Country report **KENYA**

Summary

Kenya has regained a sense of political stability after the political turmoil that followed general elections in 2007. In August 2010, a new constitution was adopted in a peaceful vote. However, the run-up to new general elections at the end of 2012 poses a major threat to Kenya's fragile stability. On top of new political tensions, rising oil prices and severe drought are now threatening Kenya's growth performance. Growth stood at 5.6% in 2010, but is expected to slow to between 4 and 5% by 2011-12. In January 2011, the Kenyan government was forced to ask the IMF for support to counter the mounting financing pressures caused by a widening current account deficit. Certain other structural constraints, such as widespread corruption and poor infrastructure, also continue to undermine Kenya's growth potential.

Things to watch:

- Political instability in the run up to the general elections
- Implementation of the new constitution
- Persistence of drought

Author: **Elena Saputo**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-68317
E.K.Saputo@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		**2010**
Economic size	*bn USD*	*% world total*
Nominal GDP	31	0.05
Nominal GDP at PPP	68	0.09
Export value of goods and services	8	0.04
IMF quotum (in mln SDR)	271	0.12
Economic structure	*2010*	*5-year av.*
Real GDP growth	5.6	4.7
Agriculture (% of GDP)	22	23
Industry (% of GDP)	16	17
Services (% of GDP)	62	60
Standards of living	*USD*	*% world av.*
Nominal GDP per head	764	8
Nominal GDP per head at PPP	1676	14
Real GDP per head	592	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			2010
Main export partners (%)		*Main import partners (%)*	
UK	10	India	15
The Netherlands	9	China	12
Uganda	9	AE	10
Tanzania	9	South Africa	7
Main export products (%)			
Tea			20
Horticulture			16
Coffee			4
Fish and fish preparations			2
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)			27
Import value of G&S (% of GDP)			43
Inward FDI (% of GDP)			0.4

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

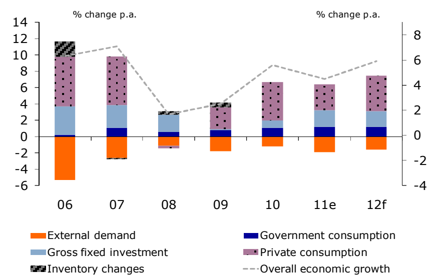
Economic structure and growth

Although Kenya is still considered a low-income country by international standards, it is seen as one of the most important and influential markets in the region and the country is considered one of the leading economies in the East African Community (EAC), a customs union between Kenya, Tanzania, Uganda, Rwanda and Burundi. Kenya's GDP per capita is among the highest of the region at USD 1,680, but this figure masks great disparities between Kenya's small and rich elite and the majority, who live in poverty.

The political turmoil that followed general elections in December 2010, combined with the effects of the global recession, caused Kenya's GDP growth to fall to 1.7% in 2008, down from 7.1% in 2007. However, the global crisis hit Kenya less than it did other countries. Also, Kenya's relatively large financial sector remained unshaken by the political turmoil in 2007. In 2009, Kenya started to recover and GDP growth reached 5.6% in 2010, driven mainly by a recovery of agricultural production and increased public investment. Strong growth in the construction and manufacturing sectors, due to increased external demand and several financial and fiscal reforms, further spurred on GDP growth. However, growth is expected to decelerate again to between 4 and 5 percent in 2011, owing to strong increases in energy prices and extreme drought throughout the first half of 2011. Although an average GDP-growth of 5% in the next years may seem quite satisfactory, it falls short of the growth rate that is needed to bring about a sustained rise in jobs and a significant decline in poverty in Kenya (six to seven percent a year). We note that any disruptions in the recently regained political stability in the run-up to the general elections in 2012 pose a further

threat to Kenya's economic forecast. Moreover, poor infrastructure, widespread corruption, a large informal sector, high unemployment and an unskilled labor force continue to complicate entrepreneurship in Kenya. On a more positive note, structural reforms by the Kenyan government, increased regional trade, and an ongoing boom in tourism, telecommunications and banking are indications of improving economic perspectives.
Although the services industry comprises some 62% of GDP, the vast majority (75%) of Kenyans are employed in the agricultural sector. Kenya's main export products are tea, horticultural products, and coffee. This dependence on primary commodity exports makes the country vulnerable to exogenous shocks, especially environmental pressures and volatile commodity prices. Linked to the boom in telecommunication, (tele)banking has continued to grow throughout 2011.

Chart 1: Growth performance



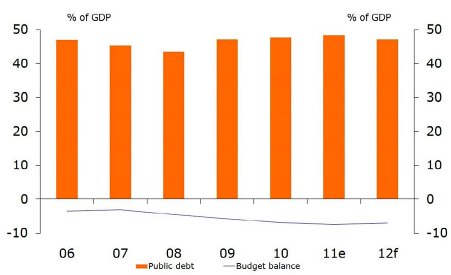
Source: EIU

Political and social situation

During the political unrest that followed the 2007 general elections, some 1500 people were killed and 300,000 Kenyans were displaced. The violence brought to the fore not only unaddressed grievances of the Kenyan population, but also re-emphasized ethnic divisions in the country. To regain some sense of order, Kenya's two main political parties, the Party of National Unity (PNU) and the Orange Democratic Movement (ODM) decided to forge a coalition. PNU's Mwai Kibaki became Kenya's president, and ODM's Raila Odinga took the position of prime minister. Although tensions between both parties remain, the coalition succeeded in bringing back a sense of order in Kenyan society. A successful and, perhaps more importantly, peaceful vote on a new constitution in August of 2010 was proof of Kenya's improved political stability. Although Kenya has managed to recuperate quite well after the turmoil of 2007, the road to stability is still fraught with risk.
The newly approved constitution brings with it a two-sided risk. If policymakers fail to implement the reforms indicated in the new constitution, this will feed into political grievances and will heighten the risk of new political unrest. However, as some of the reforms proposed in the new constitution are quite far-reaching and controversial, their implementation could cause new unrest, thus endangering stability.
A second major risk to political stability is the upcoming general election, which is scheduled for late 2012. President Kibaki will be forced to step down next year, after having served two 5-year terms in office. A struggle for his positions as both the PNU leader and the Kenyan president is expected. Adding to these tensions are the indictments made by the International Criminal Court (ICC) against six Kenyan politicians who have been accused of involvement in the post-elections violence in 2007.
Corruption is a structural problem in Kenya. In Transparency Internationals' Corruption Perceptions Index, Kenya is ranked 154th out of a total of 178 countries. Corruption in Kenya is widespread, seriously impeding governance, politics and keeping in place ethnic divisions. The government is

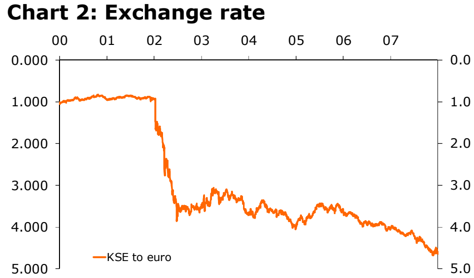
working hard to reduce corruption - important reforms are also included in the newly adopted constitution - but tackling the issue remains a huge challenge.
The unequal distribution of wealth continues to cause a lot of friction as well. Some 40 to 45 percent of Kenyans live below the poverty line and it is estimated that a mere 10% of Kenya's population earns over 40% of Kenya's total income. A GINI-coefficient of 47.7 (2010), higher than most of the country's neighbors, is a further reflection of the high degree of income-inequality in Kenya.
The lack of stability in Sudan and Somalia, Kenya's neighbors, poses a further threat to Kenya's domestic stability. Both Sudan and Somalia have been plagued by protracted conflict for many years. Thus far, Kenya has managed to steer clear of any spill-over effects. However, the drought that has plagued the entire region for the last couple of years has caused major problems, as Kenya saw a large influx of Somali refugees during the first half of 2011, heightening the risk of spillover and exacerbating drought-related problems in Kenya as well. Nonetheless, Kenya is regarded as being an important player in East Africa. It is responsible for many peace talks in the region and maintains close relations with key international donors and investors.

Chart 2: Fiscal indicators



Source: EIU

Chart 2: Exchange rate



Source: EIU

Economic policy

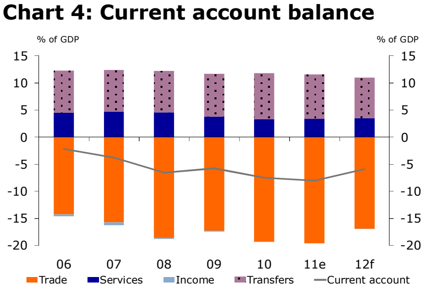
Kenya's economic policies are outlined in a long-term plan named 'Vision 2030.' In this plan, the Kenyan government sets out the economic policies deemed necessary to turn Kenya into a middle income country by 2030. It aims to do this by eradicating corruption, introducing a new constitution, improving Kenya's infrastructure, spurring on liberalization and privatization and reducing bureaucracy. Although Vision 2030 has an admirable goal, the policies set out in the document are unrealistic and the plan does not include tangible reforms. Among other things, average annual GDP-growth will have to reach some 10% in order to make Kenya a middle-income country by 2030. In January of 2011, the IMF and the Kenyan government signed an agreement for a three-year, IMF-backed program worth USD 500mln. Fiscal reforms, investments in the country's infrastructure and a full implementation of the new constitution have been set as conditions under the agreement.
Improved integration into the regional market (the EAC) is an important goal for the government as well. To reach it, the government has been stepping up reforms to tackle structural growth constraints, with an emphasis on combating corruption, improving infrastructure, deregulating the economy, liberalizing trade, and creating a strong private sector. The Kenyan government has already instituted several important structural reforms, such as the implementation of the new consumer price index (CPI) measurement in 2010.
Kenya's total external debt comprises about 27% of GDP. The public sector holds the largest part and holds all external medium-term and long-term debt. Mounting financing pressures due to a widening current-account deficit have forced the Kenyan government to request IMF financial

support in January 2011. In 2010, the Kenyan government kept the debt-service-ratio at an acceptable 16% and interest payments at around 2% of current account receipts. Thanks to the IMF-support, it is expected that the Kenyan government will succeed in keeping these figures steady in 2011.
Higher capital spending and an increase in spending on wages pushed up the budget deficit from 5.8% in 2009 to 7.0% in 2010. The budget deficit is expected to widen further in 2011, to approximately 7.4%. Public debt, meanwhile, stands at approximately 48% of GDP. Earlier this year, inflation surged to 12.9% year-on-year due to large increases in food and fuel prices. Substandard rainfall during this year's rain season will likely further push up food price inflation. Inflationary pressures were also exacerbated by an increasing demand for US dollars as a result of rising oil prices and a reduction in tea earnings due to the drought that hit the region. Consequently, the Kenyan shilling (KES) started to depreciate. To put an end to the weakening of the floating KES, the CBK started to tighten monetary policies and raised interest rates by 50bps to 6.25%. However, despite this policy change, the KES hit an all-time low in June. Fears of a further weakening are spurred on by the widening of the current-account deficit. Moreover, risk adverse financial markets could dampen the effect of further monetary tightening.

Balance of Payments

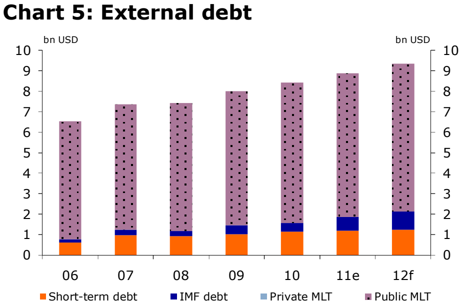
In 2011, Kenya's current account deficit is expected to widen to approximately 8% of GDP, from 7.5% of GDP in 2010, mainly the result of a continuing increase of the trade deficit to around 19.5% of GDP in 2011. Stronger regional integration and improved relationships with Asian markets have both increased the demand for Kenyan exports and could help to contain the trade deficit somewhat towards the end of 2011.
Mitigating the trade deficit are a strong result on the services and transfer balances. Tourism has been on the rise in Kenya for several years and is steadily becoming one of the most important sources of external revenue for the country. Ensuring a positive transfers balance are large inflows of workers' remittances, another main driver of Kenya's economy. The current account deficit has left Kenya dependent on foreign investments and external borrowing to finance the deficit. However, Kenya's many structural constraints make it an unattractive destination for foreign direct investment (FDI). FDI-inflows comprised a mere 0.4% of GDP in 2010. This year, the recent poor performance of the Nairobi stock exchange paired with high inflation and a monetary contraction could scare off new investors who were attracted by Kenya's positive growth figures in 2010.
The Kenyan government aims to keep an import cover ratio of 4 months. In 2010, import cover was just below this target, at 3.9 months. The import cover ratio in 2011 is expected to reach approximately 4.5 months.

Chart 4: Current account balance



Source: EIU

Chart 5: External debt



Source: EIU

External position

All long to medium term debt is held by the government, while the private sector holds all short-term debt. The share of short term debt in total debt is relatively low at about 13.5% of total debt. In addition, FX reserves more than cover the total debt service due (including short term debt).

Kenya

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	6.3	7.1	1.7	2.5	5.6	4.5	5.9
Consumer prices (average % change pa)	14.5	9.8	16.3	9.2	4.0	11.0	5.5
Current account balance (% of GDP)	-2.2	-3.8	-6.5	-5.7	-7.5	-8.0	-5.9
Total foreign exchange reserves (mln USD)	2416	3355	2879	3849	4320	5280	5580
Economic growth							
GDP (% real change pa)	6.3	7.1	1.7	2.5	5.6	4.5	5.9
Kenya, Gross fixed investment (% real change pa)	18.5	13.4	9.7	0.6	4.0	8.5	8.0
Kenya, Private consumption (real % change pa)	7.9	7.6	-0.4	3.5	6.0	4.1	5.6
Kenya, Government consumption (% real change pa)	1.5	7.6	3.7	5.5	7.5	8.0	7.6
Kenya, Exports of G&S (% real change pa)	2.4	5.7	3.6	-7.0	4.0	3.5	7.0
Kenya, Imports of G&S (% real change pa)	17.8	11.1	5.3	-0.2	5.5	7.0	8.1
Economic policy							
Budget balance (% of GDP)	-3.4	-3.1	-4.4	-5.8	-7.0	-7.4	-7.1
Public debt (% of GDP)	47	45	43	47	48	48	47
Kenya, Money market interest rate (%)	6.8	6.8	7.7	7.4	3.6	4.0	5.0
M2 growth (% change pa)	17	19	15	16	18	25	20
Consumer prices (average % change pa)	14.5	9.8	16.3	9.2	4.0	11.0	5.5
Exchange rate LCU to USD (average)	72.1	67.3	69.2	77.4	79.2	86.2	90.2
Balance of payments (mln USD)							
Current account balance	-511	-1032	-1983	-1661	-2328	-2630	-2070
Trade balance	-3253	-4256	-5649	-4989	-5980	-6420	-5910
Export value of goods	3516	4132	5040	4502	5220	5450	6310
Import value of goods	6770	8388	10689	9492	11200	11870	12230
Services balance	1028	1260	1381	1089	1024	1110	1210
Income balance	-70	-144	-45	-58	2	-10	-10
Transfer balance	1785	2108	2331	2297	2627	2700	2640
Net direct investment flows	27	693	52	95	115	410	430
Net portfolio investment flows	-21	-25	-26	-21	-25	-10	-10
Net debt flows	-107	462	-25	523	435	450	480
Other capital flows (negative is flight)	1229	841	1505	2035	2274	2740	1480
Change in international reserves	617	939	-477	971	472	960	300
External position (mln USD)							
Total foreign debt	6552	7376	7427	8005	8436	8890	9360
Short-term debt	602	964	910	1011	1143	1200	1230
Total debt service due, incl. short-term debt	1293	1444	1745	1639	1847	1950	2010
Total foreign exchange reserves	2416	3355	2879	3849	4320	5280	5580
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-14.3	-15.7	-18.6	-17.3	-19.3	-19.6	-16.9
Current account balance (% of GDP)	-2.2	-3.8	-6.5	-5.7	-7.5	-8.0	-5.9
Inward FDI (% of GDP)	0.2	2.7	0.3	0.5	0.4	1.3	1.3
Foreign debt (% of GDP)	29	27	24	28	27	27	27
Foreign debt (% of XGSIT)	83	79	68	80	75	75	73
International investment position (% of GDP)	13.7	78.5	72.1	119.2	186.9	167.2	n.a.
Debt service ratio (% of XGSIT)	16	15	16	16	16	16	16
Interest service ratio incl. arrears (% of XGSIT)	2	2	2	2	2	1	1
FX-reserves import cover (months)	3.5	4.0	2.8	4.1	3.9	4.5	4.6
FX-reserves debt service cover (%)	187	232	165	235	234	271	277
Liquidity ratio	119	122	109	117	115	119	124

Source: EIU