Kenya

Kenya at a glance: 2006-07

OVERVIEW
The president, Mwai Kibaki, will struggle to see out the remainder of his term because of the damage to his authority and credibility caused by the “no” vote in the constitutional referendum and corruption scandals that have led to the resignation of three senior ministers. The president's Government of National Unity has a fragile majority, and will continue to resist calls for early elections. Economic policy will be guided by the country's poverty reduction and growth facility (PRGF) with the IMF, although the Fund has delayed a decision to approve further loans, while other donor funding continues to be threatened by the government’s failure to take decisive action against corruption. The normal onset of the long-rains in April has ended a severe drought and minimised the potential negative impact on economic growth. The Economist Intelligence Unit continues to forecast real GDP growth of 5% in 2006 and 5.5% in 2007, based on an above-average harvest in 2006 and solid tourism growth.

Key changes from last month

Political outlook
• The Government of National Unity continues to confront serious divisions, especially between supporters of the new National Rainbow Coalition (NARC)-Kenya party, designed to provide Mr Kibaki with a new presidential vehicle in 2007, and the still loyal elements of the ruling NARC coalition (Ford-Kenya and the National Party of Kenya). The impending by-election in five constituencies (following the death of MPs in a plane crash) will provide a stern test for government’s unity and determine whether its disparate factions can still co-operate.

Economic policy outlook
• The new finance minister, Amos Kimunya, won passage through parliament in April of a supplementary budget, designed to meet recurrent spending on wages and emergency drought outlays during the rest of 2005/06. The supplementary budget seeks little in the way of new money, however, and instead proposes a significant transfer of unspent capital funds to the recurrent account, to the detriment of investment.

Economic forecast
• Our economic forecast remains unchanged from the previous month.

May 2006

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The Economist Intelligence Unit

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Kenya

May 2006

Summary

Outlook for 2006-07

The president, Mwai Kibaki, will struggle to see out the remainder of his term, given the damage to his authority and credibility caused by defeat in last year's constitutional referendum and the corruption furore that led to the resignation of three senior ministers in early 2006. The president's government of national unity appears to have a sufficient majority in parliament to thwart any opposition motions of no-confidence, or calls for an early election but his position is fragile and vulnerable to defections. Real GDP growth will be held back by drought, but it is still expected to hit 5% in 2006, rising to 5.5% in 2007.

The political scene

Three senior ministers resigned in February 2006 over corruption allegations against them, including close Kibaki allies, David Mwiraria and Kiraitu Murungi, who are implicated in dubious state contracts. Despite his woes, the president still commands a small but fragile majority in parliament. Presidential loyalists have formed a new party, the National Rainbow Coalition (NARC)-Kenya, providing a potential vehicle for President Kibaki in 2007. Both the government and opposition have continued to face deep divisions.

Economic policy

The issue of corruption continued to complicate relations with donors, despite the resignation of three senior ministers and the governor of the Central Bank of Kenya over graft allegations. The IMF has postponed a decision on the release of planned funding until May, pending the outcome of a new review mission. The government passed a supplementary budget in April 2006, switching funds from capital to recurrent spending to meet wages and drought-related outlays until the new budget on 1st July 2006.

The domestic economy

Economic growth is likely to slow in 2006 because of severe drought in the first quarter, which damaged the vital tea sector, but the normal onset of the long rains in April will minimize the damage and facilitate recovery. Better rainfall in April has helped to drive inflation down from high levels. An Indian firm, Plethico, has announced that it is set to invest US$20m in a new pharmaceutical factory near the capital, Nairobi, geared to meet rising local, regional and overseas demand. The flotation of Kenya's electricity generator has fuelled strong interest. Privatisation of Telkom Kenya has made some progress.

Foreign trade and payments

According to official estimates, Kenya's current-account deficit surged to 8% of GDP in 2005 despite healthy growth in exports and tourism, because of a steep rise in imports, although capital inflows helped to keep the overall balance of payments in surplus. The East African Community has announced its plans to push ahead more quickly to establish a common market.

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Pratibha Thaker (editor); David Cowan (consulting editor)

Editorial closing date: May 8th 2006

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Next report: Full schedule on www.eiu.com/schedule
### Political structure

<table>
<thead>
<tr>
<th><strong>Official name</strong></th>
<th>Republic of Kenya</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Form of state</strong></td>
<td>Unitary republic</td>
</tr>
<tr>
<td><strong>Legal system</strong></td>
<td>Based on English common law and the 1963 constitution; the draft of a new constitution was published in September 2002</td>
</tr>
<tr>
<td><strong>National legislature</strong></td>
<td>Unicameral National Assembly of 210 elected members plus 12 nominated members, the attorney-general and the speaker; a multiparty system was introduced in December 1991</td>
</tr>
<tr>
<td><strong>National elections</strong></td>
<td>Next presidential and legislative elections are to be held in December 2007</td>
</tr>
<tr>
<td><strong>Head of state</strong></td>
<td>President, directly elected by simple majority and at least 25% of the vote in five of Kenya's eight provinces</td>
</tr>
<tr>
<td><strong>National government</strong></td>
<td>The president and his cabinet, composed entirely of members of the National Rainbow Coalition (NARC)</td>
</tr>
<tr>
<td><strong>Political parties in parliament</strong></td>
<td>National Rainbow Coalition (NARC, 132 seats); Kenya African National Union (KANU, 68 seats); Forum for the Restoration of Democracy-People (Ford-People, 15 seats); Safina (2 seats); Ford-Asili (2 seats); Sisi Kwa Sisi (2 seats); Shirikisho (1 seat)</td>
</tr>
<tr>
<td><strong>President &amp; commander-in-chief</strong></td>
<td>Emilio Mwai Kibaki</td>
</tr>
<tr>
<td><strong>Vice-president</strong></td>
<td>Moody Awori</td>
</tr>
<tr>
<td><strong>Key ministers</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Agriculture</strong></td>
<td>Kipruto Arap Kirwa</td>
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<tr>
<td><strong>East African &amp; regional co-operation</strong></td>
<td>John Koech</td>
</tr>
<tr>
<td><strong>Education</strong></td>
<td>Noah Wekesa (Acting)</td>
</tr>
<tr>
<td><strong>Energy</strong></td>
<td>Henry Obowcha (Acting)</td>
</tr>
<tr>
<td><strong>Environment &amp; natural resources</strong></td>
<td>Kivutha Kibwana</td>
</tr>
<tr>
<td><strong>Finance</strong></td>
<td>Amos Kimunya</td>
</tr>
<tr>
<td><strong>Foreign affairs</strong></td>
<td>Raphael Tuju</td>
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<tr>
<td><strong>Gender, sport &amp; culture</strong></td>
<td>Maina Kamanda</td>
</tr>
<tr>
<td><strong>Health</strong></td>
<td>Charity Ngilu</td>
</tr>
<tr>
<td><strong>Information &amp; communication</strong></td>
<td>Mutahi Kagwe</td>
</tr>
<tr>
<td><strong>Justice &amp; constitutional affairs</strong></td>
<td>Martha Karua</td>
</tr>
<tr>
<td><strong>Labour &amp; manpower development</strong></td>
<td>Dr Newton Kulundu</td>
</tr>
<tr>
<td><strong>Lands &amp; housing</strong></td>
<td>Kivutha Kibwana (Acting)</td>
</tr>
<tr>
<td><strong>Local government</strong></td>
<td>Musikari Kombo</td>
</tr>
<tr>
<td><strong>National security</strong></td>
<td>John Njoroge Michuki</td>
</tr>
<tr>
<td><strong>Planning &amp; national development</strong></td>
<td>Henry Obowcha</td>
</tr>
<tr>
<td><strong>Regional development</strong></td>
<td>Abdi Mohamud</td>
</tr>
<tr>
<td><strong>Roads &amp; public works</strong></td>
<td>Simeon Nyachae</td>
</tr>
<tr>
<td><strong>Tourism &amp; wildlife</strong></td>
<td>Morris Dzoro</td>
</tr>
<tr>
<td><strong>Trade &amp; industry</strong></td>
<td>Mukhisa Kituyi</td>
</tr>
<tr>
<td><strong>Transport</strong></td>
<td>Chirau Ali Mwakwere</td>
</tr>
<tr>
<td><strong>Water</strong></td>
<td>Mutua Katuku</td>
</tr>
</tbody>
</table>

| **Head of the civil service** | Francis Muthaura |
| **Central Bank governor**    | Jactina Mwatela (Acting) |
Economic structure

**Annual indicators**

<table>
<thead>
<tr>
<th></th>
<th>2001 (^a)</th>
<th>2002 (^a)</th>
<th>2003 (^a)</th>
<th>2004 (^a)</th>
<th>2005 (^b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP at market prices (KSh bn)</td>
<td>1,025.9</td>
<td>1,038.8</td>
<td>1,141.8</td>
<td>1,277.1</td>
<td>1,462.0</td>
</tr>
<tr>
<td>GDP (US$ bn)</td>
<td>13.1</td>
<td>13.2</td>
<td>15.0</td>
<td>16.1</td>
<td>19.4</td>
</tr>
<tr>
<td>Real GDP growth (%)</td>
<td>4.4</td>
<td>0.4</td>
<td>2.8</td>
<td>4.3</td>
<td>5.2 (^c)</td>
</tr>
<tr>
<td>Consumer price inflation (av; %)</td>
<td>5.7</td>
<td>2.0</td>
<td>9.8</td>
<td>11.7</td>
<td>10.3 (^a)</td>
</tr>
<tr>
<td>Population (m)</td>
<td>31.4</td>
<td>32.0</td>
<td>32.7</td>
<td>33.5</td>
<td>34.3</td>
</tr>
<tr>
<td>Exports of goods fob (US$ m)</td>
<td>1,891.4</td>
<td>2,162.5</td>
<td>2,412.2</td>
<td>2,722.7</td>
<td>3,294.7</td>
</tr>
<tr>
<td>Imports of goods fob (US$ m)</td>
<td>3,238.2</td>
<td>3,159.0</td>
<td>3,554.8</td>
<td>4,320.2</td>
<td>6,141.7</td>
</tr>
<tr>
<td>Current-account balance (US$ m)</td>
<td>-341.2</td>
<td>-136.9</td>
<td>67.8</td>
<td>-378.4</td>
<td>-1,543.0</td>
</tr>
<tr>
<td>Foreign-exchange reserves excl gold (US$ m)</td>
<td>1,064.9</td>
<td>1,068.0</td>
<td>1,481.9</td>
<td>1,519.3</td>
<td>1,798.8 (^a)</td>
</tr>
<tr>
<td>Total external debt (US$ bn)</td>
<td>5.6</td>
<td>6.1</td>
<td>6.8</td>
<td>7.0 (^b)</td>
<td>7.4</td>
</tr>
<tr>
<td>Debt-service ratio, paid (%)</td>
<td>16.0</td>
<td>16.6</td>
<td>15.8</td>
<td>12.8 (^b)</td>
<td>9.4</td>
</tr>
<tr>
<td>Exchange rate (av) KSh:US$</td>
<td>78.56</td>
<td>78.75</td>
<td>75.94</td>
<td>79.17</td>
<td>75.55 (^a)</td>
</tr>
</tbody>
</table>

\(^a\) Actual. \(^b\) Economist Intelligence Unit estimates. \(^c\) Official estimates.

**Origins of gross domestic product 2004 \(^a\)**

<table>
<thead>
<tr>
<th>Components of gross domestic product 2004 (^a)</th>
<th>% of total</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, forestry &amp; fishing</td>
<td>27.5</td>
<td>74.7</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>13.3</td>
<td>17.0</td>
</tr>
<tr>
<td>Trade, restaurants &amp; hotels</td>
<td>11.2</td>
<td>16.3</td>
</tr>
<tr>
<td>Transport, storage &amp; communications</td>
<td>10.5</td>
<td>1.1</td>
</tr>
<tr>
<td>Government services</td>
<td>14.8</td>
<td>28.0</td>
</tr>
<tr>
<td>Others (net)</td>
<td>22.7</td>
<td>37.1</td>
</tr>
</tbody>
</table>

**Principal exports 2004 \(^a\)**

<table>
<thead>
<tr>
<th>Principal imports cif 2004 (^a)</th>
<th>US$ m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Horticultural products</td>
<td>499.4</td>
</tr>
<tr>
<td>Tea</td>
<td>455.6</td>
</tr>
<tr>
<td>Coffee</td>
<td>87.7</td>
</tr>
<tr>
<td>Fish products</td>
<td>52.8</td>
</tr>
</tbody>
</table>

**Main destinations of exports 2004 \(^a\)**

<table>
<thead>
<tr>
<th>Main origins of imports 2004 (^a)</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Arab Emirates</td>
<td>12.7</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>9.2</td>
</tr>
<tr>
<td>South Africa</td>
<td>8.8</td>
</tr>
<tr>
<td>US</td>
<td>7.8</td>
</tr>
</tbody>
</table>
### Quarterly indicators

#### Central government finance (KSh m)

<table>
<thead>
<tr>
<th>2004</th>
<th>2 Qtr</th>
<th>3 Qtr</th>
<th>4 Qtr</th>
<th>2005</th>
<th>1 Qtr</th>
<th>2 Qtr</th>
<th>3 Qtr</th>
<th>4 Qtr</th>
<th>2006</th>
<th>1 Qtr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue &amp; grants</td>
<td>88,653</td>
<td>64,031</td>
<td>80,524</td>
<td>74,581</td>
<td>85,571</td>
<td>67,416</td>
<td>79,652</td>
<td>n/a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditure &amp; net lending</td>
<td>86,459</td>
<td>69,823</td>
<td>72,850</td>
<td>72,895</td>
<td>87,752</td>
<td>89,207</td>
<td>76,442</td>
<td>n/a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance</td>
<td>2,194</td>
<td>-5,792</td>
<td>7,674</td>
<td>1,686</td>
<td>-2,181</td>
<td>-21,791</td>
<td>3,210</td>
<td>n/a</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Prices

- **Consumer prices, Nairobi (2000=100)**
  - 2004: 129.7
  - 2005: 135.3
  - 2006: 139.1

- **Consumer prices, Nairobi (% change, year on year)**
  - 2004: 6.1
  - 2005: 14.4
  - 2006: 17.0

#### Financial indicators

- **Exchange rate KSh:US$ (av)**
  - 2004: 78.81
  - 2005: 80.51
  - 2006: 80.73

- **Deposit rate (av; %)**
  - 2004: 2.13
  - 2005: 2.19
  - 2006: 2.84

- **Lending rate (av; %)**
  - 2004: 12.46
  - 2005: 12.26
  - 2006: 12.20

- **M1 (end-period; KSh bn)**
  - 2004: 193.68
  - 2005: 200.49
  - 2006: 209.37

- **M1 (% change, year on year)**
  - 2004: 27.0
  - 2005: 11.7
  - 2006: 8.4

- **M2 (end-period; KSh bn)**
  - 2004: 455.67
  - 2005: 475.58
  - 2006: 497.38

- **M2 (% change, year on year)**
  - 2004: 14.3
  - 2005: 15.8
  - 2006: 13.7

- **Stockmarket NSE 20 (1996=100)**
  - 2004: 2,640
  - 2005: 2,671
  - 2006: 2,946

- **Stockmarket NSE 20 (% change, year on year)**
  - 2004: 36.4
  - 2005: 12.2
  - 2006: 7.6

#### Sectoral trends (annual totals; '000 tonnes)a

- **Tea production**
  - 2004: 295
  - 2005: 295
  - 2006: n/a

- **Coffee production: unroasted**
  - 2004: 50.8
  - 2005: 50.8
  - 2006: n/a

#### Foreign trade (KSh m)

- **Exports fob**
  - 2004: 53,816
  - 2005: 53,176
  - 2006: 57,025

- **Imports cif**
  - 2004: -86,397
  - 2005: -93,616
  - 2006: -99,918

- **Trade balance**
  - 2004: -32,581
  - 2005: -40,440
  - 2006: -42,893

#### Foreign reserves (US$ m)

- **Reserves excl gold (end-period)**
  - 2004: 1,399.5
  - 2005: 1,309.6

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*a Estimates.*
Outlook for 2006-07

Political outlook

Domestic politics

The regime of the president, Mwai Kibaki, has suffered two major blows in recent months, with defeat in the constitutional referendum in November 2005 followed by the resignation of three senior ministers in February 2006 over corruption allegations. The governor of the Central Bank of Kenya, Andrew Mullei, was suspended a month later. These events have damaged the president's authority and credibility, making it less likely that he will be able to resist calls for new elections and see out the remainder of his term, which is due to end in December 2007. However, the president's patched-together government of national unity appears to have sufficient numbers in parliament to see off the Orange Democratic Movement (ODM), formed last year by the opposition Kenya African National Union (KANU) party and the rebellious Liberal Democratic Party (LDP). The ODM waged a successful campaign against the proposed new constitution, which would have cemented presidential powers, but the momentum generated by their victory is dissipating. The government of national unity has the numbers to see-off any opposition motion of no-confidence, at least for now, but its majority is fragile, and vulnerable to defections.

Apart from dealing with the opposition challenge, the government will continue to confront serious divisions within its already weakened ranks. The president seeks a new base from which to launch another presidential challenge in 2007, and is expected to take charge of the newly formed National Rainbow Coalition (NARC)-Kenya party after it is officially launched in June, with the backing of several senior ministers. However, this development is angering the remaining partners in the original NARC coalition (Ford-Kenya and the National Party of Kenya) and there is a danger of them leaving the government. The dispute is likely to come to a head with the next three months because of unexpected by-elections in five constituencies following the death of five MPs in a plane crash in the north-east of the country on their way to peace talks to end inter-tribal feuding. Four of the seats were won by KANU in 2002 but most were close contests. Some officials say that NARC-Kenya will contest the seats, but Ford-Kenya and the National Party of Kenya (NPK) insist on putting forward candidates representing the original NARC coalition. The Kibaki camp may be forced to back down on this occasion, in order to preserve its majority, but NARC-Kenya and Ford-Kenya are likely to be antagonists, not partners, in 2007. All sides, including the opposition, continue to woo Charity Ngilu's, National Party of Kenya (NPK). The coming mini-election will also pose a similar challenge to opposition unity, and will provide another test of President Kibaki's popularity after last year's referendum defeat.

The Kenyan parliament reconvened in March 2006 after a long, five-month recess, but hopes that legislators would focus on the raft of pending legislation were soon dashed, and partisan squabbles will continue to dominate business. The opposition have refused to take their places in the House Business Committee (which determines parliament's agenda), as they were allocated
fewer seats than before. As a result, the opposition are likely to challenge the government on the floor of the house at every opportunity, meaning that legislation will continue to be held up. A new three-week recess, until the end of May, will not help.

As a result of the “no” vote, Kenya retains its old constitution, adopted at independence. To the extent that this grants considerable presidential powers, it offers solace to Mr Kibaki, but it also means that a key manifesto pledge from 2002 remains unfulfilled. The government aims to restart the constitutional review process in 2006, but rapid progress is unlikely because of the persistence of deep divisions over many of its provisions, as well as the partisan political climate. The government also says that it wants to start from scratch, despite calls by civil society and the ODM to build on previous efforts, which will add to the delays. It is unlikely that a new constitution will be in place before the next election, scheduled for 2007, especially as another referendum will be required before anything can be adopted.

Election watch

A key factor that will determine the outcome of the next election is whether or not the ODM presents a united front and agrees on a single candidate. If the ODM fights as a single entity it should have a very good chance of unseating Mr Kibaki, but if the LDP and KANU wage separate campaigns the Kibaki camp could win on a split vote. It seems unlikely that the ODM will present a united front at the poll, not least because of the number of ambitious politicians on both sides who do not wish to sacrifice their chances of gaining power, and because KANU appears to be determined to go it alone. However, LDP leaders remain optimistic that a unity candidate can be agreed, and the situation is likely to remain fluid as factions and personalities jostle for advantage.

The referendum defeat, coupled with corruption allegations, has damaged Mr Kibaki’s popularity. An opinion poll in April placed Mr Kibaki in second place with 22.6% of the vote, behind Kalonzo Musyoka with 23.4%. Raila Odinga was third with 116.2% and Uhuru Kenyatta fourth with 16.3%. Notably, none has a commanding lead. However, the figures are only a rough guide and are likely to change significantly before the ballot. What is clear is that Mr Kibaki will struggle to win the backing of the electorate again, and that he will require some clear policy successes (such as clamping down on graft) to give himself a chance of victory. Even then, voters may wish to rid themselves of an entire generation of older politicians, many of whom seem unable to extricate themselves from the mire of corruption.

International relations

Kenya will continue to strive for better ties with its major bilateral and multilateral partners during the forecast period, but the outlook for relations with key donors has worsened following credible allegations of high-level corruption. The World Bank is withholding loans because of governance concerns, and the IMF has delayed a decision on the release of the next tranche of funding of the poverty reduction and growth facility (PRGF). The resignation of three senior ministers may help to convince donors that the Kibaki regime is truly serious about tackling graft, but unless prosecutions follow it is likely that the UK and the US will impose travel restrictions on implicated ministers, as happened with a former minister, Chris Murungaru, in 2005. Kenya will also
nurture regional relations within bodies such as the Common Market for Eastern and Southern Africa and the East African Community. The East African Customs Union came into force in January 2005, and full political federation between Kenya, Uganda and Tanzania is proposed by 2013. The ongoing threat of terrorist attacks by Islamists in the Horn of Africa will ensure that the country's close ties with the US remain high on the agenda. Kenya continues to play a key mediatory role in the conflicts in neighbouring Somalia and Sudan, the resolution of which would do much to enhance regional stability and prosperity.

**Economic policy outlook**

**Policy trends** Economic policy during 2006 will continue to be guided by the country's PRGF with the IMF. Kenya complied with most of the loan conditions in 2005, the second year of the PRGF, according to an IMF mission that visited the country last October. However, the IMF board did not sanction the release of the fourth and fifth funding tranches (worth US$73m), ostensibly because of paperwork delays linked to the formation of a new cabinet. However, the delay also reflects the IMF's long-standing concern about high-level corruption, which escalated in January 2006 following the emergence of new allegations linking senior ministers to corrupt state contracts. The IMF sent a new mission to Kenya in January 2006 to review progress, with a view to approving the loan in February, but the decision has once again been postponed, this time until May 2006. It is, therefore, likely that the term of the PRGF will be extended until mid-2007. Donors were encouraged by the resignation of the finance minister and two of his cabinet colleagues in February in response to corruption allegations, but this is unlikely to prove sufficient to bring the IMF back on board, and further action against graft will be required.

Allegations of high-level corruption are also straining relations with the World Bank and other donors. Although the Bank approved two new loans in January 2006, it is withholding disbursements worth US$265m because of Kenya's failure to pass an 'integrity' test. Moreover, the next meeting of the Consultative Group on Kenya (a group of 30 multilateral and bilateral donor countries led by the World Bank), originally planned for April 2006, has been postponed indefinitely. Donors are demanding clear proof that the government is serious about fighting graft, and if this is not forthcoming donor funding will be progressively withdrawn, to the detriment of the policy environment, economic performance and the war against poverty. Amos Kimunya, the new finance minister, has vowed to crack down on corruption, which is hardly surprising in the current climate, although wider economic policy under his tenure will be largely unchanged.

The privatisation bill adopted in 2005 provides the legal and institutional framework for the divestiture of state assets. However, it does not give a list of enterprises that will be sold or a precise timetable for doing so. Apart from presaging a speedier retreat by the state from the productive sectors of the economy, the bill's passage meets a key condition under the PRGF and will expedite donor funding for Kenya. Parliament's earlier opposition to
privatisation stems partly from a belief that foreigners will purchase "strategic" assets cheaply, and that this will be detrimental to Kenya. This view is probably mistaken, as privatisations involving foreign partnerships (such as the Kenya Airways link-up with the Dutch airline, KLM, in the 1990s) have often proved to be more successful than solely local efforts (because of better management and technology transfer, for example). However, to get the bill passed, the government stressed that, wherever possible, privatisation would be effected via flotation on the Nairobi stock exchange, which is dominated by domestic entities, and that specified fractions of divested companies could be reserved for Kenyans.

As a sign of its commitment to privatisation, the government plans to sell 60% of Telkom Kenya (TK) in early 2007, 34% on the bourse, and 26% to a strategic investor. TK will first be restructured, including a massive downsizing in the labour force, using funds from the proposed sale of a 9% stake in TK's mobile-phone subsidiary, Safaricom, to its partner, the UK's Vodafone (taking the latter's share to 49%), which is scheduled to take place in July 2006. It is hoped that privatisation and increased competition will lower telecom charges, which are comparatively high in Kenya. The government also sold 30% of parastatal power generator via an initial public offering on the bourse in April 2006, raising Ksh7.8bn, in a flotation that was more than three times oversubscribed. The NSE clearly has the potential to raise significant amounts of capital, although firms with weak management will also typically require a strategic investor. In another recent privatisation Kenya awarded a concession to a South African private firm to run its railways for the next 25 years.

**Fiscal policy**

Recent budget data for the first ten months of the fiscal year 2005/06 (July-June) indicate a mixed outturn: actual tax results have proved satisfactory, with inflows in the first ten months (July to April) 8% higher year on year, but 1.4% below budget targets. The failure to meet targets is mainly owing to the decline in import duties receipts, although the shortfall is easing, and the KRA expects to meet its full year target. Despite the government's good intentions, the latest public-expenditure review for 2005 identifies many weaknesses, which are evidenced by the large number of stalled projects and pending bills. The most politically challenging aspect of fiscal policy has been the need to reduce the government's wage bill while meeting demands for wage rises among key workers. Retrenchment is not an explicit donor condition, but the government has found it almost impossible to reduce the wage bill in the current fiscal year. The government will continue to move cautiously, fearing widespread strike action (particularly in the run-up to the 2007 election), and hopes instead that voluntary redundancy packages will be effective, although these may prove to be prohibitively expensive.

The Economist Intelligence Unit projects that the budget deficit in 2005/06 will be close to the government's forecast, at about 4.8% of GDP. Parliament passed a supplementary budget of KSh20.7bn in April 2006, although most of this is not new money, and instead involves a switch of unused capital funds towards the recurrent budget, to meet wage costs and emergency drought-related outlays until the next budget on July 1st 2006. Extra domestic borrowing of KSh5bn, a relatively small amount, should be comfortably met by financial markets. We
forecast that the budget deficit will remain at a similar, high level in 2006/07, especially given spending pressures in the run-up to the scheduled general election in late 2007. Budget shortfalls will be financed by committed donor funding for projects, bank restructurings, privatisation proceeds and domestic borrowing.

Monetary policy

Despite the recent departure of the governor of the Central Bank of Kenya (CBK), monetary policy over the forecast period will remain geared towards keeping underlying inflation (which excludes food and energy) below the official 5% target and maintaining exchange-rate stability. To help to achieve this, and to accommodate higher drought-related spending, the CBK has upsized its target for money supply (M3) growth in June 2006 by 2.2 percentage points, to 10%. The latest figures show that M3 grew by 12.5% in March 2006, slightly above target, although underlying inflation dipped below 5% in April 2006 for the first time in a year. To assist policy implementation, the CBK formed an advisory committee in 2005 and is working towards the introduction of a new benchmark interest rate—the Central Bank Rate. The switch would also de-link interest rates from the public-sector borrowing requirement and tie them to real macroeconomic variables. The new rate would be similar to the repurchase rate currently used in South Africa, and would be lower and less volatile than the 91-day Treasury-bill rate. The 91-day T-bill rate eased to 6.9% in April 2006 (reflecting high liquidity in the financial markets), but will rise again before stabilising in the 7-7.5% range for the next few months.

Economic forecast

International assumptions

<table>
<thead>
<tr>
<th>International assumptions summary</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
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Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

Growth in the global economy is forecast to decelerate over the outlook period, to 4.3% in 2006 and 4.1% in 2007, although this still compares favourably with rates achieved for much of the 1990s. Economic growth in the EU25, Kenya’s most important market, is expected to rebound slightly, from an estimated 1.7%
in 2005 (held back by weak domestic demand and high oil prices) to 2.2% in 2006 and 2.3% in 2007. The price outlook for Kenyan commodity exports has improved slightly: coffee prices will fall more slowly than expected in 2006 and 2007, while tea will pick up modestly, despite longer-term problems of oversupply in both sectors. Oil prices will continue to remain high over the forecast period, to Kenya's detriment as an importer.

**Economic growth**

Real GDP grew by an estimated 5.2% in 2005, the best performance for several years, driven by strong performance in trade, tourism, and transport and communications. However, the outlook for 2006 has deteriorated slightly, because of severe drought in the first quarter, which affected both food and cash crops, especially tea (one of the main exports). Lower farm production means lower disposable income and a reduced supply of raw materials for industry. The drought also threatened a shortage of hydroelectricity, although the government has avoided the prospect of damaging power cuts by commissioning emergency oil-fired generators, although this will add to already high electricity costs. The long-rains (March-June) have so far been above-average, however, bringing an end to the drought, and minimising the negative impact on GDP growth. Our forecast for real growth in 2006 is unchanged at 5% as the good rains are expected to produce an above-average grain crop in the second half of the year and will also benefit cash crops. Tourism also remains strong, with visitor numbers up by 17% year on year to nearly 170,000 in the first two months of 2006, representing a third consecutive year of rapid expansion. Telecommunications also remains buoyant because of the ongoing roll-out of mobile phones.

In 2007 we forecast real GDP growth of 5.5%, as ongoing investment in transport infrastructure, electricity and telecoms boosts all economic sectors by making it easier and cheaper to conduct business. The economy is also expected to benefit from further growth in tourism and from a slight easing of world oil prices. However, there are several downside risks to growth in 2007, including another drought, a deterioration of relations with donors because of the ongoing corruption allegations (leading to a possible suspension of project funding) and political instability in the run-up to the next general election.

**Inflation**

Inflation surged in the first quarter of 2006, because of the steep rise in food prices (which account for about 50% of the consumer price index) following drought, as well as higher energy and fuel prices. However, the normal onset of the long rains in April cut vegetable prices and is expected to produce an above-average grain harvest in the second half of the year. Average annual inflation dipped slightly to 11.3% in April, as food prices fell from March peaks, and is expected to ease further in coming months, especially after the main harvest gets under way in August. Meanwhile, average annual underlying inflation (excluding food and energy prices) dipped below the government's 5% target ceiling, for the first time in almost a year, to 4.9% in April 2006, and a further decline is expected. Nevertheless, the easing will be moderated by the persistence of high oil prices, and planned higher electricity prices. Our forecast for average inflation in 2006 as a whole is unchanged at 9% and we project that
Exchange rates

The Kenya shilling has continued to strengthen in 2006, and averaged KSh71.3:US$1 in April 2006, up by 6.4% year on year: the rise against the euro has been even more rapid, up by 12% in the 12 months to March. This reflects strong inflows from exports, tourism and remittances and short-term capital, in sufficient amounts to meet local demand for foreign exchange, and healthy reserve levels. The Kenya shilling has not been affected by political scandal or uncertain donor funding, and may rise higher still. Exporters are concerned, and are calling for a managed depreciation, but the authorities will continue to take the view that intervention in the market is warranted only if there is evidence of speculation, which does not seem to be the case at present. The strong Kenya shilling is also keeping down import costs at a time of high oil prices. We nevertheless expect the shilling to return to a path of gradual depreciation in the second half of the year (given strong, underlying import demand), although the weakening is likely to be slower than earlier anticipated. We currently forecast that the shilling will average KSh73.6:US$1 in 2006, before weakening to KSh78.8:US$1 in 2007 as the election approaches.

External sector

Kenya’s current-account deficit is estimated to have surged to 8% of GDP in 2005, as the growth rate of imports outpaced that of exports. Exports are expected to continue to rise at a robust pace, driven by manufactures, re-exports, raw materials, horticulture and tea—although exports of tea, the number-one earner, are likely to dip in 2006 because of last year’s drought. At the same time, import growth is expected to moderate slightly during the forecast period as delays in the disbursement of donor funds trim externally financed purchases, and because of the projected easing of oil prices in 2007. On balance, we project that the merchandise trade deficit will narrow in 2007. At the same time the invisible trade surplus is expected to widen, driven mainly by rising tourism receipts, which will benefit from stepped-up marketing campaigns, particularly in non-traditional markets such as China, Japan and India. The outlook for current transfers, both public and private, is more uncertain. The contribution of the diaspora, in the form of private transfers, remains important but it is nevertheless expected to continue to decline, particularly as political uncertainty rises in the run-up to the next election. Overall, the current account will remain in deficit, but we expect the gap to narrow to 7.6% of GDP in 2006 and 6.6% of GDP in 2007.
Forecast summary
(% unless otherwise indicated)

<table>
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<th>2004</th>
<th>2005</th>
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a Actual. b Economist Intelligence Unit estimates. c Economist Intelligence Unit forecasts. d Official estimates.

The political scene

Senior ministers resign because of alleged corruption

The government of President Mwai Kibaki has continued to be undermined by allegations of high-level corruption. Within two months of a new government being formed, in December 2005 (following defeat in the constitutional referendum), three senior ministers were forced to resign because of corruption allegations against them. The rout was sparked by a leaked report written by the former senior anti-graft official, John Githongo (who fled to the UK and resigned in February 2005), giving details surrounding the infamous Anglo-Leasing scandal, which erupted in 2004 (August 2004; Economic Policy). Mr Githongo’s evidence implicated four senior ministers—the finance minister David Mwiraria, the energy minister, Kiraitu Murungi (who was justice minister...
Mr Mwiraria resigned in early February (February 2006, The political scene) and was followed two weeks later by Mr Murungi. This represents a significant loss for the president, as both are long-term allies. They deny charges against them, however, going as far as accusing Mr Githongo of being an agent of foreign interests. The Anglo-Leasing deals were potentially worth KSh7bn (US$100m), but were scuppered when they came to light. The third resignation was that of the education minister, George Saitoti—a long-serving veteran from the former Kenya African National Union (KANU) regime—who went after the long-awaited release of the Goldenberg report into fraudulent trade deals in the 1990s: he was finance minister in the early years of the scandal. Despite the resignations of the senior ministers, the president did not sack Mr Awori. The three ministers may not be the last to fall.

The resignations of the ministers obliged President Kibaki to undertake another cabinet reshuffle. However, apart from shifting the lands minister, Amos Kimunya, to finance (he is one of the few remaining supporters to have detailed financial knowledge, being a qualified accountant), the president opted not to bring any more people into the cabinet and re-allocated the empty portfolios to existing ministers on an acting basis: land went to the environment minister, Kivutha Kibwana; education went to the science and technology minister, Noah Wekesa; and energy went to the planning minister, Henry Obowcha. This leaves the way open for the president to reinstate ministers who have resigned, if they are cleared, although more likely he will be obliged to name permanent replacements soon.

The loss of three senior ministers in a month (followed by the Central Bank governor, Andrew Mullei, in March) is unquestionably damaging to the president, although he can at least present it as a sign of fresh determination to tackle graft. The vice-president's escape, however, despite being implicated in Anglo-Leasing, does not help the president's credibility. The main problem is that Mr Awori is a vital component in the cabinet's regional and ethnic balance (as well as being an ‘elder’ statesman), and if he were to go, the spotlight would inevitably fall on the president himself, and more probing questions would be asked about the extent of his knowledge of the Anglo-Leasing contracts. Mr Githongo's evidence clearly suggests that the president was kept informed. Mr Kibaki hopes that the sacrifice of the three ministers, coupled with his renewed commitment to the fight against graft, will deflect attention from his own role in the affair, but he will struggle.

The pressure on Mr Awori mounted in mid-April when parliament adopted (with the reluctant support of the governing side) a report, produced by the Public Accounts Committee (PAC) and chaired by the opposition leader, Uhuru Kenyatta, into the Anglo-Leasing affair. The PAC report broadly endorsed Mr Githongo public assertions, weakening the vice-president's position, although it has no legal standing, and simply calls for further investigations. The PAC also called the attorney-general, Amos Wako, “negligent” and civil service head, Francis Muthaura, “incompetent”.

President Kibaki is forced into another cabinet reshuffle

The vice-president hangs on to his position
Meanwhile, the fate of the ministers who resigned, and the vice-president, mainly rests with the Kenya Anti-Corruption Commission (KACC), which has not yet completed its own investigations into Anglo-Leasing—and other scandals—and has rejected setting a firm deadline for doing so. It would then be up to the attorney-general to decide whether to prosecute or not. While the attorney-general decided to prosecute Mr Mullei, for abuse of office, he has not taken similar action against the agriculture minister, Kipruto Kirwa, despite the KACC recommending prosecution on both cases.

The split between the government and its former Liberal Democratic Party (LDP) over last year’s referendum, and the ministerial crisis over corruption, left the president feeling vulnerable to a vote of “no-confidence” in his government when parliament reconvened in March, after a five-month break. However, by co-opting so many ministers (and assistants) into his Government of National Unity, the president appears to have built a strong enough defence to overcome any possible challenges from the Orange Democratic Movement (ODM)—formed by KANU and the LDP to campaign against the proposed new constitution in last year’s referendum. The government won an important vote by 94 votes to 81, in March, and the opposition has refrained from bringing forward a “no-confidence” motion (at least to date), as it cannot be sure of victory. However, the Government of National Unity’s majority remains fragile and it is vulnerable to defections, which are commonplace in Kenyan politics, especially in the run-up to general elections.

Meanwhile, any hopes that legislators would focus on the large volume of pending legislation were soon dashed as the house descended into typically partisan squabbling. The opposition members refused to take their places on the House Business Committee (which determines parliament’s agenda), as they were allocated fewer seats than before. The government filled the committee with its own nominees, but this leaves the parliamentary agenda susceptible to frequent opposition challenges on the floor of the house. Prospects for the passage of vital legislation has, therefore, diminished and was further undermined by the calling of another three-week recess in early May. The budget for fiscal year 2006/07 (July-June) will become the main focus of debate when members of parliament (MPs) return.

President Kibaki’s loyalists registered a new party in February, known as NARC-Kenya, and although the president has not yet confirmed if he will become the party’s leader and contest the 2007 election under its banner, there is little doubt that NARC-Kenya was formed to provide a new vehicle for the president to do so. The original NARC party is now virtually defunct, following the sacking of the LDP from government after it sided with KANU to defeat the president’s proposed new constitution at the end of 2005. This leaves Ford-Kenya (led by local government minister, Musikari Kombo), the National Party of Kenya (NPK, led by the health minister, Charity Ngilu), and President Kibaki’s old Democratic Party (DP) as NARC’s chief entities, but they cannot agree on the way forward. Ford Kenya and the NPK have never supported the idea of merging into a single party and are opposed to the formation of NARC-Kenya. At present, Ford Kenya intends to put forward its own presidential candidate in
2007 (although it is also facing internal divisions), while the NPK is undecided and as usual, is being wooed by all sides, including the opposition. At the same time, the DP is stuck with a narrow regional base and is unlikely to deliver a presidential victor on its own (as was the case in 2002).

This latter point is particularly important in explaining the NARC's decision to set up NARC-Kenya, which will have, its founders hope, a broad national appeal. The party certainly has high-profile backers, including the vice-president, Moody Awori, and several other ministers and ex-ministers (including those sacked in February). They also clearly believe that the NARC name, in whatever form, still has popular resonance. Some opponents have suggested that NARC-Kenya is simply the DP in another guise, but while most MPs affiliated to the DP are switching to NARC-Kenya, the new party will have a broader membership. Meanwhile, the future of the DP is uncertain, although some party officials (if not MPs) are reluctant for it to disband. NARC-Kenya attracted 54 MPs (including eight ministers) to a "consultative forum" in April, showing that it has a large block of support, but far from a majority. NARC-Kenya plans to open constituency offices and start a recruitment drive after an official launch, scheduled for June. Mr Kibaki's intentions may become clearer at this stage.

A sharp split is emerging in the coalition

The formation and activities of NARC-Kenya are causing sharp splits in the governing coalition, and could lead to damaging new defections from the GNU by disgruntled Ford-Kenya and NPK members. Tensions have been brought to a head sooner than expected because of the impending by-election for five seats in the north-east, following the plane crash near Marsabit in April that killed five MPs including two assistant ministers (see box). Officials have indicated that NARC-Kenya will contest the seats, four of which were won by KANU in 2002, but this has infuriated Ford-Kenya and the NPK who are insisting that candidates represent the existing NARC coalition. How this is resolved could have a significant impact on government stability, but it seems that the president may back down on this occasion, in order to preserve his fragile governing majority.

The Marsabit plane crash triggers a mini-election

The country suffered a major shock on April 10th, when 14 officials, including five MPs, were killed when a military plane crashed, apparently because of bad weather, near Marsabit in the northeast of the country. The officials were on their way to a third round of peace talks aimed at bringing inter-tribal feuding in the region to an end. Peace efforts are now on hold. Among those killed were the assistant security minister, Mirugi Kariuki (the president's trusted trouble-shooter), assistant regional development minister, Titus Ngoyoni, and deputy leader of Kenya African National Union (KANU), Bonyana Godana. The tragedy will trigger by-elections in five constituencies, which will take place within 3-4 months, as required by law. Four were won by KANU in 2002, but most were close contests. One of the most interesting features of what is being referred to as a "mini-election" is whether or not the Government of National Unity and the opposition, Orange Democratic Movement (ODM), can agree on single candidates, or whether individual parties within these broader groupings put forward their own
The opposition faces numerous divisions

On a more positive note for the president, the opposition is beset by as many divisions as the governing side, with the main focus of disagreement being the future of the ODM, and specifically whether or not to build on the success of the referendum campaign and put forward a single presidential candidate in 2007. The prospects of a united front are not good, however, given the number of ambitious politicians in the opposition's ranks, and the reluctance of KANU, in particular, to submerge its identity within a coalition. KANU's leader, Uhuru Kenyatta, has signalled a number of times that the party will fight the 2007 election as a separate entity—no doubt hoping that voters will return to Kenya's long-term ruling party in the wake of NARC's poor record—but another KANU faction under William Ruto is in favour of finding a unified candidate (and seeks the position himself). To further complicate matters, a third KANU faction, under Nicholas Biwott, has now left the party and formed New KANU, which backs the Kibaki regime.

The LDP are also in favour of a unified candidate, but must first face the difficult and often-postponed challenge of choosing its own leader. According to the ODM's tentative plan, the KANU and LDP candidates would then compete for the ultimate honour, although precisely how is not clear. The LDP leadership contest is likely to become a bruising battle between the former ministers, Raila Odinga and Kalonzo Musyoka (who both enjoy a prominent national profile). But at present, the party cannot even agree on how to choose its presidential candidate; Mr Odinga favours a delegate system and Mr Musyoka a popular vote. The party may postpone a final decision until next year, adding to the uncertainty.

The state takes action against a media outlet

The government sparked a furore in early March when state agents (of unknown identity) attacked the offices of the Standard media group (one of Kenya's big two media houses, along with the Nation), damaging printing presses, seizing computer equipment, burning copies of the paper, and switching off Kenya Television Network (KTN) for 12 hours. The raid was linked to the arrest of three journalists from The Standard concerning a report in the newspaper alleging that talks took place at the state house between the president and the opposition leader, Kalonzo Musyoka, which both parties deny. All three journalists have since been charged with publishing an alarming statement, although the trial that was due to start in late April has been postponed until July 2006. At the same time, The Standard is taking legal action against the state.

The official's claims that state security was at stake appear far-fetched. The raid sparked genuine fears about the future of press freedom in Kenya and provoked anger among civil society groups and donor representatives, leading to street protests. However, the government appears to have weathered the storm, at least for now, and internal security minister John Muchuki, and information minister, Mutahi Kagwe, both fended off calls for their resignation. Mr Kagwe plans to bring a new media bill to parliament soon, proposing a new self-
regulatory structure, and giving the media council greater powers to punish violators: debate is likely to be fierce.

Economic policy

The fight against deep-rooted corruption in Kenya has continued to remain high on the policy agenda. While the government appears to be taking the issue more seriously than it has before, donors remain unconvinced that enough progress has been made, and a large amount of prospective funding remains in suspension. The IMF and World Bank funding is in limbo, and the latest Consultative Group (CG) meeting between the government and donors, planned for April 2006, has been put on hold indefinitely. At the last CG meeting in April 2005, the government unveiled a new, two-year anti-graft plan (May 2005; Economic Policy), which kept donors on board, but virtually nothing was done until the latest revelations in January 2006 from the former anti-graft official, John Githongo, linking ministers to dubious state contracts.

Three ministers resigned in February over corruption allegations, including the finance minister and the justice minister, who were both linked to the infamous Anglo-Leasing scandal (August 2004; Economic Policy), while the Central Bank governor, Andrew Mullei, was suspended in March because of allegations that he improperly awarded consultancies. The ministerial departures, although significant, are not sufficient by themselves to convince donors that the government is truly committed to weeding out corruption. Other evidence is needed, including actual prosecutions in court of corrupt individuals, especially of high-level ministers. Mr Mullei is due in court in June, although any charges against culprits in the Anglo-Leasing affair will not be prosecuted until the Kenya Anti-Corruption Commission (KACC) has completed its investigations. The implicated ministers and the Central Bank governor all proclaim their innocence.

Against this background the IMF has again postponed a decision on whether or not to release the fourth and fifth tranches (worth US$73m) of the three-year Poverty Reduction and Growth Facility (PRGF) that was originally agreed in November 2003. The IMF executive board was due to give its verdict in December 2005 (following a relatively positive assessment from an IMF mission in October, which noted that Kenya had complied with most loan conditions in 2005), but this was postponed until February 2006, and then again, until May. As well as concerns over corruption, the delay is partly the result of administrative difficulties linked to the cabinet reshuffle in December 2005, and the resignation of the former finance minister in February (and his replacement by the former lands minister, Amos Kimunya), which meant that important documents could not be signed on time. The IMF managing director, Rodrigo de Rato, said in March that “a pro-active and clear governance agenda would unlock increased financial support by the donor community”.

Following talks between Mr Kimunya and Bretton Woods officials in March, and again at the IMF/World Bank spring meeting in April, a new timetable has been laid out. According to this, an IMF mission will visit Kenya in May to
complete the assessment of the second year of the PRGF (namely 2005), and agree a letter of intent and a reform programme for the 2006/07 financial year (starting July 1st), before submitting its report to IMF executive board for approval. The government has had some policy successes, including the passage of a new privatisation bill in the second half of 2005—paving the way for greater private-sector participation in the economy—and the maintenance of a sound macroeconomic environment (based on solid growth, moderate inflation and a robust currency), but this may not prove to be sufficient for the Fund given the intense focus on corruption. According to the IMF, only SDR75m (US$111m) of the PRGF has been disbursed to date, leaving SDR150m outstanding. The PRGF is due to expire in November 2006, but it will probably be extended to mid-2007.

The Netherlands suspends aid to Kenya

While the IMF and World Bank ponder re-engagement with Kenya, the Netherlands (a key bilateral donor) showed its impatience, in April, over the government’s failure to stem corruption by suspending funding worth US$146m. The funds were earmarked for projects in the education, environment, and water sectors (in partnership with other donor agencies such as the UN International Children’s Fund (UNICEF) and the UK’s Department for International Development), but have been frozen because of a lack of tangible evidence that action is being taken against graft. A Dutch government statement called for greater efforts to measure and monitor corruption, so that any progress could be clearly identified. To support this effort, the Netherlands will continue to support good governance and judicial reform programmes. Not surprisingly, the Kenyan government was angered by the suspension and accused the Dutch government of taking insufficient account of recent progress made.

World Bank re-engagement remains on hold

The new finance minister, Amos Kimunya, has stressed his commitment to fighting corruption since his appointment in February, and he will hope to have sufficiently impressed the Bretton Woods officials at recent meetings for them to re-engage with his country. Kenya is renowned for making promises and then taking no action, but the finance minister is optimistic that the World Bank will disburse funds, in the short term, for at least “one or two” out of the five projects (worth about US$265m in total) that were suspended in January 2006 because of corruption concerns. The World Bank is auditing the five suspect projects, all of which were approved in the second half of 2004, but has yet to give an official verdict. Moreover, even if the projects are deemed “clean”, funding will also depend on progress in the wider war against graft. It is likely, as Mr Kimunya suggests, that the World Bank will take a gradual approach to re-engagement. This will lead to delays in projects being undertaken, to the detriment of Kenya’s development efforts.

The Central Bank governor is suspended amid corruption allegations

The governor of the Central Bank of Kenya, Andrew Mullei, was suspended in March 2006 because of corruption allegations made against him, although, as with other ministers who have departed recently, he proclaims his innocence. It is alleged that Mr Mullei, a former IMF directory who took over the job in early 2003, awarded four consultancies in 2004 worth US$125,000 in total, including one to his son, without
following proper open-tendering procedures. Although the amount of money involved is tiny compared with the Anglo Leasing and Goldenberg scandals, the allegations proved sufficient in the current, highly sensitised environment to land him with a charge of “abuse of office”. This followed investigations by KACC and a decision to prosecute by the attorney-general. The CBK board tried to defend Mr Mullei, and cleared him during an internal inquiry, but the authorities took a hard-line approach.

Mr Mullei’s suspension is controversial, however, as the security of tenure that an incumbent enjoys under the Banking Act requires that a tribunal must be set up (by the president) to carry out a probe before the post-holder can be removed. Moreover, he had been close to completing an investigation into alleged money laundering at Charter House Bank, linked to “prominent” individuals, and had been expected to withdraw the bank’s license. The government’s counter-argument is that the provisions of the Economic Crimes Act (from 2003) require accused persons to step down from their posts while investigations are under way. It also helps that Mr Mullei has been suspended, rather than sacked. The debate will continue, but his fate now rests with the courts, with the trial set to start in June 2006. If cleared, he may return to his post. Mr Mullei’s deputy, Jacinta Mwatela, has been appointed governor in the interim, and no change in policy is expected. The currency markets appear to have shrugged off the transition and the Kenya shilling has remained strong.

In April the new finance minister, Amos Kimunya, won passage in parliament for a supplementary budget for 2005/06 (July-June), based on spending of KSh20.7bn (US$288m)—about 5% of the annual total—to ensure that recurrent needs are met until the new budget for fiscal year 2006/07 takes effect on July 1st. The supplementary budget seeks KSh12.5bn for recurrent spending (including wage payments, retrenchment costs and drought-related outlays) and KSh8.2bn for capital projects in education and energy (including an emergency power generation contract to meet the projected shortfall in hydroelectric power). The bulk of this will not be new money, but will be funded by cutbacks elsewhere, especially capital outlays on roads and health. Overall, there will be a shift of KSh7.5bn from the capital to the recurrent budget.

What is notable is that such large sums remained unspent from capital allocations so late in the financial year. This illustrates a persistent failure of governance to ensure that projects are properly organised, implemented and completed. The cutbacks in capital spending also have negative implications for the country’s longer-term economic growth and overall development. The supplementary budget does not call for an increase in the projected headline deficit of KSh66bn (4.8% of GDP) in 2005/06, although the government will seek an additional KSh5bn in domestic borrowing, on top of the KSh25bn already planned for. While higher government borrowing tends to put upward pressure on interest rates, the financial sector is currently highly liquid and more than happy to meet the government’s financing needs, while the amount of extra proposed borrowing is relatively small.

Mr Kimunya struggled to win parliamentary backing for the supplementary budget as legislators clashed with the executive over a proposed rise in ministerial allowances (by KSh325m in total) and demands by members of government to secure passage of a supplementary budget

The supplementary budget struggles to win approval
parliament (MPs) for an increased mileage allowance (worth KSh220m in total) to compensate for the recent increases in oil prices. These rather petty concerns dominated the debate, rather than more pressing issues such as the implication of cuts in the capital budget and a lack of transparency in some spending allocations, illustrating the relatively narrow focus of much of Kenya’s ruling elite in both branches of government. However, the opposition was still strong enough to force the executive to back down, as any failure to pass the budget would also have been seen as a vote of no confidence in the government. The government conceded that increases in ministerial allowances would not come from the national assembly budget (as had been proposed) but from ministerial budgets. Parliamentarians also won a steep rise in their travel allowances (backdated to July 2005) that will see each of the 222 MPs take home a lump sum of almost KSh1m ($13,800) on top of already generous remuneration package. As part of the budget deal, MPs also secured a promise that the constituency development fund (CDF) would be trebled from 2.5% to 7.5% of government revenue (from about Ksh7bn to KSh21bn a year). However, while there are examples of the CDF contributing to local development, outlays are not adequately monitored, and in effect allow MPs to ‘buy’ the support of their constituents, even if this takes place via projects rather than cash handouts. The move was criticised by the World Bank’s country director, Colin Bruce, and if implemented it will put pressure on next year’s budget.

The domestic economy

Economic trends

Heavy rainfall across much of the country in April 2006 brought an end to the severe drought that had persisted for several months. It also caused severe flooding in some locations. The weather outlook is promising, with above average rains forecast for most of the country during the remainder of the long rains season (which ends in June). This means that the negative impact of the drought on economic growth will be minimised. However, performance suffered in many sectors during the first quarter, which will detract from the final growth rate. Production of tea, one of the country’s main exports (which accounts for about 4% of GDP) was particularly hard hit, with output tumbling by 51% year on year in the first two months of 2006 as bushes withered. Other cash crops also suffered, and while flower production rose slightly (protected by irrigation), fruit and vegetable production declined (as some is rain-fed), leading to a 5% year-on-year decline in horticulture output in the first two months of 2006. Moreover, the short-rains grain harvest in January and February was poor (40% of normal) while the livestock sector (contributing around 3% of GDP) suffered badly, with mass animal deaths in pastoral areas. The drought left 3.5m people dependent on food aid, while the downturn in rural income curbed household demand for goods and services.

Drought also cut water levels at hydro-electric dams (the country’s main power source), convincing the government to commission emergency, oil-fired electricity supplies for a one-year period from May 2006, at considerable
expense. On the plus side, this will enable Kenya to avoid power rationing and blackouts (beyond the usual system inefficiencies), which could have further undermined economic growth. But on the minus side, power prices will increase from already high levels, and in combination with the persistence of near-record world oil prices, will put further pressure on manufacturing costs. Simultaneously, revenues are being squeezed by the strong Kenya shilling. Growth is also being constrained by delays in donor funding, putting holes in the government budget and delaying much-needed capital spending.

Kenya’s key sectors are expected to do well in 2006

Given such developments, officials have trimmed the expected real GDP growth rate for 2006 to 5.5% (from 6% initially), although this still appears too optimistic. The Economist Intelligence Unit forecasts for real GDP growth in 2006 is unchanged at 5% as the favourable long-rains season should ensure a timely recovery from drought. The good rains are expected to produce a second consecutive above-average grain crop in the main harvest period in the second half of the year (which accounts for 85% of national annual output). Apart from favourable weather, the area sown with cereals has risen by 5% this season because of strong producer prices, according to the ministry of agriculture. Tourism also remains strong, with visitor numbers up by 17% year on year to nearly 170,000 in the first two months of 2006, representing a third consecutive year of rapid expansion. The drought did not lead to mass wildlife deaths in national parks, as had been feared. The telecommunications sector also remains buoyant because of the ongoing roll-out of mobile phones. Subscriber numbers rose by 700,000 in the second half of 2005 to 5.3m in total, and further growth is likely in 2006.

Inflation starts to ease in line with food prices

Inflation surged in the first quarter of 2006 to average an increase of 17.8%, because of the steep rise in food prices (which account for about 50% of the consumer price index) following drought and a poor short-rains harvest, as well as higher energy and fuel prices. Year-on-year inflation seems to have peaked in March 2006 at 19.1% (compared with a recent low of 3.7% in October 2005), driving the average annual inflation to 11.4%—up from 10.3% in 2005. However, the normal onset of the long rains (March to June) is already bringing down the price of vegetables, and is expected to lead to another above average grain harvest in the second half of the year.

Inflation dipped in April, to 14.9% year on year, although at 11.3% the average annual rate was virtually unchanged, as food prices declined from March highs. It is expected to ease further in coming months, especially after the main harvest gets under way in August. Average annual underlying inflation (excluding food and energy prices) also dipped below the government’s 5% target ceiling, for the first time in almost a year, to 4.9% in April and a further decline is likely in the months ahead. The return of core inflation to below 5% is a success for the government’s tighter monetary policy. Nevertheless, the easing will be moderated by the persistence of high world oil prices (which is pushing up transport costs) and higher electricity prices, following a planned switch to emergency, oil-fired generators in response to drought. Our forecast for average inflation in 2006 as a whole is unchanged at 9%.
Interest rates on treasury bills move downward

The benchmark, 91-day Treasury Bill rate fell to 6.9% in April, the lowest for almost 18 months—and the fourth consecutive monthly decline—which will trim government interest-rate payments and boost the uptake of private-sector credit. The main reason for the slippage in rates is the high level of demand for government paper by financial institutions (as it offers a secure and relatively high return), and all auctions in the past four months have been heavily oversubscribed. This reflects high levels of liquidity within the banking system.

Although private-sector credit growth has slowed from the peaks of the first half of 2005 (when it exceeded 20% year-on-year, in response to low interest rates in 2004), it continues to expand at a brisk pace, rising by 12.8% to KSh382bn (US$5.4m) in the year to March 2006. Notably, this accounted for almost three-quarters of total net domestic credit held by the banking system. A breakdown of private credit allocation in March 2006 shows that manufacturing (12.6%) and trade (10.6%) had the largest shares, followed by private households (9.1%) and business services (7.6%). By comparison, the fastest growing segments in the year to March 2006 were business services (up by 48.8%), transport and communication (up by 38.7%), consumer durables (up by 34.6%), mining (up by 26.4%) and private households (up by 25.1%): credit growth to manufacturing was relatively disappointing, at 6.7%.

The 91-day T-bill rate is not expected to decline much further in the short-term, and in contrast to recent movements it edged back up to 7.1% in the first weekly auction in May, partly because of the prospect of higher government borrowing. However, the amount of extra funds sought by the government from the domestic market will be modest, at Ksh5bn, according to the recent supplementary budget. The financial markets are comfortable with this, and we expect the 91-day rate to stabilise in the 7-7.5% range in coming months.

The Kenya shilling remains strong amid political flux

The Kenya shilling remained strong against the major currencies, despite the resignation of the finance minister in February, the suspension of the Central Bank governor in March, and the delayed disbursement of the next tranche of IMF funding under the poverty reduction and growth facility (PRGF). The currency strengthened to average KSh71.3:US$1 in April, up by 6.4% year on year: the rise against the euro has been even more rapid, up by 12% in the 12 months to March. While exporters continue to complain vociferously about the
downturn in Kenya shilling earnings (and the squeeze on their profits), the interim CBK governor, Jacinta Mwatela, will take the same stance as her predecessor based on non-interference in the market provided that it is being driven by fundamentals (and not by speculation), which is thought to be the case at present.

The strong Kenya shilling reflects robust inflows of foreign currency from exports, tourism and remittances (which is enough to satisfy demand for foreign exchange) as well as a weakening of the US dollar. The currency remains underpinned by strong reserves, which peaked at an all-time high of US$1.93bn in January 2006—up by 310% year on year—before dipping slightly to US$1.92bn in February. We expect the Kenya shilling to return to a path of gradual depreciation, given strong underlying import demand (bolstered by high oil prices), but the start of the process is taking longer than expected. The Kenya shilling is likely to strengthen further in May before drifting to around KSh72:US$1 by mid-year. By contrast, exporters are calling for a return to the KSh76-78:US$1 range that prevailed in the first half of 2005. The strong currency is, nevertheless, holding down import costs, notably the cost of oil imports and helping to curb inflationary pressure.

Agriculture

Cash crop production

(‘000 tonnes unless otherwise indicated)

Jan-Feb % change

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2005</th>
<th>2006</th>
<th>2005/06</th>
</tr>
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<tr>
<td>Sugarcane</td>
<td>4,654.00</td>
<td>4,693.30</td>
<td>822.6</td>
<td>883.3</td>
<td>7.4</td>
</tr>
<tr>
<td>Tea</td>
<td>324.6</td>
<td>328.5</td>
<td>60</td>
<td>29.6</td>
<td>-50.6</td>
</tr>
<tr>
<td>Horticulture</td>
<td>166.1</td>
<td>163.2</td>
<td>29.3</td>
<td>27.9</td>
<td>-4.85</td>
</tr>
<tr>
<td>Coffee</td>
<td>49.9</td>
<td>47.7</td>
<td>12.1</td>
<td>10</td>
<td>-16.7</td>
</tr>
</tbody>
</table>

Sources: Central Bureau of Statistics; Kenya Sugar Authority; Horticulture Crops Development Association; Kenya Tea Board.

Kenya's production of tea, which accounts for about 4% of GDP, and is one of the country's key exports—earning US$516m in 2005 according to recent data from the Central Bank of Kenya—fell sharply in the first quarter of 2006 because of drought. Output tumbled by 51% year on year to 30m kg in the first two months of 2006 (with production in February being the lowest monthly total for five years), and the figure for March is unlikely to have been much better. The downturn was accompanied by widespread factory closures and the temporary lay-off of thousands of workers. However, the return of normal rainfall in April is already pushing production higher, and most factories have re-opened, although it will take several weeks for all the withered bushes to recover or be replanted.

National production will undoubtedly fall in 2006 because of the drought—after a record year in 2005—although the scale of the decline is uncertain. At the height of the dry period, a decline of between 16% (to 275m kg) and 31% (to 250m kg) was mooted, although the Kenya Tea Board now estimates that annual output will fall by no more than 9%, to about 300m kg, provided the weather is favourable during the remainder of the year. Export earnings are
likely to decline by a similar margin in 2006, as although prices at the Mombasa tea auction (which handles around 75% of the tea crop) climbed in response to shortages, they will fall again as output recovers. World prices remain on a gradual downward trend as a result of global overproduction combined with a slowdown in the growth rate of global consumption, from 2.2% a year in 1993-2002 to an estimated 1.2% a year from 2003-2014.

In addition to falling world prices, profitability in the Kenyan tea sector is being squeezed by the rise in production costs (especially of energy and transport) and the strength of the Kenya shilling, which has cut local currency earnings from exports denominated in US dollars. The Kenya Tea Board is advocating a number of tactics to address the problems facing the sector, including greater emphasis on quality not quantity, a switch to more drought-resistant tea varieties and a campaign to increase local tea consumption. However, despite the uncertain outlook, investment in the tea sector remains strong, and the Kenya Tea Development Association (KTDA), which markets 60% of the national crop, plans to build eight new factories over the next four years at a cost of US$49m, to relieve pressure on the existing 54 factories.

The tea sector suffered an outbreak of labour unrest in April as the Kenya United Small Scale Tea Owners Association (KUSSTO) called on small-scale growers, which account for 60% of the national crop, to suspend deliveries to the KTDA, in an attempt to push up producer prices for green tea from KSh9/kg (US$0.13/kg) to KSh15-20/kg. However, KTDA remains adamant that it cannot afford such an increase because of weak world prices, and points out that about 4 kg of green tea is needed to produce 1 kg of final, black tea. The response to the strike call was half-hearted and limited to certain locations, partly because of the poor timing, with most farmers wanting to take advantage of the start of the rains and make up for income lost during the drought. Nevertheless, the row about low producer prices is expected to rumble on.

The plantation sector (about 40% of national output) is facing a different set of labour problems as it attempts to cut labour costs by introducing picking machines. Wages for tea workers have risen faster than output in recent years, leading to a decline in labour productivity. However, labour unions are deeply opposed to the move and appear to have the backing of the government, which fears extensive job losses: each machine can replace up to 50 workers. The labour minister, Newton Kulundu, told firms in early May that machines would be permitted to harvest no more than 3% of the crop.

### Manufacturing

An Indian firm, Plethico, is investing US$20m in a new pharmaceutical factory near the capital, Nairobi, geared to local, regional and overseas markets. The factory is due to open in January 2007 after a first phase of investment costing US$10m, while a second phase, also costing US$10m, will be ready in 2008. According to Plethico, Kenya was chosen as a manufacturing hub because of the country's favourable business environment and increasing friendliness towards investors, as well as the much higher returns on capital obtained in
emerging African markets, of 30% on average, compared around 15% in
developed markets. Plethico has applied for registration from Kenya Pharmacy
and Poisons Board (the regulatory body) to produce more than 100 types of
medicines (including antiretrovirals, antimalarials, and antibiotics), and aims to
lift this to 250 in the medium-term. The firm will also seek to produce on
contract for other pharmaceutical firms, and envisages a rise in demand
throughout the region as regulatory controls over medicines are tightened
(thereby eliminating poorer quality competition). Plethico also aims to become
the first local pharmaceutical firm to export to industrial country markets and
will seek certification from the relevant global agencies.

Kenya has around 30 companies in the pharmaceutical sector (including
subsidiaries of foreign firms) and is the largest producer in the Common Market
of Eastern and Southern Africa (COMESA), according to an official survey from
2005. Pharmaceutical ventures seeking export markets received a boost in April
2006, as Kenya Airways launched a specialist cargo service to cater for the
sector. The airline is the first African carrier to offer a dedicated pharmaceutical
service (which requires strict controls over temperature), and hopes to take
business from foreign competitors. The service will initially be available on the
Lusaka, Lilongwe and Entebbe routes, before other African destinations are
added later in the year.

Energy

The government is in the process of part-privatising KenGen, the country’s
main electricity generator, via an Initial Public Offering (IPO) on the Nairobi
Stock Exchange for 30% of the company’s shares. The IPO is the first sale since
the sale of Mumias sugar in 2001 and, by aiming to raise KSh7.8bn (US$108m)
for the government, is the largest ever in Kenya. There has been massive interest
in the 660m KenGen shares on offer—at a price of KSh11.9/each (US$0.17/each)
—from both the public and institutions, and preliminary figures suggest that the
issue has been massively oversubscribed, with 280,000 applications worth
more than KSh26bn (US$366m) in total.

The government has not yet finalised its share allocation scheme, but it appears
as if small bidders (for between the minimum 500 and 1,000 shares) will
receive their allocations in full but that all other bidders will be restricted to a
maximum of 5,000 shares. KenGen employees, who have been allocated 5% of
the firm, may be the largest individual gainers. Bidders for large quantities, of
up to 1m shares and more (which mainly comprises of institutions) will be
disappointed, and if they seek more shares they will have to buy them on the
bourse when trading begins on May 17th.

Share prices are expected to rise sharply, to between KSh15-24, offering a good
return to those willing to sell. The government will finalise share allocations a
week prior to the start of trading, but whatever method chosen, it will have to
refund KSh18bn in oversubscriptions. This, nevertheless, illustrates the potential
of the stockmarket to raise large amounts of capital and will give a clear boost
to the privatisation process. The flotation is also in line with the government’s
stated preference to privatise state assets via the bourse, wherever possible, in
order to boost local ownership and participation in the process. The KenGen sale bodes well for the planned flotation of 34% of Telkom Kenya (TK) in 2007, although a strategic investor will also be sought for a 26% share in TK and to take on management responsibility. In KenGen's case, there will be no change in management and, unlike TK, it is a highly profitable concern: pre-tax profit was KSh2.6bn (US$36m) in 2004/05 and is likely to be higher in 2005/06.

Fearful that drought could lead to power shortages and widespread economic damage, KenGen, acting on the recommendation of a high-level Emergency Power Committee (a body including ministers, officials, power-sector players and manufacturers) signed a contract in March 2006 with the UK firm, Aggreko, after an open bidding process—for the generation of 100 mw from two oil-based generators for a 12-month period starting in May 2006. The prospect of shortages and rationing has thus receded, but the costs are considerable, and will be reflected in higher tariffs for end-users, to the detriment of Kenya's international competitiveness. KenGen will pay a basic charge of US$8.6m a month whether the generators are functioning or not (a cost that will be covered by the government), while the cost of power could amount to US$25m a month.

Even prior to the Aggreko contract, KenGen planned a sharp 34% rise in the tariff charged to monopoly distributor, the Kenya Power and Lighting Company (KPLC), to KSh2.36 per kwh (thus reversing a concessionary discount in place for the past two years to keep KPLC afloat), while the KPLC has also been given the authority to impose price rises. The Aggreko contract will add to the pressure and end-user prices are likely to pass KSh8 per kwh in coming months. Industry profits will be squeezed, although the alternative of cuts and rationing would be far more costly. More positively, the onset of heavy rains in April will help to replenish dams and boost hydroelectric generation. This means that Aggreko plants are unlikely to operate at full capacity, and with the government covering the basic charges, the rise in end-user prices may be less than feared.

Management of power distribution is handed to an Irish firm

The Electricity Supply Board (ESB) of Ireland won the bid, in March 2006, for the contract to manage Kenya Power and Lighting Company (KPLC) for an initial two-year period (extendable by one year), with a remit to restore the firm's weak financial position and to push ahead with electrification programmes, especially in rural areas (The domestic economy, Energy; February 2006). The management team will attempt to meet a number of performance benchmarks:

- in year one, a cut in system losses from 18% to 16%;
- a reduction in outages from 11,000 to 6,000 a month;
- the connection of 150,000 new customers;
- a cut in average repair times from 7.8 to 6.8 hours; and
- Further targets apply in year two.

ESB's contract victory came shortly after KPLC's managing director, Jasper Dour, was sacked (in February) because of poor performance and alleged irregularities in procurement of goods, but it is not clear when the ESB will start work. They were due to take over in April, but the deadline has slipped, partly because the World Bank funds earmarked to pay the contractor (under the wider energy-sector recovery
programme) may not be forthcoming immediately because of the row over corruption. When the ESB does assume management responsibility, they may also face resistance from vested interests within the firm, dissatisfied at their loss of power, which could complicate day-to-day running. In the longer-term, the government, which holds 48% of KPLC, is considering splitting the firm in two, into separate distribution and transmission arms, with a view to further privatisation. A tender for consultants to advise on the unbundling was issued in April.

Transport

The parastatal, Kenya Airways Authority (KAA), unveiled a five-year strategic plan in March 2006 based on expansion at Nairobi’s Jomo Kenyatta International Airport (JKIA), and other regional airports, at a cost of approximately US$100m. The World Bank is contributing US$10m to the project although the KAA plans to raise the bulk of the funds from the domestic financial markets. The firm considered raising capital on the Nairobi Stock Exchange (NSE) in 2005, but has yet to make a final decision. The main aspect of the five-year plan is to lift capacity at JKIA, by more than doubling terminal space from 26,000 sq metres to 55,000 sq metres within two years, in order to relieve congestion.

The airport is designed to handle 2.5m passengers a year, but numbers rose to 4.2m in 2005. The KAA also aims to secure “category one” status for JKIA with the US Federal Aviation Authority, thereby allowing for direct flights to US airports. The Kenya Civil Aviation Authority and US officials undertook a security inspection in February 2006, although the verdict is not yet known.

Other aspects of the KAA’s strategic plan include an improved water supply to JKIA, the rehabilitation of airstrips throughout the country and improved fire-fighting capacity at all airports. The plan also calls for expansion at Kisumu airport, on Lake Victoria (costing US$13.8m), and at Malindi airport, on the coast (costing US$4.8m), which will give a boost to tourism. However, the KAA says that expansion at Malindi can only go ahead once local leaders gain secure title over nearby land, which is currently occupied by squatters.

Telecommunications

The government announced in late-February 2006 that it will push ahead with the privatisation of Telkom Kenya (TK), by selling 60% of the company in the first half of 2007, 34% via a float on the NSE and 26% to a strategic investor with responsibility for managing the company. The government has appointed the International Finance Corporation (IFC; the World Bank's private-sector arm) as transaction advisor for the sell-off, replicating the role taken by the institution in the privatisation of Kenya Airways in the late-1990s. Privatisation of TK has long been a key demand of donor-backed reform programmes, but the sale has been repeatedly thwarted and delayed. A first attempt at privatisation was controversially scrapped in 2001 after bids received were deemed too low, while the NARC government’s initial plan to part-privatise the firm in the first half of 2005 (via a flotation and a direct sale to a strategic investor) fell victim to
delays in passing a new privatisation bill and the poor financial state of the loss-making parastatal.

Restructuring of TK, which is heavily overstaffed, having 18,000 workers (10,000 more than necessary) remains a prerequisite to a successful sell-off, and this is clearly recognised in the government’s latest proposals. The perennial problem of finding the funds needed for restructuring will be solved by a sale of a further 9% stake in Kenya’s dominant mobile phone operator Safaricom—a 60:40 joint venture between TK and Vodafone—mostly likely to Vodafone, taking the UK firm’s share to 49%. The sale of an additional stake to Vodafone has been mooted for some time, but the government has been reluctant to dilute its shareholding in a “prize” asset, especially below the 50% mark. Vodafone, as the major partner, has pre-emptive rights to the Safaricom shares, and has expressed formal interest in buying the stake on offer, and even though it would not acquire majority control, the firm would gain increased representation on the board. However, a sale to Vodafone is not guaranteed as a price has yet to be agreed. The government will seek considerably more than the US$100m offered by Vodafone in mid-2005 for 11% of Safaricom. Depending on the valuation method used, the 9% share in Safaricom could be worth as much as US$120-140m. The government may turn to the bourse if a price cannot be agreed. The sale of the Safaricom shares is scheduled for completion by mid-2006, giving time for TK to prepare for privatisation in 2007.

The main focus of restructuring will clearly be on shedding the 12,000 surplus workers, in line with a retrenchment plan put forward by the government in April 2006, which kicked off on May 1st. Under the first phase, 2,400 mainly older workers (aged 50 and above) will be made redundant, with the cost being funded internally. The second phase will target all non-core workers (such as messengers, security guards and porters) and will be paid for by funds generated from the Safaricom sale. The total cost of retrenchment is estimated to be Ksh8.4bn (US$116m). There is a risk of labour unrest, although the severance packages on offer are better than the statutory minimum.

The government hopes that the privatisation of TK will rejuvenate the fixed-line telephone segment, which has stagnated at less than 300,000 subscribers...
(despite a long waiting list) and facilitate investment in modern equipment, leading to lower call charges. By contrast, the number of mobile phone subscribers reached 5.2m at end-December 2005 (up 700,000 in six months): about two-thirds are with Safaricom and one-third with Celtel Kenya. Safaricom continues to expand, and in March secured a massive loan of KSh12bn (US$169m) from a syndicate of local commercial banks (at one percentage point above the 91-day T-Bill rate), to repay other loans and commitments (including dividends to TK and Vodafone) and to fund investment.

Given past experience in Kenya and the likely distraction of a general election in 2007, privatisation of TK is highly unlikely to go according to plan. TK lost its monopoly on the fixed-line segment in mid-2004, at least in theory, but the planned licensing of a second national operator (SNO) fell apart soon afterwards, with the government rejecting the only winning bid (probably because of fears that TK could not cope with the extra competition). A new tender for a SNO was opened in February 2006 and a winner is due to be announced in July, but it is not yet clear if there has been much interest.

The planned licensing of the third mobile phone operator has also been beset by confusion and conflict. On the plus side, the government announced in March that TK would finally lose its monopoly on international calls in mid-2006, and that the existing mobile phone operators would be granted gateway licenses. The extra competition is expected to lead to a steep decline in international tariffs (perhaps by as much as 50%) to the benefit of the wider economy. In another important move that will cut call costs, both TK and private operator Kenya Data Networks (in partnership with Seimens of Germany) are installing fibre-optic cables between Mombasa and Nairobi, and aim to link up with the global network in the medium-term, possibly via the planned East African Submarine System (EASSy), running between South Africa and Sudan, although this is taking time to come to fruition.

### Foreign trade and payments

According to the latest, provisional results from Central Bank of Kenya, the country’s overall current-account deficit surged to US$1.58bn in 2005 (8% of GDP), from US$375m in 2004, mainly because of exceptionally strong growth in imports. The import bill surged by 42% to US$6.1m, with all major categories posting large gains. Equipment and machinery leapt by 78% to US$1.78bn (partly because of aircraft purchases), oil jumped by 20% to US$1.34bn (reflecting the rise in world prices), manufactures climbed by 13% to US$0.78bn and chemicals rose by 12% to US$0.83bn. Other imports had the fastest rise; up by 84% to US$1.41bn. As a result, the trade deficit increased from US$1.6bn in 2004 to just under US$3bn in 2005.
Exports also displayed robust growth in 2005, rising by 18% to US$3.2bn, but this was not enough to stem a sharp increase in the trade deficit. Tea retained its dominant position, and was also the fastest growing export, with earnings rising 23% to US$561m. Manufactured exports increased by 20% to US$350m, and remain dominated by garment sales to the US under the African Growth and Opportunity Act (AGOA), although earnings from this source are declining in the wake of increased competition from China. Total Kenyan exports under AGOA (which are mainly garments) fell from US$287m in 2004 to US$278m in 2005, and were down by 18% year on year in the first two months of 2006 to US$42m, according to US figures. On the plus side, exports to the East African Community (EAC)—Kenya, Tanzania and Uganda—and the Common Market for Eastern and Southern Africa (COMESA) states are rising. Horticulture is also confronting stagnation, hurt by a profits squeeze and rising competition from other states, and exports were just 4.1% higher in 2005 at US$433m.

The wider trade deficit was partly offset by an 11% increase in the surplus on invisible trade to US$1.35bn, although this may be an underestimate. Provisional figures from the Central Bank of Kenya suggest that tourism earnings rose by just 4% in 2005 to US$517m, but revenue is likely to have been far higher as tourist numbers jumped by 24.5% to 812,000. Meanwhile, the deficit on the income account fell sharply (partly because of Paris Club debt rescheduling dating from 2004) while current transfers—all of which comprised private remittances—dipped slightly to US$639m: no official transfers were received during the period. Despite the sharp rise in the current-account deficit, the overall balance of payments showed an increased surplus (of US$276m) because of counterbalancing flows on the financial and capital account. Once again, short-term flows, including errors and omissions comprised the bulk of the surplus.

### Current account

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchandise exports (fob)</td>
<td>2,728</td>
<td>3,225</td>
<td>18.2</td>
</tr>
<tr>
<td>Tea</td>
<td>456</td>
<td>561</td>
<td>23.0</td>
</tr>
<tr>
<td>Horticulture</td>
<td>416</td>
<td>433</td>
<td>4.1</td>
</tr>
<tr>
<td>Raw materials</td>
<td>407</td>
<td>382</td>
<td>-6.1</td>
</tr>
<tr>
<td>Manufactures</td>
<td>292</td>
<td>350</td>
<td>19.9</td>
</tr>
<tr>
<td>Re-exports</td>
<td>688</td>
<td>663</td>
<td>-3.6</td>
</tr>
<tr>
<td>Merchandise imports (cif)</td>
<td>-4,320</td>
<td>-6,149</td>
<td>-42.3</td>
</tr>
<tr>
<td><strong>Trade balance</strong></td>
<td><strong>-1,592</strong></td>
<td><strong>-2,924</strong></td>
<td><strong>-83.7</strong></td>
</tr>
<tr>
<td>Invisible trade (net)</td>
<td>1,217</td>
<td>1,348</td>
<td>10.8</td>
</tr>
<tr>
<td>Non-factor services (net)</td>
<td>685</td>
<td>780</td>
<td>13.9</td>
</tr>
<tr>
<td>Tourism</td>
<td>495</td>
<td>517</td>
<td>4.4</td>
</tr>
<tr>
<td>Income (net)</td>
<td>-116</td>
<td>-70</td>
<td>39.7</td>
</tr>
<tr>
<td>Current transfers (net)</td>
<td>649</td>
<td>639</td>
<td>-1.5</td>
</tr>
<tr>
<td>Private transfers</td>
<td>649</td>
<td>639</td>
<td>-1.5</td>
</tr>
<tr>
<td><strong>Current-account balance</strong></td>
<td><strong>-375</strong></td>
<td><strong>-1,576</strong></td>
<td><strong>-320.3</strong></td>
</tr>
<tr>
<td>Balance of payments</td>
<td>117</td>
<td>276</td>
<td>135.9</td>
</tr>
</tbody>
</table>

Leaders from the EAC states—meeting in Arusha, Tanzania, in April, decided to speed up the process of negotiating a common market. Talks will now start on July 1st 2006 and are due to be completed by end-2008. Ratification would follow by June 2009 and implementation would take place on January 1st 2010, a year earlier than originally planned. The process builds on the establishment of an EAC free-trade area and customs union in January 2005. Although this project is advancing successfully, the limitations of the current set-up have become more apparent over time. In particular, the members’ decision to retain separate customs entities in each country, rather than forming a single customs union, has created a raft of disagreements about exactly which provisions and exemptions apply, especially in regard to the common external tariff that applies to trade with non-member countries. Moreover, the free-trade agreement contains no provision for the free movement of labour, which is proving a limiting factor to intra-EAC investment. More practical difficulties, such as inefficient customs posts also remain a problem, although steps are being taken to correct this: plans call for the conversion of the key Malaba crossing between Kenya and Uganda to a “one-stop” facility, open for 24 hours a day. The concept may then be rolled out to other crossing points.

### Exports to East Africa

(US$ m unless otherwise indicated)

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Uganda</strong></td>
<td>404</td>
<td>454</td>
<td>561</td>
</tr>
<tr>
<td>% of total exports</td>
<td>18.7</td>
<td>16.6</td>
<td>17.4</td>
</tr>
<tr>
<td><strong>Tanzania</strong></td>
<td>192</td>
<td>208</td>
<td>263</td>
</tr>
<tr>
<td>% of total exports</td>
<td>8.9</td>
<td>7.6</td>
<td>8.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>596</td>
<td>662</td>
<td>824</td>
</tr>
<tr>
<td>% of total exports</td>
<td>27.6</td>
<td>24.2</td>
<td>25.6</td>
</tr>
</tbody>
</table>


Negotiations towards a common market will have to address these and other issues (such as the harmonisation of labour laws, taxes and investment regimes) as well as the problem of overlapping trade blocs. Kenya and Uganda also belong to COMESA, while Tanzania is a member of the Southern African Development Community (SADC). Nevertheless, despite delays and challenges, sub-regional integration is advancing, and Kenyan exports to its EAC partners grew strongly in 2005, the first year of the customs unions, by 24.5% to US$824m (one-quarter of Kenya’s total exports). This is despite the maintenance of tariffs on some Kenyan exports, by Tanzania and Uganda, for an interim, five-year period. The tariffs are due to finally expire on the day set for the start of the common market. Apart from pursuing economic union, including the eventual adoption of a single currency, the Arusha summit also agreed to push ahead towards the goal of political federation.