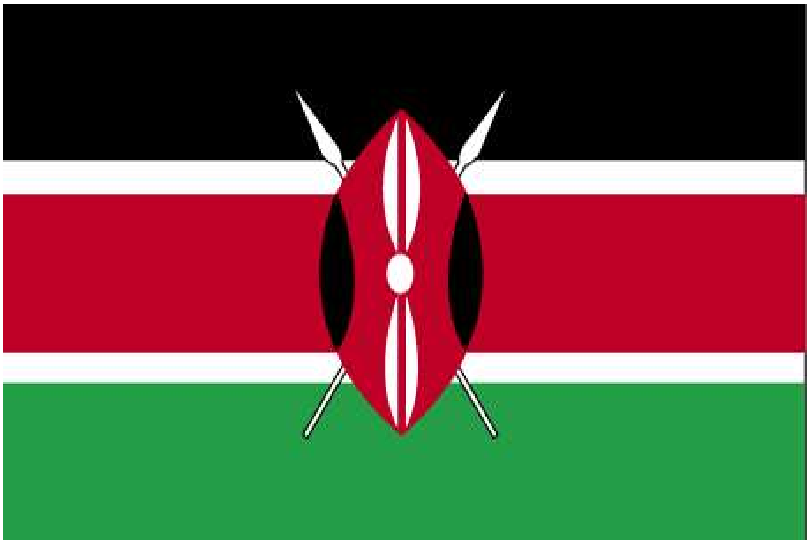
Rabobank

Country report **KENYA**



Summary

Kenya's 2007 presidential elections, which were marred by severe unrest and violence, have led to a recent constitutional reform meant to curb new unrest. Nevertheless, the upcoming general elections, which are expected to take place in March 2013, may potentially lead to new violence and unrest. The trial held at the International Criminal Court against presidential candidate Uhuru Kenyatta may increase political uncertainty significantly if he is elected. Other risks stem from Kenya's relationship with Somali-based militant group al-Shabaab, following Kenya's participation in a military operation in Somalia. Acting in revenge, al-Shabaab has carried out multiple terrorist attacks inside Kenya in the last 18 months and kidnapped tourists visiting Kenya. Economic growth is expected to come in at between 4 and 5 percent, a level comparable to last year. Large twin deficits on the current account balance (around 10 percent of GDP) and fiscal balance (between 6 and 7 percent of GDP) increase the country’s vulnerability. Nevertheless, external debt remains relatively small, at 23% of GDP. Foreign reserves cover 4 months of imports.

Things to watch:

- Political and social instability during the upcoming general election period
- Twin deficits on the current account and fiscal balances

Author: **Reinier Meijer**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-31568
R.Meijer@rn.rabobank.nl

Kenya

National facts		
Type of government	Republic	
Capital	Nairobi	
Surface area (thousand sq km)	580,367	
Population (millions)	39.0	
Main languages	English	
	Swahili	
Main religions	Christian (82.6%)	
	Muslim (11.2%)	
	African religion (5%)	
Head of State (president)	Mwai Kibaki	
Head of Government (prime-minister)	Raila Odinga	
Monetary unit	Kenyan Shilling (KES)	

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	35	0.05
Nominal GDP at PPP	71	0.09
Export value of goods and services	10	0.04
IMF quotum (in m SDR)	271	0.12
Economic structure	*2011*	*5-year av.*
Real GDP growth	4.4	4.7
Agriculture (% of GDP)	22	23
Industry (% of GDP)	16	16
Services (% of GDP)	62	60
Standards of living	*USD*	*% world av.*
Nominal GDP per head	832	8
Nominal GDP per head at PPP	1711	14
Real GDP per head	590	7

Social and governance indicators	rank / total
Human Development Index (rank)	128/182
Ease of doing business (rank)	95/183
Economic freedom index (rank)	106/179
Corruption perceptions index (rank)	154/180
Press freedom index (rank)	70/175
Gini index (income distribution)	47.7
Population below $1.25 per day (PPP)	20%

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
UK	10	India	15
The Netherlands	9	China	14
Uganda	8	AE	10
Tanzania	8	South Africa	8
Main export products (%)			
Tea			20
Horticulture			16
Coffee			4
Fish and fish preparations			1
Main import products (%)			
Industrial supplies			38
Machinery and other equipment			22
Food & beverages			8
Consumer goods			6
Openness of the economy			
Export value of G&S (% of GDP)			28
Import value of G&S (% of GDP)			47
Inward FDI (% of GDP)			1.0

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

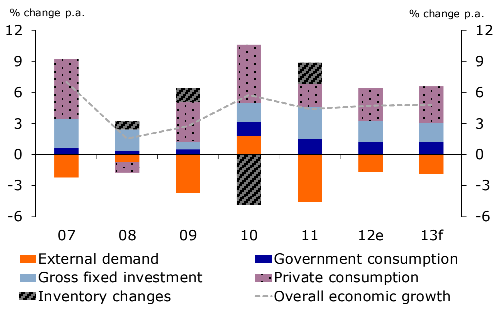
With a GDP per capita of USD 832, Kenya is classified as a low-income country. Unlike many other sub-Saharan African countries, Kenya is a country with a relatively well-diversified economy and a low reliance on donor funding. The services sector, which among others consists of tourism, banking services and telecom, makes up nearly two-thirds of GDP. Another important sector of the economy is the agricultural sector. Although only responsible for 22% of GDP, this sector accounts for two-thirds of total exports and 75% of employment. This makes Kenya vulnerable to commodity price fluctuations and to floods and droughts. The agricultural sector has struggled with a severe regional drought in the last few years, but this year's rainfall was favorable. The industry sector has a share of 16% of GDP, but this share may increase in the coming decade, as on- and offshore oil reserves have recently been discovered. However, political and regulatory challenges have to be overcome before these reserves can be exploited, while security risks stemming from Somali pirates are expected to obstruct the development of Kenya's offshore oil reserves as well.

Kenya is a member of the East African Community (EAC), which is a customs union that further comprises of Burundi, Rwanda, Tanzania and Uganda. Kenya's largest export products are tea and horticulture, each of which makes up between 15 and 20 percent of total exports. The country is generally perceived as a hub for financial, communication and transportation services in Eastern and Central Africa.

Economic growth slowed from 5.8% in 2010 to 4.4% last year because of drought, power shortages, high inflation and deteriorating global conditions. This year's economic growth is expected to come in at between 4 and 5 percent again. On the one hand, favorable rainfall, lower inflation and lower interest rates are expected to boost growth, while on the other hand the weak global economy is expected to curb tourism and external demand. Tourism has been hit by terrorism (see section below) as well. Downside risks to this forecast are the threat of a further worsening of the eurozone crisis and the possibility of post-election instability and disruption in Kenya. Bottlenecks in the physical infrastructure as well as the mediocre business climate are substantial hurdles to stronger growth. Infrastructural investment by the government may deliver results in the longer term, while the impact of other measures of the government to improve the business climate is limited. Foreign direct investment inflows into the Kenyan economy have been historically low, at less than 1% of GDP a year during the last decade (except 2007, in which the flows amounted to 2.7% of GDP). The discoveries of oil reserves are expected to boost foreign investment in the oil sector.

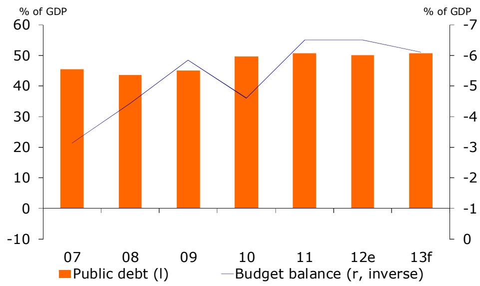
The financial sector of Kenya is relatively well developed. Large volatility in interbank rates in the past 12 months does not seem to have hit the banking sector as a whole. The ratio of non-performing loans stood at 4.5% in the second quarter of 2012.

Figure 1: Growth performance



Source: EIU

Figure 2: Public finances



Source: EIU

Political and social situation

Following the highly disputed presidential elections of 2007, a constitution reform in 2010 made fundamental changes in the way Kenya is governed. The 2007 elections led to large-scale violence between supporters of the declared winner Mwai Kibaki and supporters of opposition candidate Raila Odinga. In the violence, an estimated 1,300 people died and about 500,000 people became displaced. Kibaki's Orange Democratic Movement (ODM) and Odinga's Party of National Unity (PNU) started negotiations with help of international mediators, leading to an agreement in which Kibaki was appointed as president, Odinga was appointed as prime minister and the constitution was reformed. As a consequence of the reform, the parliament has been empowered to check the president's executive powers, an upper chamber (Senate) was created to supplement the unicameral lower chamber (National Assembly) and more power was decentralized to the regions. The 2010 referendum on whether or not to reform the constitution was called free and fair and occurred without violence. This offers some hope for the upcoming elections, although new violence and unrest are still substantial risks.

A coalition of the ODM and the PNU currently rules the country. There has been a lot of discussion about the date of the upcoming general elections. On 31 July 2012, the Court of Appeal ruled that

elections must take place in March 2013. The election committee has provisionally named 4 March 2013.
Due to a two-term limit in the constitution, President Kibaki must stand down after the upcoming elections. Two deaths have weakened Kibaki's PNU in 2012, as one of the party's front-runners for the upcoming elections, Internal Security Minister George Saitoti, was killed in a helicopter crash in June 2012, while one of his allies, Environment Minister John Michuki, died after suffering a heart attack in February 2012. The weakening of the PNU is expected to boost Odinga's chances of winning the elections. In 2012, former ministers Uhuru Kenyatta and William Ruto[1], who both want to run for president in the next elections, were accused of crimes against humanity by the International Criminal Court following the 2007 post-election violence. The trial is scheduled to start in April 2013, after the general elections. This is not expected to withhold both presidential aspirants from campaigning for the presidency. Kenyatta, who tops the list of the recently founded The National Alliance (TNA), came in second in a recent presidential election poll, while Prime Minister Odinga is leading. Nevertheless, if Kenyatta would win the presidency or gain a position in the government, his trial is expected to increase political uncertainty significantly.

Kenya participates in a military operation in Somalia, which is meant to eliminate Somali-based militant group al-Shabaab, which currently rules the country undemocratically. In a reaction to this, Kenya has been severely hit by terrorist attacks in the last 18 months. Most attacks targeted security personnel in the North Eastern region at the border with Somalia, but some incidents also took place in the capital Nairobi and in Mombasa. Al-Shabaab has been held responsible for the incidents. Furthermore, in the autumn of 2011, several tourists were kidnapped, among them a disabled person. Somali bandits have been held responsible for the kidnappings. However, it is not known whether Al-Shabaab or Somali-based pirates kidnapped the tourists. The incidents have led to foreign countries banning travel to the northeastern coast near the Somalian border and consequently to a decline of tourist arrivals.

Corruption is widespread in Kenya. A recent study found that three out of four Kenyan companies pay bribes. Also on Transparency International's Corruption Perceptions Index, Kenya only ranks 154th out of 183 countries.

Economic policy

Kenya's policy is formulated in cooperation with the IMF under a three-year Extended Credit Facility worth USD 760m. Priorities for 2012 are to maintain disciplined monetary policy, to continue building hard currency reserves, to accelerate the pace of fiscal consolidation and to promote competition and enhance supervision in the financial sector. In addition, investment in infrastructure is needed, but room for public investment is limited, as the public debt level and debt service must be kept under control.

Kenya's budget balance showed deficits averaging close to 5% of GDP in the last five years. Budget spending in financial year 2012-13 is estimated to be 22% higher than in the previous financial year. A key reason for the increased spending is the newly established budget for county governments, which represents about 10% of spending. Although budget revenues are also expected to be 19% higher, these expectations are based on very optimistic growth assumptions. Taking into consideration that this year's growth will be affected by the weak global economy, the

[1] Both are members of the Kenya African National Union (KANU), which is part of the Party of National Unity (PNU).

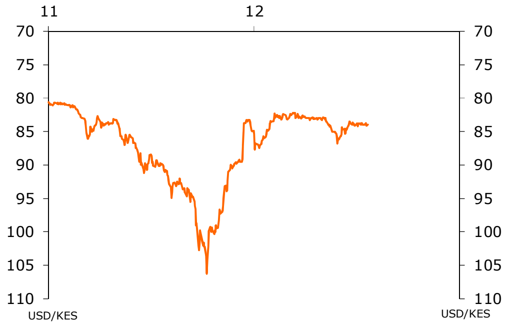
budget deficit is estimated at around 7% of GDP. An important reason behind Kenya's large budget deficits is that the country is less dependent on donor aid than many other African countries in the region. Grants amount to around 1% of GDP or 4% of total government revenues. Kenya has substantial public debt, which stood at 51% of GDP in 2011.

The Central Bank of Kenya (CBK) manages the managed float exchange rate regime of the Kenyan shilling. The shilling fell over 20% in the second half of 2011, as investors pulled out of emerging-market currencies as the global economy weakened. This depreciation and a regional drought led to rising food and fuel prices, causing inflation to rise significantly above the CKB's core inflation target of 5% to a peak of 20% at the end of 2011. After the CBK raised its benchmark interest rate rate from 7% in September 2011 to 18% in December 2011, the shilling appreciated again and inflation started falling from mid-December 2011 onwards. The shilling appreciated from a low of 106 shillings per US dollar in mid-November 2011 to 84 shillings per US dollar in July 2012, while inflation declined from a peak of nearly 20% in November 2011 to nearly 8% in July 2012. In response to decreasing inflation as well as sluggish growth, the CBK cut the interest rate by 150bps to 16.5% in July 2012, which was the first cut in 18 months.

Figure 3: Inflation

Source: EcoWin

Figure 4: Exchange rate



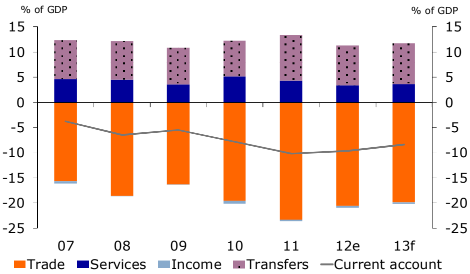
Source: EcoWin

Balance of Payments

Strong import growth, high oil prices and high food prices have led to a worsening of Kenya's trade balance in the recent few years. Kenya's trade deficit increased from 16% of GDP in 2009 to 23% of GDP last year. Due to slightly stronger export growth, the trade deficit is expected to narrow to 20% of GDP this year. In the meantime, the surpluses on the services and transfer balances increased significantly in the last few years. The services balance surplus widened from 3.5% of GDP in 2009 to 5.2% of GDP in 2010, reflecting the growing domestic services sector. The surplus declined to 4.3% of GDP in 2011, among others as a consequence of a decline in tourism following the kidnapping of tourists and the consequent travel ban from the US. For 2012, we expect the services surplus to decline to about 3% of GDP, as the receipts from the tourism sector remain subdued. Brisk growth in remittances boosted Kenya's surplus on the current transfers account from 7.1% of GDP in 2010 to 9.1% of GDP last year, and is expected to come in at about 8% of GDP in 2012. Overall, Kenya's current account records a deficit. In the period 2004-2007, the deficits were between 0 and 4 percent of GDP. Since 2007, the deficit has deteriorated substantially as a consequence of the higher trade deficit. The current account deficit widened from 3.8% of GDP in 2007 to 10.2% of GDP last year. We expect a similar deficit in 2012, as the trade deficit remains very high.

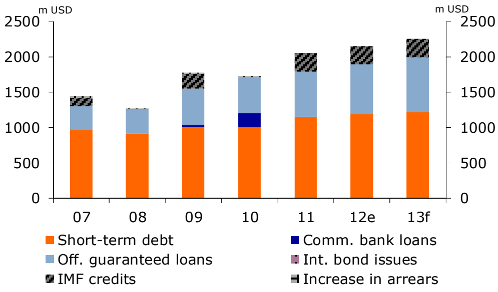
Foreign direct investment inflows are less than 1% of GDP, which is insufficient to cover the current account deficit. At the same time, portfolio inflows are insignificant as well. This means that Kenya is reliant on external debt inflows to finance its current account deficit.

Figure 5: Current account



Source: EIU

Figure 6: Debt-creating inflows



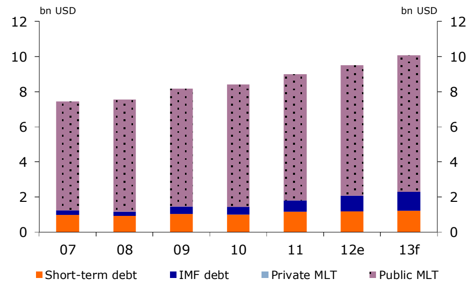
Source: EIU

External position

Kenya's external position is relatively comfortable with a modest amount of external debt, standing at 26% of GDP or USD 9bn last year. Debt is expected to decline to 23% of GDP in 2012, due to a rise of GDP. However, in terms of US dollar, debt is forecast to increase to USD 9.5bn this year. Around 80% of external debt is public sector debt owed to multilateral and bilateral creditors. The country's has arrears amounted to USD 246m in 2011, but these consist mostly of small historical arrears, which are gradually being worked out.

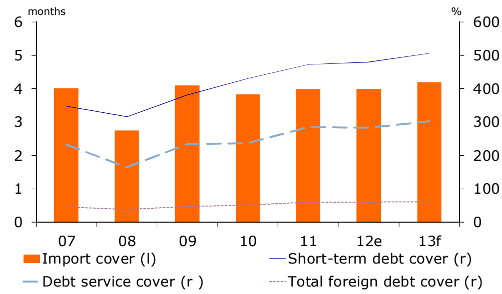
Kenya's foreign-exchange reserves are forecast at USD 5.7bn end-2012. The reserves cover 4 months of imports, which is not extremely comfortable, but above the minimum comfort level of 3 months. The liquidity ratio is estimated at 111% this year, which is acceptable. Meanwhile, the debt service cover is comfortable at around 280%.

Figure 7: Foreign debt



Source: EIU

Figure 8: External liquidity



Source: Covers offered by official FX-reserves, EIU

Kenya

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	7.0	1.5	2.7	5.8	4.4	4.7	4.8
Consumer prices (average % change pa)	9.8	16.3	9.2	4.0	14.0	10.1	5.6
Current account balance (% of GDP)	-3.8	-6.5	-5.5	-7.8	-10.2	-9.6	-8.4
Total foreign exchange reserves (m USD)	3355	2879	3849	4320	5436	5680	6150
Economic growth							
GDP (% real change pa)	7.0	1.5	2.7	5.8	4.4	4.7	4.8
Gross fixed investment (% real change pa)	13.6	9.5	2.8	7.7	12.5	8.0	7.0
Private consumption (real % change pa)	7.3	-1.3	5.0	7.2	2.8	4.0	4.5
Government consumption (% real change pa)	4.4	2.5	3.8	9.2	10.6	7.6	7.8
Exports of G&S (% real change pa)	7.3	7.2	-9.3	17.7	6.7	6.5	6.6
Imports of G&S (% real change pa)	11.1	6.6	2.8	6.1	15.6	7.8	8.0
Economic policy							
Budget balance (% of GDP)	-3.1	-4.4	-5.8	-4.6	-6.5	-6.5	-6.1
Public debt (% of GDP)	45	44	45	50	51	50	51
Kenya, Money market interest rate (%)	6.8	7.7	7.4	3.6	8.7	5.0	5.5
M2 growth (% change pa)	19	15	16	22	19	26	20
Consumer prices (average % change pa)	9.8	16.3	9.2	4.0	14.0	10.1	5.6
Exchange rate LCU to USD (average)	67.3	69.2	77.4	79.2	88.8	85.8	93.9
Recorded unemployment (%)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Balance of payments (m USD)							
Current account balance	-1032	-1983	-1689	-2512	-3536	-3950	-3480
Trade balance	-4256	-5649	-4988	-6303	-8046	-8440	-8240
Export value of goods	4132	5040	4502	5225	5787	5940	6580
Import value of goods	8388	10689	9490	11528	13833	14390	14820
Services balance	1260	1381	1071	1660	1497	1390	1510
Income balance	-144	-45	-31	-155	-137	-140	-140
Transfer balance	2108	2331	2259	2286	3150	3250	3380
Net direct investment flows	693	52	70	184	326	370	400
Net portfolio investment flows	-25	-26	-21	-18	3	-20	-20
Net debt flows	474	-2	577	369	603	530	570
Other capital flows (negative is flight)	829	1482	2033	2448	3721	3310	3000
Change in international reserves	939	-477	971	472	1116	240	470
External position (m USD)							
Total foreign debt	7462	7549	8182	8400	8999	9510	10070
Short-term debt	964	910	1012	1005	1151	1190	1220
Total debt service due, incl. short-term debt	1446	1749	1644	1819	1904	2000	2040
Total foreign exchange reserves	3355	2879	3849	4320	5436	5680	6150
International investment position	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-15.6	-18.5	-16.3	-19.6	-23.2	-20.5	-19.8
Current account balance (% of GDP)	-3.8	-6.5	-5.5	-7.8	-10.2	-9.6	-8.4
Inward FDI (% of GDP)	2.7	0.3	0.4	0.6	1.0	1.0	1.0
Foreign debt (% of GDP)	27	25	27	26	26	23	24
Foreign debt (% of XGSIT)	80	69	83	74	68	70	69
International investment position (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	15	16	17	16	14	15	14
Interest service ratio incl. arrears (% of XGSIT)	2	2	2	2	2	1	1
FX-reserves import cover (months)	4.0	2.8	4.1	3.8	4.0	4.0	4.2
FX-reserves debt service cover (%)	232	165	234	238	285	283	302
Liquidity ratio	122	109	117	110	112	111	116

Source: EIU