The State of Kenya’s Economy
1. Stabilizing but vulnerable

In 2012, Kenya’s economy returned to a more stable path. Inflation is declining and is below 10 percent; the exchange rate has stabilized and low fiscal deficits have brought debt levels to below 45 percent. While Kenya’s economic growth slowed in 2011 to 4.4 percent, it is now back on track, with economic stability and good rains, and is projected to reach 5 percent in 2012 and 2013. At the same time, Kenya’s economy is more vulnerable than ever to shocks, due to a large and widening current account deficit, which could reach 15 percent of GDP in 2012. Another oil price shock, poor harvest, or an episode of domestic instability, could easily create renewed economic turbulence. Kenya’s exports continue to be driven by traditional products, and are sold to traditional markets. At a global level, Kenya’s exports remain few (tea, tourism, and horticulture) and are recording modest growth. However, in Africa, especially East Africa, trade has been expanding rapidly, which demonstrates the potential of regional integration for Kenya.

1.1 Economic performance in 2011

In an environment of global turbulence and domestic shocks, Kenya recorded moderate growth of 4.4 percent in 2011. For the second consecutive year, the economy experienced positive growth across all quarters and sectors, even though agriculture performed poorly. The agriculture sector growth declined from 6.4 percent in 2010, to 1.6 percent in 2011. This is attributed to dry weather conditions in 2011. However, in terms of total value, Kenya’s export crops benefited from favorable global prices, which compensated for reduced output and explained the increased export earnings. Growth in the services sector remained robust, at 5.1 percent, though this was at a slower pace than in previous years. Industry experienced tepid growth in 2011 at 2.8 percent, a significant decline from 5.3 percent in 2010 (see figure 1.1 for details).

Kenya’s growth for the last four years has been relatively modest. Since the 2008 crisis, Kenya has been growing at an average of 3.5 percent per year, well below the average for Sub-Saharan Africa (5.5 percent, excluding South Africa) and significantly slower than the East African Community (EAC) countries, some of which are among the fastest growing developing countries in the world. For example, Rwanda grew at 7.9 percent, Uganda 7.2 percent, and Tanzania 6.7 percent during the 2008-2011 period (see figure 1.2).

Figure 1.1: Growth remained resilient in all sectors and all quarters

![Graph showing sectoral growth rates and quarterly GDP](source: World Bank Computations based on KNBS data.)
Revenue from tea and coffee increased substantially – but only due to high prices, not volumes (which declined). Tea, coffee and horticulture—Kenya’s main export crops—all saw a decline in production in 2011 compared to 2010 levels (see figure 1.3); but the global commodity price rally was strong enough, which enabled the value of Kenya’s export commodities to actually increased in 2011 compared to 2010. However, potential gains for Kenya from higher oil prices, were eroded by the higher oil prices which Kenya had to pay.

Some of the highlights of the economy in 2011 include:

• Tea production contracted by about 5 percent in 2011, but domestic currency earnings from the subsector benefitted from high global prices and a weak shilling for part of the year, as earnings increased by 17 percent;
• Coffee production also declined in 2011 compared with 2010, but coffee farmers emerged the real winners in 2011, as global prices increased by 50 percent; and
• Agricultural growth remained modest, due to the dry weather conditions. The 2011 drought was concentrated in Kenya’s arid and semi-arid regions, which affected pastoralist’s livelihoods, especially livestock, but impacted agricultural production only mildly. The food sub-sector cereal production increased by 5 percent and horticulture production declined, but prices increased thus earnings remained stable in 2011.
A decline in hydropower generation negatively affected industry. Low water levels, resulting from the drought in 2011, led to a decline in hydropower generation and a shift towards emergency diesel generated power. As global oil prices peaked, the cost of diesel generated power increased, raising the costs of production for industry. Furthermore, interruptions in electricity supply have costed businesses in Kenya some 7 percent of their annual sales revenue, which also explains the decline in manufacturing growth to 3.3 in 2011 (from 4.5 percent in 2010). Since other sectors grew faster than manufacturing, the sector’s share in GDP declined from 9.9 percent in 2010 to 9.4 in 2011.

The services sector sustained robust performance in 2011. Tourism continued to experience a boost, recording higher tourist arrivals than 2007, which had been a record year. Kenya has been attracting significant numbers of tourists from new markets, with substantial growth from the Middle East (42 percent) as well as Asia (25 percent), compared to 2010. This could be as a result of new flight routes which Kenya Airways has inaugurated to the Far East. The tourism market from Europe recorded relatively lower growth of 11 percent, when compared to previous years and to other markets.

1.2 The Monetary sector: At the center of the stabilization effort

The strong intervention of the Central Bank during the third quarter of 2011, has helped to ease inflation and to stabilize the exchange rate. High interest rates are attracting foreign exchange inflows, which have strengthened the financial account, and financed a widening current account deficit, which remains vulnerable to high oil prices (see discussion on the external account). By raising the Central Bank Rate (CBR), all interest rates in the money market increased and private sector credit growth slowed. As a result, the shilling stabilized against the major currencies, overall, inflation declined, and core inflation leveled off.

The Central Bank increased interest rates to stabilize the economy. Specifically, it tightened monetary policy in October 2011, by increasing its policy rate to 18 percent from 7 percent, previously. As a result, money market interest rates increased, with the repo and the interbank market rates also increasing sharply by 13 and 7 percentage points, respectively, in the same month.

The Central Bank measures resulted in an increase in both deposit and lending rates. In response to tighter monetary policy, commercial banks increased both their lending and deposit rates. Average lending rates of commercial banks increased by 525 basis points, from 14.8 percent in October, to 20 percent in December; deposit rates increased by 278 basis points, from 4.2 to 7.0 in the same period. The interest rate spread widened from 11 to 13 percentage points, as lending rates remained high (see figure 1.4). In response to public outrage against

Figure 1.4: Inflationary pressure easing ...as high interest rates rose

Source: World Bank Computations based on KNBS and CBK data.
commercial bank lending rates, there have been attempts to curb interest rates on loans, through legislative amendments to the Finance Bill tabled in parliament, but these have been successfully resisted by the executive. Had the amended Finance Bill passed, it would have threatened all the gains made during the last decade, in deepening both Kenya’s financial markets and financial inclusion (see Box 1.1).

**Lending to the private sector has contracted in response to high interest rates.** Growth in lending to the private sector has declined from a peak growth rate of 36.3 percent in September 2011, to 26.0 percent in February 2012. The contraction affected all sectors, except building and construction, transport and communication, and real estate (see figure 1.5). The slowdown in lending growth has mainly impacted private households (-3.4 percent contraction), trade (-2.5 percent), and manufacturing (-2.4 percent). While the significant drop in credit to households is desirable to contain inflation, a decline in credit growth to trade, and manufacturing harms growth. However, credit growth continued in building and construction, transport and communication, real estate. Building, construction and real estate are non-tradable sectors with high import content, which remain profitable even when the real exchange rate is overvalued.

Financial markets have welcomed the government’s decision not to cap lending rates. Recent sharp increases in interest rates have been painful for many Kenyans. However, these interest rate hikes were necessary to stabilize the economy, and cool off aggregate demand; which would have hurt the economy even more, and for a longer period. In addition, there is a perception that banks are charging an undue high “mark-up” for loans, also called the “spread” between deposits and lending rates. These perceptions drove some legislators to propose a legislative interest-rate cap.

### 1.3 Responsive fiscal Consolidation

The government adopted a prudent fiscal response to the 2011 shocks, demonstrating its commitment to fiscal discipline. As revenue and domestic borrowing underperformed, the government rationalized its expenditures. Government expenditures were cut from the budgeted 33.6 percent of GDP, to 30.3 percent in 2011/12. This fiscal consolidation resulted in a reduction of domestic borrowing by about 2 percentage points from 3.8, to 1.9 percent of GDP. As a result, public debt as a share of GDP declined from 48.8 percent in 2010/11, to 43.1 percent in 2011/12 (see figures 1.6 and 1.8). Revenue performance remained strong at 24.0 percent of GDP and government contained

---

*Figure 1.5: Lending to private sector contracted by 10.3 percent... except for non tradable sector*

![Graph showing growth in credit to the private sector.](image)

**Source:** World Bank computations based on CBK data.

*This ratio excludes the recent syndicate loan of US$ 600m.*
Evidence around the world demonstrates that attempts to control prices, especially interest rates, almost always backfire, often leading to higher interest rates and usually hurting the poor most. There are three main reasons for these unintended outcomes. First, any interest rate ceiling means that credit has to be rationed, in which case there is no guarantee that the most productive investment receives the credit. Often credit is rationed on political grounds and the banks that give out these loans often don’t get repaid, putting their balance sheets in jeopardy. Kenya already has a number of painful experiences: in the mid 1980s 11 banks collapsed and in the 1990s 23 banks became insolvent, some of which were put under receivership and merged under consolidated institutions. Second, with interest rate caps, there emerges a “curb market” in credit, with lenders charging exorbitant interest rates to (typically poor) people who have no other option than to borrow in these parallel markets. Third, in the longer run, interest rate ceilings make people reluctant to put their money in banks, leading to slower financial development, which in turn hampers growth. Alternative ways to bring interest rates down include:

(i) Promote competition and transparency. The CBK could direct commercial banks to adopt the Annual Percentage Rate (APR) framework, which would facilitate full disclosure on the cost of borrowing to customers. The APR is the effective interest rate that a borrower pays on a loan. Currently, there are too many hidden charges. In addition, the CBK could ensure that the weighted average lending and deposit rates for every commercial bank and deposit taking micro-finance Institution are posted on the CBK website each month by type of loan. This would allow consumers to effectively evaluate their lending and borrowing options.

(ii) Improve efficiency in the banking industry. Even though Kenya has adopted IT systems which will have brought down operating costs for commercial banks (e.g. ATMs, fewer back-office operations and front office operations), these lower costs have not been passed on to customers: banking charges are still very high in Kenya when compared to other countries. The CBK and Kenya Bankers Association need to further review the interconnectivity of bank platforms, as a way of bringing down operations costs of banks.

(iii) Sharing both positive and negative customer information via a credit bureau would reduce non-performing loans. Parliament should pass laws to force banks to share both positive and negative customer information. When banks reward good borrowers with lower rates and punish those with negative ratings by charging higher rates, both the share of non-performing loans and the cost of borrowing will decline.

(iv) Improving efficiency of commercial banks by encouraging them to lend to each other in the horizontal repurchase market. Banks are hesitant to provide such lending since the master-repurchase agreement does not guarantee them collateralized assets in the event of default. The CBK should amend the master-repurchase agreement to enable banks holding government securities as collateral to realize it upon debtor default.

(v) Addressing the need for a comprehensive consumer protection policy for financial services is a cornerstone for a vibrant financial market as consumers are encouraged to take greater responsibility in their financial decision-making. This will include tightening consumer laws to protect bank customers.

(vi) Reduce overall costs for customers. The authorities need to cap legal fees on discharging/charging securities, eliminate stamp duty on debentures/charges, and allow sharing of securities.

Source: World Bank staff.

A larger share of total spending is allocated to the development budget. The government has devoted a larger share of its budget towards development spending on a significant number of infrastructure projects both at national and constituency level (through the Constituencies Development Fund or CDF). The development budget has grown considerably, from 4.7 percent of GDP in 2006/07, to 7.9 percent of GDP in 2010/11 (see figure 1.7). The medium-term outlook will see a further increase to about 10 percent of GDP, a third of total spending. Meanwhile, recurrent spending was constrained at or below 21 percent of GDP over 2009/10 to 2011/12.

Fiscal consolidation was achieved at a cost, but it was necessary to contain inflation. Although the budgetary allocation for development expenditure
has increased, the cut back in domestic borrowing ultimately translated into reduced development spending in 2011/12. The pre-crisis budget allocations called for development spending to increase to 12.5 percent of GDP, but this had to be scaled back to 9.6 percent. The Kenyan budget is structured so that domestic revenues finance the recurrent budget, while domestic borrowing and foreign financing support the development budget. Short falls in revenues also resulted in reductions in recurrent spending, for operations and maintenance. Revenue collection was under budget by about 1 percentage point of GDP, which was reflected in a similar cutback in recurrent spending.

The government has resorted to external borrowing, to ease pressure in domestic money markets and complement monetary policy. Monetary tightening affected government borrowing through higher costs of borrowing (interest rates on government paper), and created a liquidity crunch, as borrowing from the CBK discount window was restricted. For the first time since 2003, the government found it difficult to fund the budget, by borrowing in the domestic market. Monetary tightening forced commercial banks (the main holders of government security), to hold onto their funds, as the Central Bank increased the reserve requirements, and limited activities at the discount window. The lack of liquidity in the market pushed interest rates from 6.4 percent in mid-2011, to 21.8 percent at year end. The government borrowed US$ 600 million in foreign denominated debt from a syndicate of foreign commercial banks, to plug the fiscal gap in the 2011/12 budget. This loan eased the pressure on domestic money and exchange rate markets, and yields on government debt have declined.

| Table 1.1: Fiscal consolidation as a result of shocks in 2011 (% of GDP) |
|-----------------|--------------|--------------|--------------|--------------|--------------|
|                 | 2009/10      | 2010/11      | 2011/12       | 2011/12 BPS  | 2011/12      |
| Revenue         | 22.3         | 24.1         | 24.9          | 24.0         | -0.9         |
| Expenditure and net lending | 29.5        | 29.3         | 33.6          | 30.3         | -3.3         |
| Recurrent       | 20.5         | 21.1         | 20.9          | 20.5         | -0.4         |
| Development     | 8.7          | 7.9          | 12.5          | 9.6          | -2.9         |
| Fiscal Deficit  | -6.4         | -4.5         | -7.4          | -4.9         | 2.5          |
| Public debt     | 36.2         | 48.8         | 45.9          | 43.1         | -2.8         |

There is potential to expand the primary deficit over the medium-term, if growth increases in line with expectations. If Kenya continues to grow at 4.3 percent in the next three years, it can run an average primary deficit of 3.0 percent of GDP. However, if Kenya grows at 5 to 6 percent in the next three years, it would have room to increase its fiscal deficit to an average of 5.5 percent of GDP, to sustain a debt-to-GDP ratio at 45 percent. In our view, Kenya still needs significant investment in infrastructure, in order to increase potential output, and minimize underlying structural supply constraints, like the high cost of energy. Our projections show that Kenya could sustain a slightly higher deficit than planned, to enable both a reasonable level of infrastructure investment, and a debt-to-GDP ratio of 45 percent (see figure 1.9).

The first budget under the new constitution will allocate 26 percent of ‘shareable’ revenue to devolved government units – including any funds spent through the CDF – according to the Budget Policy Statement (BPS). The Constitution (Article 187) provides that finance follows functions. Using this provision, the central government has earmarked KES. 139 billion for devolved functions, plus KES. 21 billion for the CDF, which is 26 percent of audited Revenues (2010/11), and 16 percent of total estimated revenue and grants in the 2012/13 BPS. The largest share of the revenue is allocated for infrastructure, followed by health, public administration and social protection (see figure 1.10). The Commission on Revenue Allocation (CRA) has proposed a formula for consultation to allocate the county equitable share among the 47 counties: which assigns a 60 percent weight to population; 20 percent for a basic equal share; 12 percent to poverty levels, 6 percent to land area; and, 2 percent to county fiscal responsibility (see figure 1.10).²

² For more insights into Kenya’s devolution process, especially fiscal decentralization, see the forthcoming World Bank report “Devolution without Disruption - Pathways to a successful new Kenya” [title TBC].
1.4 External Account remains out of balance

In 2011, the current account deficit nearly doubled to 13.1 percent of GDP. Imports grew by almost 20 percent, while exports only increased by 10 percent. Import growth was mainly driven by oil imports, which accounted for 27.6 percent of the total import bill in 2011, jumping from US$ 2.7 billion (8.9 percent of GDP) in 2010, to US$ 4.1 billion (11.6 percent of GDP) in 2011. The growth in oil imports reflects a 33 percent increase in oil prices (from US$ 79.5/bbl to 106) during 2011, coupled with a 12 percent increase in volume (from 3.2 to 3.6 million metric tons), which was due to the need to expand thermal power, as hydropower operated below potential. With factor income and transfers roughly constant, the deterioration in the trade balance was also apparent in the current account balance.

The widening current account deficit also pulled the overall balance into negative territory. The current account deficit was mainly financed by short term flows, which were attracted by high interest rates. The interest rate differential between domestic rates and those in the international markets (LIBOR), after controlling for inflation, increased from 26 basis points in August 2011, to a peak of 700 basis points in October 2011, before falling to 473 basis points in March 2012. As a result, net inflows into the financial account increased by 68 percent in 2011 to US$ 4.2 billion (mainly short-term inflows). Net short-term flows increased by 45 percent from US$ 1.1 billion in 2010, to US$ 1.7 billion in 2011. Net Errors and Omissions increased by US$ 1.5 billion from US$ 0.85 billion in 2010, to US$ 2.4 billion in 2011, which also helped finance the current account deficit.

Short term inflows have increased the supply of foreign currency and stabilized the exchange rate. Significant increases in net short term foreign currency flows (mainly portfolio flows) increased the supply of dollars in the market, which stabilized the exchange rate – at least for the moment. By early 2012, the shilling had recovered the nominal losses experienced in 2011. During the first four months of 2012, the shilling appreciated against the US dollar (to 82.9 from 101.3), the UK pound (to 131.2 from 159.4) and the Euro (to 109.6 from 138.9). This represents a nominal appreciation of about 18 percent against these major currencies, since October 2011. Going forward, any reduction in interest rates should be gradual, so as to maintain macroeconomic stability, and not endanger external financial inflows, which are stabilizing the exchange rate.

A strong shilling and high domestic prices have resulted in a real exchange rate appreciation, negatively affecting exports. The recent appreciation of the shilling, coupled with high inflation, wiped off any competitive advantage Kenyan exporters might have gained through a weaker exchange rate in 2011. The trade weighted real exchange rate appreciated by 17.2 percent, between October and December 2011, and the trade weighted nominal exchange rate appreciated by 15.5 percent during the same period. The appreciation in the real effective exchange rate reflects the impact of high domestic prices, and reduction of earnings of Kenyan exporters.

3 KNBS numbers report a current account of Kshs 296 billion and Nominal GDP of Kshs 2.5 trillion.
Figure 1.11: FDI and short term inflows financed the current account deficit

Source: Central Bank of Kenya.

Figure 1.12: The Shilling has appreciated sharply


Notes: 1) NEER (nominal effective exchange rate) is the trade weighted exchange rate; 2) REER (real effective exchange rate) is the trade weighted exchange rate but also takes into account domestic and foreign price differentials.
2. Growth Prospects for 2012 and 2013

The World Bank projects an average GDP growth rate of 5.0 percent in the medium-term. Macro stability has been restored but remains fragile. The prevailing conditions through the first half of 2012, call for a cautious approach to monetary and fiscal policy management. It may be too early to relax monetary policy, but high interest rates will nevertheless slow down investment. The two most significant downside risks to the growth outlook are: (i) the rising oil prices; and, (ii) the crisis in the euro zone, which could push the current account deficit to over 15 percent of GDP. The war in Somalia, preparations for general elections, and the roll-out of devolved government, are likely to increase fiscal pressure which is likely to be managed through cuts in development spending.

2.1 Growth prospects

The World Bank maintains its growth forecast of 5.0 percent for 2012 and for 2013, a moderate rate that will be driven by consumption. Growth could reach 5.4 percent in a high growth scenario, but it could also dip further to 4.1 percent in the low case (see figure 2.1). The baseline growth scenario assumes a continuation of appropriate policy vigilance to sustain prevailing macroeconomic stability, which would see a gradual decline in interest rates and inflation while maintaining exchange rate stability. Kenya’s growth outlook trends with the average for Sub-Sahara Africa (5.5 percent in 2012, and 5.6 percent in 2013) but it is still below its fast growing neighbors, Tanzania (6.7), Uganda (6.2), and Rwanda (7.6).

The low growth scenario assumes the risks discussed in section 2.2 play out. A contagion of the Greek crisis to the rest of the PIGS (Portugal, Italy and Spain) would see a slowdown in the growth of Kenyan exports and tourism. The resurgence of exchange rate volatility and high inflation in the domestic market, combined with political uncertainly, would slow down consumption and investment. The high growth scenario assumes the rally of commodity prices will continue even as oil prices stabilize, see annex A2 for details. The baseline scenario is discussed in greater details in the following sections.

Aggregate demand growth was sluggish in the first half of 2012 but will recover during the second half of the year. During the first half of 2012, high inflation (and prices) and high lending rates, constrained investment and consumption; in the first six months of 2012, the CBR has been maintained at 18 percent, sustaining the pressure on interest rates. Ongoing fiscal consolidation will also see a slowdown in public investment growth. In the second half of 2012, inflation and interest rate pressure will ease, and food prices will decline after the harvest season. As the momentum of the political campaign builds, high liquidity in the economy will boost consumption. Lending to the private sector is expected to pick up, as banks try to grow their lending portfolio. The syndicate loan by the government will reduce the government borrowing from the domestic market, crowding out lending to private sector, and help build the CBK foreign exchange reserves.

Figure 2.1: Growth will be moderate at 5.0 percent in 2012 and 5.0 percent in 2013

Demand for Kenya’s exports will remain flat in high income countries but rapid growth within the EAC countries will provide an expanding market for goods and services. Globally, growth will remain subdued at 2.5 percent in 2012, increasing modestly to 3.0 percent in 2013. With the deepening euro zone crisis, growth in high income economies is expected to be only 1.5 percent and 2.0 percent - in 2012 and 2013 respectively. Growth in developing countries will remain robust, exceeding 5.5 percent in the medium-term. Sub Saharan Africa will be among the fastest growing regions in the world. This will impact favorably on Kenya, providing increased export opportunities.

In the real sector, agricultural output is expected to be in line with forecasts. The rains arrived later than expected in the first part of 2012, but the current forecast points to a normal growing season. Frost experienced in the early part of the year impacted tea production, which will likely be 20 to 30 percent lower than in 2011. Industry may record a mixed performance; construction remains robust, as the growth in lending to the sector suggests. Growth in services will hold, particularly wholesale and retail trade as consumption picks up. However, tourism and travel outcomes will depend on the government’s ability to maintain internal security, in the face of terrorist threats, and concerns of instability in the run-up to the elections. Growth in tourist arrivals from Europe will be moderate, as a result of conflict in the region.

Pressure on the external trade and current account balances could continue in 2012. Oil prices have started rising again in 2012, as a result of uncertainties in the Middle East (especially Iran and Syria). The World Bank forecasts an average oil price of US$115 per barrel in 2012, but overall prices are likely to remain volatile. Further, trade balance pressure will emanate from imports of heavy equipment for ongoing geothermal projects.

Moderate export growth is expected in 2012. The cost of power is expected to decline as the heavy rains received in 2012 will boost hydropower generation, thereby improving the competitiveness of Kenya’s industrial sector. However, slow economic growth in some of Kenya’s main trading partners will weaken demand in key markets, and the current account deficit is expected to widen, as a result. Figure 2.2 simulates the impact of higher oil prices on the

---

**Table 2.1: Fiscal consolidation as a result of shocks in 2011 (percent of GDP)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</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>5.1</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>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fiscal Framework (endFY) percent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue</td>
</tr>
<tr>
<td>Total expenditure</td>
</tr>
<tr>
<td>Grants</td>
</tr>
<tr>
<td>Budget Deficit (incl. grants)</td>
</tr>
<tr>
<td>Total debt</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>External Account Vol growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports, GNFS</td>
</tr>
<tr>
<td>Imports, GNFS</td>
</tr>
</tbody>
</table>

current account, and the balance of payments based on the following two scenarios (in both of which the overall balance of payments would be in deficit, and put pressure on the exchange rate):

Figure 2.2: The current account deficit could reach 15 percent of GDP if the oil price stays above US$100

![Current Account and BOP Simulation at different Oil Prices Chart]


- In a scenario where the price of oil remains at US$ 120 throughout 2012, the oil import bill will increase by US$ 1.3 billion in 2012, and the current account balance will worsen by US$ 2.0 billion (1.7 percent of GDP), increasing the overall current account deficit to 14.9 percent of GDP, and;
- In a more extreme scenario, an average price of US$ 130 per barrel in 2012, would see the current account deficit deteriorate further, to 16.8 percent of GDP.

2.2 Risks to the outlook

Our key assumption is that Kenya’s economy is stabilizing but remains vulnerable to shocks, and will grow at 5 percent in 2012 and 2013. It is presumed that there will be a continuation of appropriate policy vigilance to sustain prevailing macroeconomic stability, which would see a gradual decline in interest rates and inflation, while maintaining exchange rate stability. However, there are significant downside risks to this growth projection, with any of these developments, having significant adverse effects on Kenya’s economy. The immediate risks are:

1. A sharp reduction in interest rates when inflation declines, could reverse short term foreign currency inflows, and trigger another cycle of exchange rate volatility.
2. The worsening of the crisis in the euro zone, will negatively impact Kenya’s balance of payments position through three main channels: a reduction in demand of Kenya’s exports and tourist arrivals from Europe; a reduction in portfolio inflows from the region; and, a reduction in migrant remittances.
3. Tensions in the wider Middle East region could lead to a potential surge in oil prices. Already, in March 2012 oil prices reached US$ 120 per barrel, and these could increase further, if conflict actually materializes, worsening Kenya’s current account deficit.
4. Government’s possible pursuit of a tight fiscal policy, could choke off public investment, through huge cut backs in development spending, dampening growth prospects.
5. Fiscal expansion to accommodate demands for higher expenditures by newly created departments (most notably expansion in personnel spending resulting from devolution), higher wages for teachers and other professional, as well as elections related expenses, could jeopardize macroeconomic stability.
6. Political risk associated with the forthcoming general elections, and ICC trials of major political figures, might discourage both public and private investment and growth prospects.

The risk remains that the exchange rate will continue to be volatile if current account pressure is not reduced. Kenya’s weak external position makes it vulnerable to further macroeconomic instability in 2012. The high oil prices, weak external environment in Europe (one of Kenya’s main export destinations and tourist sources), may trigger intense pressure on the currency. Any sharp reduction of interest rates in 2012 by the monetary authorities; when inflationary pressure subsides, could trigger another cycle of exchange rate volatility.
Skilled policy balancing will be required to maintain stability. Our simulations show that inflation has declined, and a gap is emerging between the simulated (notional) CBR, and the actual CBR (see figure 2.3). However, a premature reduction in interest rates, could reverse the gains in demand management, which could take time to contain as happened in 2011. For instance our analysis shows that monetary policy actions take up to 11 months to have an impact in the market, and that the impact can last up to two years.4

Figure 2.3: Inflation has declined but any reduction in interest rates should be gradual

Tight monetary policy has slowed down growth of narrow money, but foreign currency inflows are driving growth of broad money. The market response to the high interest rate policy has seen a degree of currency substitution, from local to foreign currency deposits, which is keeping liquidity high. The inflows of foreign currency deposits kept the growth of broad money high, even as the CBK strained to contain the growth of the money supply through high interest rates (see figure 2.4). In 2011, broad money (M3 = foreign currency deposits + narrow money) increased by 18.6 percent, and narrow money (currency in circulation and quasi money or M2) recorded a growth of 16.4 percent. The growth of narrow money (M2) slowed down to 13.9 in 2011, compared to 20.8 in 2010, while the average growth for foreign currency deposits accelerated to 5.1 percent in 2011, compared to 2.4 percent in 2010. The slowdown in the growth of narrow money explains why commercial banks have been complaining of “lack of liquidity in the market.” However, measuring liquidity through broad money (M3) would signal the need for further tightening, while M2 signals the “true” liquidity position in the market. Further tightening can lead to a vicious cycle of high interest rates, growth in foreign currency deposits, growth in broad money, and contraction in narrow money; which would tax economic activity. This scenario explains the under subscriptions in the Treasury bill market in the first six months of the 2011/12 fiscal year, and higher and volatile interbank rates in the money market.

Figure 2.4: Slow growth of “narrow” money, rises in “broad” money

4 IMF “Kenya: 2011 Article IV Consultation”.
3. Rebalancing the economy

The rising current account deficit can be interpreted to mean that Kenya is living beyond its means. For Kenya to achieve and sustain a high growth rates it needs to rebalance the economy by increasing savings for investment—and also increasing exports. As Kenya seeks to diversify exports products and markets, regional integration would help to reduce the trade deficit as well as its domestic food prices.

3.1 From Short term stabilization to sustained growth

The slowdown in GDP growth in 2011 was as a result of Kenya’s underlying macroeconomic imbalances. Aggregate domestic absorption slowed down as inflation constrained private consumption, interest rates constrained investment, and fiscal consolidation curtailed growth in public spending. In Kenya, private consumption accounts for over 70 percent of GDP and a combination of high domestic prices, a weak shilling and high interest rates, constrained private consumption in 2011. Investment slowed down as government cut back on development spending (see fiscal section), and growth in credit to the private sector contracted during the second half of 2011, in response to higher interest rates. The deficit in the external account widened, acting as a further drag on growth (for more details refer to section on external account).

Kenya’s high current account deficit problem in 2011 was driven by high private consumption, and huge imports of machinery for public infrastructural projects. As noted above, the current account deficit is a reflection of the savings investment gap, which in part is driven by the fiscal deficit to finance infrastructural projects worsened the current account in 2011. Low savings indicate that consumption expenditure is high, relative to investment in the Kenyan economy, where development assistance (grants) is minimal. High interest rates would attract foreign savings to finance the current account.

Kenya needs to undertake structural reforms to establish the foundation for long term growth. The decline of Kenya’s external balance (high and widening current account deficit and real appreciation of the shilling), has been accompanied by growing tensions from internal imbalances, which have created the 2011 economic instability (high Inflation, low savings, and high unemployment). This calls for structural reforms to shift incentives away from heavy investments in non-tradable goods (i.e. building and construction, and real estate) towards the production of goods and services for export markets.

The recent oil discovery in Turkana, if commercially viable, will improve Kenya’s trade balance. But for oil to catalyze development, Kenya will have to avoid the special macroeconomic and governance challenges associated with natural resources. Kenya can use the lead time to production, to lay the right foundations for a successful oil economy. This should include a strong focus on diversifying the economy, to make other export sectors more competitive. Countries as
diverse as Botswana, Chile, and Norway have shown that natural resources can be a blessing, but this requires hard work and sound institutions - see Box 1.2 for a discussion of the challenges.

3.2 Leveraging the EAC Customs Union

All the key indicators of Kenya’s external competitiveness have followed a worrying trend. As emphasized in previous publications, Kenya remains vulnerable to external shocks, and this has become more pronounced, as the frequency of global shocks increases. For instance, Kenya’s merchandise exports can only pay for just over one third of her imports, having declined from 65 percent of imports in 2003, to about 38 percent in 2011. The widening current account deficit is worrying, and could reach 15 percent in 2012, in light of the recent oil price surge (see figure 3.1). Kenya’s grain deficit has also widened, as agricultural productivity declines, and the population increases.

Box 3.1: Making Oil work for Kenya: Oil Management Challenges

Avoiding “Dutch disease”: The oil sector has limited linkages with other sectors of the economy. A big resource boom will increase the demand for labor, drive up wages and thereby prices for non export sectors such as services and real estate. This leads to a real appreciation and thus hurts the export sector and import-competing sector. In the extreme it could lead to a deindustrialization of the country – the so called “Dutch disease”. The Arab uprising has demonstrated the dangers of jobless growth.

Strong policy and legal framework to embed transparency in oil revenue management: A strong legal framework will be required to ensure there is an open and transparent system for the management and use of oil revenues. Kenya can leverage good practice to start on sound footing:

• Kenya can learn from Ghana’s Petroleum Revenue Management Act, which is hailed as a world class piece of legislation, providing for the collection, allocation and management of upstream petroleum revenue, and defining a strong and transparent mechanism for monitoring oil receipts and for spending those revenues.

• Kenya can participate in the Extractive Industries Transparency Initiative (EITI). The EITI emphasizes that governments should provide up to date and credible information to citizens on revenues collected, oil reserves, production and prices and fiscal regimes for private investors. The reports are then audited and made publicly available on a regular basis. For instance, in Nigeria the EITI audited accounts for 1999 – 2004 revealed huge discrepancies, with the government found to be owed US$5 billion, the largest part of which was owed by the state-owned oil company.

Smoothing oil revenues over both the short- and long-term: In the short-term, the sheer volatility of international oil prices makes planning and budgeting for oil revenues a huge challenge. Having an oil revenue stabilization account can help to provide a buffer against short-term price fluctuations. In the long-term, Kenya can maximize the economic returns from oil by investing oil revenues in education, health and infrastructure and by saving for the future instead of spending it all at once.

Sharing the benefits with communities and counties: Several elements are important in the design of sharing systems. It is important not to undermine the efficiency and transparency of revenue reporting: this should continue to be a national responsibility. It is important to maintain simplicity and transparency in revenue sharing: if rules are clear, well-designed, and seen as acceptable by key stakeholders there will be fewer grounds for mistrust between national and sub-national actors. The draft Mining and Minerals Bill proposes 5 percent of royalties go to local communities and 15 percent to counties: the windfall of significant additional revenues for counties benefiting from a share of royalties should be factored into to calculation of the county’s other fiscal transfers to avoid undermining the inter-governmental revenue sharing arrangements. Also, the policy framework should ensure that short-term volatility of oil revenues is not passed down to counties that receive a share, as they will find it far harder to manage. Building systems for improved absorptive capacity in beneficiary counties is also key.

Avoid populist policies such as fuel subsidies: No matter how high oil prices will go and no matter how tempting it would be for the government to establish price ceilings or to introduce energy subsidies, the negative impacts would be dramatic. Research has shown that oil subsidies benefit the rich disproportionately because they own cars, often big ones. Nigeria is currently struggling to cut back its inequitable fuel subsidies. Kenya should avoid this.

Source: World Bank staff.