The State of Kenya’s Economy

Ksh/US $

Current account deficit

US$ Millions

Exchange rate

January 2010

September 2011

Current account deficit

US$ Millions
Kenya’s economy has been navigating through an economic storm in 2011. Economic growth is still robust, although below potential and initial expectations. At an estimated 4.3 percent, Kenya’s growth rate will fall short of its 2010 performance, when the economy rebounded strongly at 5.6 percent but will be higher than Kenya’s long-term average rate of 3.7 percent. The ongoing economic crisis underscores Kenya’s structural challenges, especially weak exports, which are the primary cause of Kenya’s recent macroeconomic instability, and contributor to the sharp decline in the Kenyan shilling. For 2012, the World Bank projects a 5.0 percent growth rate, if the government is able to effectively manage the current crisis, maintain political stability in the run-up to the elections, and address the security challenges arising from the conflict with Somalia.

1. Kenya’s economic performance in 2011

1.1 An Economy under Pressure

Despite a number of economic challenges, Kenya will still experience a satisfactory growth rate of 4.3 percent in 2011. This will be higher than Kenya’s long-term growth rate of 3.7 percent but still a full percentage point below the average projected for Sub-Sahara Africa. In the first half of 2011, the Kenyan economy grew by 4.5 percent, driven by a strong performance in the financial sector (8.2 percent), construction (8.1 percent), as well as hotels and restaurants (6.4 percent). Moderate growth was recorded in the agricultural and industrial sectors. Overall growth for 2011 is expected to be balanced across all key sectors, with the services sector maintaining its position as the growth engine over the last decade (see figure 1.1 and table 1):

- **Agriculture has performed average despite the moderate drought.** Agriculture production grew by 3.5 percent in the second first half of the year as rains normalized, especially in Kenya’s “bread basket”, the Rift Valley, and production held up again. The drought mostly affected Kenya’s livestock production in Northern and Eastern regions. It is estimated that the drought shaved off 0.2 percentage points from GDP growth, mainly as a result of livestock mortality. Beyond these arid regions, low rainfall and high temperatures affected tea production. In addition, the crises in North Africa and Europe adversely affected the demand for Kenya’s cash crops, mainly horticulture, coffee and tea.

- **Industrial sector growth remains driven by construction while manufacturing is lagging.** The construction sub-sector recorded an impressive 8.1 percent growth in the first half compared to a 2.2 percent growth in the same period in 2010. Manufacturing grew at a modest 3.2 percent, compared to 5.5 percent in the same period last year. The drought impacted hydro power generation and the resulting high cost of energy has adversely affected the industrial sector. The share of hydro power in Kenya’s energy supply declined from 57 percent in July 2010, to 43 percent in July 2011. This in turn increased dependence on back-up thermal power generation, which uses expensive imported fuel as its feedstock. Industries that depend on imported raw materials, saw their production costs increase significantly due to high import costs (oil and steel), along with the depreciation of the shilling. The costs of imported machinery and equipment also increased substantially. The combined effect of these factors has negatively impacted the competitiveness of industry, resulting in a sluggish performance in 2011.

- **The services sector is holding up, fueled by continued growth in ICT and a strong performance in tourism.** Services grew by 4.3 percent in the first half of 2011, mainly driven by financial intermediation (8.2 percent); hotels and restaurants (6.4 percent), and transport and
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communication (5.2 percent). Tourist arrivals increased by 13.6 percent in the first half of 2011, compared to 2010 levels. Despite Europe’s economic slowdown, 46 percent of arrivals were still from Europe, 25 percent from the rest of Africa, 12 percent from the Americas, and 10 percent from Asia. However, the emerging security concerns stemming from Kenya’s incursion in Somalia will dampen tourist arrivals for the remainder of the year, though the high season is over.

The ICT revolution is reaching new milestones and is stimulating growth in other services. The mobile phone revolution has continued, with subscriptions peaking at 25.3 Million at the end of June 2011, which is more than the number of adults in Kenya. Since June 2010, subscriptions increased by more than 25 percent. In the same period, internet users increased by 60 percent, climbing to 12.5 Million. This indicates that the data revolution is now also in full swing. A key factor in the growth of internet usage is the new affordable tools, including smart phones and social networking applications with both internet and mobile interface that are proving increasingly popular, especially among the urban youth. The sector has also generated additional innovations, including M-banking, linking mobile money with personal bank accounts, M-credit, and M-insurance, which are expanding the reach of financial services to previously unbanked segments of the population (see figure 1.2).

Figure 1.1: Kenya’s growth is projected at 4.3 percent in 2011, balanced across sectors but below the average for SSA

Source: World Bank computations based on KNBS data
However, Kenya’s economy has come under pressure in 2011. Four mutually reinforcing shocks have curtailed Kenya’s high growth momentum:

- Higher global fuel prices, which were triggered by the crisis in the Arab world. In the first nine months of 2011, international crude oil prices increased by 37.4 percent. This resulted in a 42.2% increase in Kenya’s oil import bill. Oil now represents 26% of Kenya’s imports.

- Higher food prices, notably maize, of which Kenya imports substantial quantities. Kenya’s food deficit had to be met through highly priced imports of maize, with global prices increasing from a 9-month average of US$ 167 per metric ton in 2010 to US$ 299 in 2011. Moreover, Kenyans ended up paying up to US$ 530 per metric ton of maize, due to additional policy distortions that disrupted the domestic food market.

- Drought in the Horn of Africa, which led to a massive influx of refugees and significant loss of livestock. The drought only marginally affected Kenya’s agricultural production, but severely affected communities owning livestock, who live in drought-afflicted areas. Below normal rainfalls resulted in higher power costs as hydropower production declined, adversely affecting the competitiveness of the industrial sector.

- The Euro crisis, which created uncertainty in the global markets and increased currency volatility. Europe is the main market for Kenya’s horticulture, and the third destination for Kenya’s tea. The economic slowdown in Europe, along with the crisis in the Arab world, a significant destination for Kenya’s tea, negatively impacted the growth of Kenya’s key exports.

Escalating food and fuel prices, in turn, drove up inflation, which increased by 18.9 percent from the beginning of 2011, through to the third quarter. This is the highest rate of inflation Kenya has seen since the introduction of a new methodology for measuring inflation in 2009. Transport inflation has doubled – from 13 to 26 percent in the first ten months of the year. Likewise food inflation has more than doubled from 10 to 26 percent, between January and October 2011 (see figure 1.3). Second round effects are now emerging as core inflation, which excludes food and energy prices, increased from 1.4 to just over 10 percent in the same period. Food inflation remains

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1Crude oil price increased from an average of US$ 79.7 per barrel in 2010 to US$ 109.4 in the first 9 months of 2011.
the driver of overall inflation, and the situation is particularly severe for maize and sugar, where Kenya’s policies have actually contributed to rising prices:

- **Maize.** Kenyans paid a record US$ 45 per bag of maize in July 2011 which was more than double the price at the beginning of the year and about 70 percent above the already high world market prices (see figure 1.4).

- **Sugar.** Kenya’s record high inflation in the second half of 2011, is strongly influenced by rising sugar prices. Today, Kenyans pay about twice as much for sugar as Europeans, even though the drought did not affect sugar-producing areas. As in the case of maize, a number of well connected businessmen benefit from disproportionately high prices, which they manipulate through their control of import licenses, to the detriment of Kenyan public.

High inflation tends to hurt the poor disproportionately. This is especially so when inflation is driven by high food and fuel prices, as the poor spend a significant proportion of their income precisely on food and transport. A breakdown of Kenya’s inflation by urban income groups shows that low income households have been hit hardest by inflation in 2011. For instance, in October 2011, the inflation experienced by low income households was 19.6 percent, compared to the previous year, by

**Figure 1.3:** Overall inflation has been driven by food and transport … hurting the poor most

**Figure 1.4:** Kenyans pay too much for maize and sugar

*Source: World Bank computations based on KNBS data*
contrast to 14.5 percent for high income households (see figure 1.3).

These shocks hit the economy at a time when fiscal policy buffers had been depleted and monetary policy was still expansionary. The fiscal stimulus of 2009 and 2010 was largely financed through domestic borrowing, which increased public debt as a share of GDP, by three percentage points (up to 48.8 percent against a policy target of 45 (see figure 1.5).

The Central Bank was still pursuing a broadly accommodative monetary policy in response to the 2009 economic crisis when the 2011 shocks hit. Domestic interest rates both in the short and long end of the market were at historic lows until they started to rise in the second half of 2011 (see figure 1.5). Furthermore, the Central Bank had run down foreign exchange reserves during the 2009 crisis, so that foreign exchange reserves were below the statutory 4 months of import cover at the beginning of 2011.

1.2. An economy out of balance

Kenya’s economy has been out of balance for a long time but in 2011 a number of external shocks exposed Kenya’s unsustainable external position. The rapid rise of oil prices in the first half of 2011, and the Euro crisis in the second half of the year, as well as the drought in the Horn of Africa, triggered the depreciation of the Kenyan shilling to an all time low (see figure 1.6). At the same time, Kenya’s current account deficit reached a record high: between December 2010 and September 2011, it grew by almost 4 percentage points, from 6.7 to 10.5 percent of GDP. In the first three quarters of 2011, imports expanded by 22.7 percent, compared to 15.0 percent for exports, increasing the current account deficit by US$ 1.9 Billion. By May 2011, earnings from Kenya’s top exports (tea, horticulture, and manufactured goods), along with international travel, were not sufficient to pay for oil imports alone (See figure 1 in the executive summary).

The prevailing expansionary policies accentuated internal and external macroeconomic imbalances. Growth in credit to private sector, reflecting robust domestic demand, put pressure on domestic prices. By September 2011, private sector credit had grown by 36 percent since the beginning of the year. Rising aggregate demand could not be met by domestic production, and spilled into high demand for imports. Export growth proved to be lackluster as Kenya’s main European and Middle Eastern markets experienced their own economic pressures. Finally, increasing international prices for fuel and food created inflationary pressures domestically while also increasing the cost of the import bill. The resulting imbalances were reflected in a widening current account deficit, and a depreciating shilling.

Figure 1.5: Debt has increased to 48.8 percent of GDP and interest rates rose sharply

Source: World Bank computations based on MOF & CBK data
Figure 1.6: How the genie came out of the bottle – Explaining the decline of the Kenya shilling

Source: World Bank
Short term flows help to finance the current account deficit, but constitute a source of volatility. The deficit in the current account is largely financed via short term financial flows, which consist of money invested in the equity and money markets, often referred to as footloose capital. These inflows can quickly reverse into net outflows (see figure 1.7). Yet Kenya’s imports consist mainly of oil, capital machinery and intermediate inputs, which are all essential for growth, and are difficult to scale back. Although Kenya’s balance of payments has previously been in surplus (the tip of the iceberg), it remains vulnerable to external shocks and outflows of footloose capital.

The global downturn, particularly in Kenya’s export markets, has curtailed the growth in exports, following a strong performance in 2010. The moderate growth of horticulture exports (2-2.5 percent for the first three quarters of 2011) broadly reflects Europe’s economic growth, while tea exports were also affected by disruptions in North African markets. Exports of coffee grew by 9.2 percent as at September 2011, despite a decline in production as a result of a 128.7 percent increase in coffee prices since 2010. Tea exports contracted by 1.8 percent in the same period, despite a 25.3 percent increase in prices. The political crisis in Egypt and marked decrease in demand from Pakistan, the major destinations for Kenyan tea, resulted in a slowdown in exports, while drought conditions contributed to below normal levels of production (see figure 1.7).

Figure 1.7: The current account deficit is at record levels putting pressure on the overall balance of payment

Source: World Bank computations based on CBK data
Remittances increased significantly in 2011, but the growth in service exports was disappointing. The growth of services exports was flat in 2011, which is in contrast to the 23.4 percent increase registered in 2010. This is explained by current transfers which declined by 3.0 percent from US$ 2.3 billion in 2010, to US$ 2.2 billion in 2011, mainly as a result of declining public current transfers (money sent to NGOs and civil society organizations declined from US$ 0.2 billion in 2010, to US$ 0.06 billion in 2011).² Remittances grew by 33.2 percent increasing from US$ 0.6 Billion in 2010, to US$ 0.8 Billion in 2011.

The Kenya shilling exchange rate had to yield to the pressure on the external account, and experienced a significant depreciation in the third quarter of 2011. In the last twelve months, the shilling lost approximately a quarter of its value against the US dollar, the UK sterling pound and the Euro. The shilling depreciated from KSHS 81 to the US dollar in January 2011, to a high of Kshs 104 in September 2011, before settling back to under Kshs 100 to the US dollar in November 2011. There are two main underlying reasons for these developments: investors’ uncertainty with the Kenyan economy in the year ahead, and negative terms of trade shock which resulted in a deterioration of the trade balance. In turn, uncertainty induced depreciation may have further contributed to a higher trade deficit over the short run, while the trade deficit may have further increased investors uncertainty (see figure 1.8).

Figure 1.8. Exchange rate volatility accelerated in 2011

²Current transfers are those transactions in which an economy provides real and financial resources that are immediately or shortly consumed by other economies without receiving equivalent values in return. Examples are workers’ remittances sent or received by residents to or from non-residents, and donations or gifts given or received by the government to or from other government or non-residents.
The initial adjustments made by the Central Bank of Kenya in the policy rate were not sufficient to contain inflation. When inflation started to rise at the end of 2010, the initial policy stance was appropriate as inflation was still below the Central Bank’s five percent target. But when that target was exceeded at the end of the first quarter of 2011, the Central Bank could have considered raising the Central Bank Rate (CBR). Negative real lending rates in the first three quarters of 2011 and robust growth in credit to the private sector, indicate that CBR increases did not achieve the intended objective. Real lending rates turned negative in June 2011, and credit to private sector remained robust, growing at 36 percent in the year to September 2011. The market also began reacting to inflationary concerns in April 2011, as reflected in the steep rise in interbank and 91-day T-Bill rates, but the CBR remained unchanged. CBK finally raised the CBR dramatically in October 2011, in an effort to contain spiraling inflation. In figure 1.9, a simulated CBR, adjusted for domestic capacity utilization, shows a hypothetical path, if the CBR had been adjusted periodically as inflation picked up, compared with the actual CBR.⁴

Credit to the private sector crowded out lending to government, impacting budget implementation. Interest rate on government paper (91 day T-Bills) turned negative in January 2011 and the subscription to government paper (both T bills and bond auctions) declined. In the first quarter of FY 2011/12 only 44 percent of government bonds were subscribed compared to 121 percent in a similar period in FY 2010/11. Consequently, domestic borrowing was 0.4 percent of GDP against a target of 1.5 percent. This forced the government to trim down expenditures and net lending to 5.9 percent of GDP, compared to the initial plan of 7.3 percent. Development and recurrent expenditures were scaled back by 0.7 and 0.6 percentage points of GDP, compared to initial targets.

1.3. Restoring macroeconomic stability

Since October 2011, CBK has taken decisive action to restore macroeconomic stability. The CBK’s Monetary Policy Committee raised the CBR by 400 basis points in October 2011, and by a further 550 basis points in November 2011. These recent hikes in interest rates along with additional measures announced by Ministry of Finance, have begun to stabilize the exchange rate and curtail the flight from the shilling (see figure 1.10).⁵

Adjustments to the CBR have resulted in substantially higher short term interest rates. Domestic interest rates both in the short and long maturity instruments have risen sharply, while capital markets activities have diminished. The recent tightening of monetary policy through significant increases in the CBR, and open market operations to reduce liquidity led to an increase in short term rates. By October, 2011, the repo, interbank and the 91 Day Treasury bills rates had increased by 16, 14 and 12 percent respectively, as growth in money supply declined.⁶

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**Figure 1.9. Kenya’s monetary response: First too little – then a strong catch-up**

Source: World Bank computations based on CBK data

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⁴Note (i) The simulated CBR is a hypothetical CBR which is adjusted to take into account domestic Inflationary Pressure and domestic capacity utilization (ii) It can be calculated as simulated \( CBR = \pi + r + 0.5(\pi - \pi^*) + 0.5(y - y^*) \), where CBR is the Central Bank Rate, \( \pi \) is the inflation rate that excludes food and energy prices, \( r \) is the equilibrium interest rate (assumed to be 2 percent), \( y \) is the log of quarterly GDP and \( y^* \) is the log of trend quarterly GDP. We assume that when formulating monetary policy, the CBK put equal weight in fighting inflation deviation from target and GDP growth from target.

⁵The Shilling has reversed its path appreciating from 107 in October to 93 in November.

⁶Money supply growth (M1, M2 and M3) has been declining significantly since February 2011. The growth in M3 has declined from 20.8 percent in February to 16.7 in August while M2 and M1 have declined from 21.4 and 27.6 percent respectively to 15.0 and 20.7 percent in August 2011.
Long term interest rates have remained relatively steady but increased steeply in November, in response to the tighter monetary policy stance. However, the transmission mechanism, between short term and long term rates in the market, is still weak. Tighter monetary policy has led to sharp increases in interbank and 91 day Treasury bill rates, but long term rates have not responded in a similar fashion. However, after the CBR increased to 16.5 percent in November, lending rates have increased to 20-25 percent, while deposit rates have increased to 10 percent. The interest rate spread (lending minus deposit rates) remains steady at around 10 percent.

The additional credit from the International Monetary Fund (IMF) will rebuild foreign exchange reserves and support the Kenya Shilling. The government has approached the IMF for additional financing through the Exogenous Shock Facility. If the credit is approved it will provide an additional US$
250 Million to the existing US$ 500 Million facility. Front loading disbursements in FY 2011/12 will help rebuild foreign exchange reserves and stabilize the shilling.

**Recent shocks have provided fresh impetus to fiscal consolidation.** Fiscal consolidation started in FY 2011/12. Initially the Government planned to reduce debt to GDP ratio from 48.8 percent in FY 2010/11 to 46.7 percent by 2013/14. However, the recent shocks and the need to reduce domestic demand have called for a more aggressive consolidation, which would reduce debt by an additional 2 percentage points, to 44.6 percent by 2013/14. The consolidation is to be achieved through spending cuts in the medium term, to improve the primary deficit from -2.7 percent to -2.2 percent of GDP and by a further 0.1 percentage point in FY 2012/13 (see figure 1.12).

**If the envisaged consolidation takes place, it will rebuild fiscal policy buffers back to pre crisis levels.** However, fiscal consolidation will be more difficult in light of emerging pressures. The implementation of the new Constitution and the elections in FY 2012/13 will build additional spending pressures (see the outlook for FY 2012-13 and special focus of this report).

**1.4 Rebalancing the economy**

The current shocks have revealed Kenya’s declining international competitiveness as a major structural weakness in the economy. While the recent policy measures will constrain demand and restore exchange rate stability in the short term, problems will remain in the long run if supply side weaknesses in Kenya’s exports are not tackled urgently.

The weakening of the shilling has translated into only marginal benefits for exporters. A look at the trade weighted nominal effective exchange rate (NEER), which is a measure of how the shilling performs against the currencies of Kenya’s trading partners, indicates that the shilling had lost 20 percent of its value against them from January 2011 to September 2011. However, export competitiveness measured by the real effective exchange rate (REER) improved by about 7 percent (see figure 1.13). There are three possible explanations for this: (i) the benefits of a weaker exchange rate are being eroded to some extent by high domestic inflation (the real exchange rate has depreciated much less than the nominal exchange rate); (ii) Kenya’s export products have a high import content (for instance chemicals and fertilizer), and the benefits of a weaker currency are

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**Figure 1.12: The government is taking a tighter fiscal position**

![Graph showing fiscal projections](image)

*Source: World Bank computations based on MOF*

**Figure 1.13: The depreciation in the Ksh has marginally improved Kenya’s competitiveness**

![Graph showing NEER and REER](image)

*Source: World Bank computations based on CBK data*
significantly offset when the currency depreciates; and, (iii) the depreciation seen since January 2011 is being driven mainly by fundamentals, and reinforced by speculative activity.

The current shocks have increased Kenya’s vulnerability and highlighted structural problems in the economy that require long-term solutions. In the second economic update of June 2010, it was argued that the ‘Kenyan economy is running on one engine’, that economic growth is largely driven by domestic demand, and export growth is fragile. The extent of Kenya’s economic fragility is reflected in the recent volatility of the shilling. Kenya’s trade performance is below its potential. Three structural weaknesses in Kenya’s export performance were identified, that have contributed to the current external vulnerability: (i) Kenya’s openness to trade has improved only marginally in the last decade compared to comparator countries (see figure 1.14); (ii) the gap between potential and actual exports to current markets has widened; and, (iii) export diversification has progressed slowly and the export basket remains concentrated. In addition, the state of infrastructure, particularly energy, rail, and the port of Mombasa undermine export competitiveness. These challenges need to be addressed and resolved for Kenya to increase its export competitiveness.

2. Outlook for 2012

2.1. Achieving moderate growth: the World Bank’s projections

The World Bank projects a growth rate of 5.0 percent in 2012, increasing to 5.5 percent in 2013. Ongoing public investment in roads and energy will drive growth, while private investment is anticipated to grow moderately for two main reasons: first the tighter monetary policy stance adopted in the last quarter of 2011 is expected to continue in 2012; and second, investors are likely to remain cautious until a new government is elected and peacefully installed. Private consumption will increase from 2011 levels once inflation is contained, and the harvest from the current short rains produces an increase in the food supply. But fiscal consolidation will constrain growth in public consumption, as discussed in the previous section (see table 2).

Table 2: Macro Economic indicators 2007-2013

<table>
<thead>
<tr>
<th>Variable</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011*</th>
<th>2012**</th>
<th>2013**</th>
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</thead>
<tbody>
<tr>
<td>GDP</td>
<td>7.0</td>
<td>1.6</td>
<td>2.6</td>
<td>5.6</td>
<td>4.3</td>
<td>5.0</td>
<td>5.5</td>
</tr>
<tr>
<td>Private Consumption</td>
<td>7.3</td>
<td>-1.3</td>
<td>3.8</td>
<td>2.8</td>
<td>3.0</td>
<td>3.9</td>
<td>4.1</td>
</tr>
<tr>
<td>Government Consumption</td>
<td>4.4</td>
<td>2.3</td>
<td>5.5</td>
<td>4.8</td>
<td>4.5</td>
<td>4.3</td>
<td>4.6</td>
</tr>
<tr>
<td>Gross Fixed Investment</td>
<td>13.6</td>
<td>9.5</td>
<td>0.6</td>
<td>7.4</td>
<td>10.2</td>
<td>9.5</td>
<td>11.0</td>
</tr>
<tr>
<td>Exports, GNFS</td>
<td>7.3</td>
<td>7.5</td>
<td>-7.0</td>
<td>6.1</td>
<td>8.9</td>
<td>6.7</td>
<td>6.7</td>
</tr>
<tr>
<td>Imports, GNFS</td>
<td>11.1</td>
<td>6.6</td>
<td>-0.2</td>
<td>3.0</td>
<td>8.6</td>
<td>6.7</td>
<td>6.7</td>
</tr>
</tbody>
</table>

Source: World Bank

Figure 1.14: Kenya’s openness to trade has stagnated while Asian economies have taken off

Source: WDI
The pressure on the external account will ease as the current account deficit narrows. Tighter monetary policies and the depreciated currency will act as a brake on aggregate domestic demand. Also, the drop in international oil prices from an average of US$ 105 per barrel to a forecast price of US$ 97 per barrel in 2012, will reduce the costs of oil imports. Imports of intermediate goods used for production such as capital equipment and machinery, will decrease as private investment slows down. Production of tea and coffee should increase following good rains in late 2011. With improving conditions in Middle Eastern markets, exports of these crops will most likely increase. The flower industry is looking at markets in Asia, which could become competitive as these economies continue to grow. A similar situation applies to tourism and the Kenya Tourist Board has in fact begun an aggressive campaign to attract tourists from Central Europe and Asia. Kenya is already seeing the dividends from this strategy, as tourist from China increased by 50 percent between 2010 and 2011. Another bright spot for Kenya’s exports are the ECA countries, whose economies are growing rapidly. Finally, strong growth in EAC countries should translate into higher regional exports of manufactured goods. This combined with a depreciated shilling should allow Kenya to expand its exports of manufactures within the region. Growth could even approach 5.5 percent in 2012, if a number of favorable factors materialize. Kenya’s economic and political situation would need to stabilize, and world markets would need to grow more rapidly, than what is currently forecasted. With moderate inflation, an improved current account, and a small decline in interest rates, private investment would pick up. However, a smooth run up to the elections will be essential for this scenario to materialize.

But growth could fall to around 3.1 percent if the environment worsened instead of improving. This scenario could develop if a number of adverse developments materialize, either from external shocks or from any of the numerous domestic challenges facing the Government (see section 2.2 below). Figure 2.1 shows the various economic growth scenarios for 2012 and 2013.

Figure 2.1: Starting 2012, growth should again reach 5 percent – if no shocks occur

2.2 Risks to economic growth in 2012: Euro crisis and elections

On the external front, the most challenging development would be full blown recession in the Euro zone⁷. Europe remains Kenya’s main market for horticultural exports and tourism. Any crisis in the euro area would affect the demand for these products, and further weaken Kenya’s foreign exchange position. The current slow-down in Europe has led to anemic growth in Kenya’s horticultural exports, and this sector would be hit hard by a Euro crisis, unless the industry is able to diversify its markets.

Internal challenges in 2012 constitute another set of risks to economic growth. There are two major challenges which the government will need to address with great skill, in order to avoid economic disruption:

- Successfully managing the economic transition from a high inflation environment with a deteriorating fiscal position, to a moderately growing economy with restored macroeconomic fundamentals; and,

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⁷Annex Table A1.17 (Economic Shocks: Comparing 2009 vs. 2012 Outlook) compares the situation Kenya faced in 2009 at the time of the last global downturn with the situation it is likely to face in 2012.
• Successfully managing the fiscal pressure associated with the run-up to the 2012 elections, and the current military incursion in Somalia.

Growth will suffer if Kenya is not be able to reduce inflation or restore its fiscal balance. Inflation should moderate in coming months as higher interest rates curb consumption and investment. Furthermore, expected reductions in the international price for oil, and increased domestic production of food should reduce the pressure on prices. Finally, the government is committed to restoring the fiscal balance, and has already demonstrated this by reducing borrowing and spending in 2011. It remains to be seen if the government can hold the line on spending in 2012. In particular, it may need to intervene to keep growth on track if the private sector holds back significantly because of the political uncertainty.

The second major risk is the uncertainty associated with the run-up to the 2012 elections and the political transition to a new government. In the past, Kenya’s growth performance has suffered during election years (both before and after the election). Over the past three decades, Kenya has had its lowest growth periods - on average about one percentage point below the long-term average - in or just following election years (see table 3).

Elections have impacted activity via a number of channels. Most election years have had several common factors. They were characterized by negative growth in investment and household consumption, which typically decline in periods of uncertainty. Elections in Kenya are prone to uncertainty because they have often resulted in violence and new policy regimes.

Looking forward into 2012, the economic circumstances are more challenging than in 2007. The government will need to control public spending in light of inflation pressures and public debt burden. Although the government has committed to reducing expenditures, it will face spending pressures related to the devolution process, and to organizing and financing the 2012 elections.

The 2012 elections will not only usher in a new national government, but also a new system of devolved government. Businesses and investors will need to adjust to new institutional arrangements at the local level, that are yet to be fully developed, and to the possibility that a new government may come in with new policies. The result is likely to be a wait-and-see attitude from the private sector. But there is also an upside dividend if the election is handled well. The election period presents an opportunity for the government to restore public confidence in the legitimacy and power of institutions, and its ability to ensure justice, equity, and an enabling environment for development. The new government will need to manage these expectations, and the outgoing government will have to ensure a peaceful, flawless transition. Presently, there is every indication that the current government is aware of these challenges, and is proceeding with a program to keep the economy and the country on an even keel.

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**Table 3: Kenya’s growth is lower in election and post-election years**

<table>
<thead>
<tr>
<th></th>
<th>Average Growth rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>All years 1980-2010</td>
<td>3.4</td>
</tr>
<tr>
<td>Election years</td>
<td>2.4</td>
</tr>
<tr>
<td>Post election years</td>
<td>2.7</td>
</tr>
<tr>
<td>Non election years</td>
<td>3.9</td>
</tr>
</tbody>
</table>

*Source: World Bank based on KNBS*

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Kenya has experienced low growth in two thirds of the election years over the last thirty years. In these cases, pre-election violence and political uncertainty deterred domestic and international investors. The year 2007 was an exception, when Kenya benefited from stable macroeconomic policies and the Economic Recovery Strategy (ERS), and achieved its highest growth rate (7 percent) in recent history. The management of post-election dynamics is equally challenging. Over the last six elections, three were followed by low-growth, especially in 2008, when the post-election violence put an abrupt end to the achievements of previous years (see figure 2.2).

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*One of the uncertainties surrounding the 2012 elections is the ongoing investigations by the International Criminal Court (ICC) on the violence that followed the 2007 elections. The ICC is investigating six politically influential Kenyans (including several potential candidates for the Presidency in 2012) and will decide in January 2012 whether to confirm charges against these individuals for a full trial. It is unclear what impact the ICC decision will have on the run-up to the 2012 elections, but a decision to go for full trial could result in some domestic political turmoil.*
Figure 2.2: Kenya has experienced slow growth in many election and post-election years

**Elections and economic performance**

**Election years (Average growth 2.4)**
- 1983 (1.3) – Snap elections called after the attempted Coup d’état in 1982 against President Moi leading to the amendment of the Constitution reverting back to a single party state.
- Widespread drought in the country affected 200,000 people
- 1992 (-0.8) – Kenya reverts back to a multi-party state.
  - Severe drought threatens 1.5 Million people
  - Elections characterized by violence mainly in Rift Valley and Nyanza
  - People in Rift Valley displaced
- 1997 (0.5) – El Nino floods disrupted food production and economic activity.
  - Pre-election violence in Rift Valley and Coast
- 2002 (0.5) – Pre-election violence in Rift Valley

**Post Election years (Average growth 2.7)**
- 1984 (1.8) – Widespread drought extending from 1983 negatively affecting agriculture.
- 1993 (0.4) – Highest inflation in the history of Kenya, annual average of 46%. In August, inflation reached 100%
- 2008 (1.6) – Large scale post-election violence on the largest scale ever experienced in the country
- 1998 (3.3) – El Nino floods disrupted food production and economic activity.
  - Terrorist action targeting the US Embassy had an impact on Tourism.
- 2003 (2.9) – A new government installed with a lot of national and international goodwill.
  - As a result, external debt increased to 38% of GDP.
  - Agriculture begins to recover cereal yields increased by 7.1%.
- 1988 (6.2) – High agricultural production, with yield of cereals per hectare increasing by 11.3% due to good rains.

Source: World Bank