problem, carries major risks. It could lead to widespread bank failure, because government securities comprise a substantial proportion of bank assets. The persistent poor quality of assets has remained mainly in six public sector institutions that account for 58 per cent of the industry's NPLs. This is attributed to poor risk management, the poor state of the economy, the ineffective administration of justice, and external pressure by dominant shareholders. In 2003, the government mandated the central bank to explore the feasibility of forming a Non-Performing Loans Agency to help clean up bank balance sheets and commission a tribunal with judicial powers to deal with non-performing loans. This is a step in the right direction. The central bank has already commissioned a bank-wide study, the outcome of which will contribute to the implementation framework for putting NPL portfolios as off-balance sheet items for the institutions.

Reforms have also been introduced to improve the functioning of the Nairobi Stock Exchange (NSE). In 2002, the capital markets authority began implementing its strategic plan for 2002-2005, involving the fundamental reorganisation of stock market operations. Key improvements include the implementation of a central depository and automated trading systems, to improve and enhance trading, delivery, registration, settlement and depository formations in the market. Other measures have been implemented to provide incentives for investment, including corporate tax reductions and authorisation for foreign investors to acquire up to 75 per cent of the shared capital of a listed company.

Political and Social Context

The political climate of Kenya, which since independence in 1963 was dominated by the Kenya African National Union (KANU), changed in 2002. Since the legalisation of political pluralism in 1992, multi-party elections held in 1992 and 1997 had both been won by KANU. The third multi-party election held in December 2002 brought together the main opposition parties to KANU in the National Rainbow Coalition (NARC), which won the election. Although the 2002 elections were preceded by economic and political uncertainties, and the failure to conclude the consultation process for the New Constitution, the elections were deemed relatively peaceful and fair. Since the transition in 2002, the country's participatory democracy and political pluralism appear to be stable and working well.

The NARC government has given recognition to the immense harm that poor governance and the breakdown of law and order have done to Kenya, and is taking important positive measures to improve both economic and institutional dimensions of governance. The government has articulated various reforms in public administration, national security and law and order under the Economic Recovery Strategy launched in June 2003. So far, the government has also expeditiously implemented the provisions of the Anti Corruption and Economic Crimes Act and the Public Officer's Ethics Act that were introduced in May 2003. Significant actions taken since then include the appointment of the head of Transparency International's Kenya Chapter to lead the fight against graft, and the declaration of the assets of the President and his Cabinet. Other policy initiatives already undertaken to address instances of bad governance include: *i)* appointing a task force on public collections; *ii)* appointing a committee on truth, justice and reconciliation; *iii)* appointing several commissions, including a judicial commission on the Goldenberg scandal; and *iv)* relaunching the constitutional review process, which was stalled in the run up to the 2002 general elections. In addition, the government has committed itself to presenting the Procurement and Disposal of Public Assets bill, and the Management and Accountability bill to parliament during 2003/04. Other important proposals on which the government is basing its drive for good governance include *i)* a review and enactment of laws to deal with modern crimes such as terrorism, money laundering, cyber-crime, and tax evasion; *ii)* the strengthening of security agencies with interventions covering training, equipment, recruitment and increased collaboration with neighbouring countries; and, *iii)* improvement of the efficiency and effectiveness of the legal and judiciary process. The government is also committed to enhancing local governance through a devolution process arising from the ongoing Constitutional review process.

Kenya's recent poor economic performance has translated into increased poverty and the aggravation of the country's unemployment problem. The 2002 per capita income of $360 is lower than it was a decade ago. The number of Kenyans classified as poor has increased from 11.3 million (48.4 per cent of the population) in 1990 to 17.1 million (55.4 per cent of the population) in 2002. Poverty is particularly severe in the Arid and Semi-Arid Lands (ASAL) region, where over 65 per cent of the population is classified as poor. In some of the region's poorest districts, the poverty level is over 80 per cent. Kenya has about 2 million persons officially classified as unemployed, representing about 14.6 per cent of the labour force. A most worrying figure is that young people constitute about 45 per cent of the total number of unemployed. In addition, disguised unemployment, particularly in the public sector, is a serious problem, whilst child labour is an emerging and disturbing phenomenon. High unemployment, particularly in the formal sector, is attributed to low labour productivity, which is mainly due to low education and skills and labour market rigidities.

The social dimension of poverty in Kenya can be seen from the proportion of the population with access to education and health. Health standards in Kenya are relatively low. In 2002, life expectancy at birth was at 46 years, while the infant mortality rate (IMR) and under-5 mortality rate were estimated at 74 and 112 per 1000 live births respectively. Maternal mortality rate was at 590 per 100 000 live births in 2002. Health standards of large proportions of the population have been undermined by the HIV/AIDS epidemic, the increasing incidence of malaria and tuberculosis, and the worsening socio-economic situation and poverty levels. A further adverse effect on the health situation stems from the recent brain drain in the health sector. As a result, some medical personnel, especially nurses and doctors, have left Kenya to work in the United States, Britain and South Africa. Kenya continues, however, to train substantial numbers of medical personnel. The government's recent intensification of a campaign against the HIV/AIDS epidemic appears to be bearing fruit. According to the Kenya Economic Survey, the HIV prevalence rate has continued to slow down nationally from 13.4 per cent in 2000 through 13.0 per cent in 2001 to 10.2 per cent in 2002. A similar trend has been observed in both rural and urban areas, though the urban prevalence rates still remain above the rural rates.

In 2003, levies and extra tuition to be met by parents were abolished and a free primary education programme in public schools was implemented, in order to promote country-wide access to education. The government's education policies received major commitments of support from the DFID and the World Bank, to meet the basic cost of teaching and learning materials, wages of critical non-teaching staff, and co-curricular activities. The primary-school gross enrolment and net enrolment rates were 90.8 per cent and 74.6 per cent respectively in 2002/03. The education system continues to grapple with the underlying challenges of non-enrolment, high levels of dropout and low completion rates, particularly among girls. Enrolment in primary schools continued to show gender imbalances; for example, while the transition of boys from standard 4 in 1998 to standard 8 in 2002 was 79.4 per cent, that of girls was 75 per cent. The evidence also indicates that only 55.8 per cent of candidates in the 2002 Kenya Certificate of Primary Education (KCPE) were admitted to form 1 in 2003, giving a transition rate of 46.2 per cent.

