The State of Kenya’s Economy
1. Recent Economic Developments

1.1 Highlights over the Last 18 Months

After recovering from four waves of economic shocks, Kenya’s growth improved and reached 2.6 percent of GDP in 2009. This is a moderately strong recovery in view of the global economic crisis and it exceeded growth in Sub-Saharan Africa (see figure 3). As we reported in our first Kenya Economic Update (December 2009), the post-election violence, the food and fuel crisis, the global financial crisis and the 2009 drought almost caused the Kenya’s economy to stagnate. Growth dropped from 7.1 percent in 2007 to 1.6 percent (2008), before reaching 2.6 percent in 2009. In both years the recovery was below population growth and for the second consecutive year the incomes of most Kenyans contracted. Last year’s growth was mainly driven by services and a strong construction sector, overshadowing the low growth in manufacturing and contraction in utilities (see figure 3).

While Kenya has responded to the global shocks very well, the 2009 drought created a heavy toll on economic activity. Despite the global financial crisis, Kenya’s tourism rebounded strongly in 2009 from depressed 2008 levels. Moreover, Kenya’s strong macroeconomic policies and its relatively limited integration in the global economy shielded it from some of the worst aspects of the 2009 global downturn. However, a domestic food crisis developed in 2009 brought on by a severe drought and compounded by weak governance and irregularities in the operations of the government run maize board. In addition, the drought caused enduring electricity short-falls which hit the manufacturing sector.

In 2009, the agriculture sector disappointed again contracting by 2.4 percent. The sector was hit hard by the drought. The situation was most severe for maize, Kenya’s main food staple. Due to shortages and imprudent policies which led to the “maize scandal”, prices increased to double of world market levels hitting the poor especially hard. On a more positive note, the livestock sub sector expanded by 3 percent despite the severe drought as a result of policy incentives and micro credit to dairy farmers, which demonstrates the potential of agriculture once appropriate incentives are in place. The export performance among Kenya’s key export crops has been mixed and partly benefitted from rising prices:

- **Horticulture** exports experienced a double dip of declining output and prices, reflecting a downturn in global demand.
- **Tea**, traditionally Kenya’s strongest export earner, suffered in reduced output from the drought but benefitted from global prices increases.

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• **Coffee** received a double dividend, with both volume and prices increasing. However, coffee accounts for only about 4 percent of Kenya’s exports.

**Industry in 2009 grew at 3.5 percent.** A lot of the growth in industry can be attributed to the construction sub sector (representing 4.2 percent of GDP) which experienced double digit growth (14.1 percent), while the much larger manufacturing sector, at 11 percent of GDP, stagnated at 2.0 percent growth (figure 3).<sup>2</sup> Cement production and cement consumption recorded impressive growth rates, of some 20 percent due to high demand for infrastructure projects. The weak performance in manufacturing was caused by the spillover effects from the drought transmitted through higher costs (and outages) for utilities, water and electricity. However, the sector was also affected by the ban of fish products to the European Union, and a reduction in the import quota for Kenyan garments into the United States of America.

**The service sector continues to drive Kenya’s economy.** Services grew by 4.2 percent led by Communication, Transport and Trade. Tourism rebounded to almost reach 1 million tourists (close to 2007 levels). Kenya’s information and communication revo-

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2 For a summary of all the sectoral shares in the economy and the 2009 growth rates, see Annex 2.
olution continues. Mobile telephone and internet connectivity expanded by another 20 percent. Telephone ownership reached 19.7 million people by end 2009. If this strong growth continues through 2010, statistically every Kenyan above the age of 15 would be connected to mobile services. Internet connectivity had reached 4 million by the end of 2009 (see figure 3).

In 2009, sectors which are mainly producing for the domestic market, so called “non-tradables” which include most of the service sectors and construction, have been doing well. Domestic demand grew at 4.0 percent and led Kenya out of its economic crisis. In 2008, domestic demand, especially private consumption, contracted when the post-election violence interrupted economic activity and when food prices rose sharply. The price of maize, Kenya’s main staple, doubled between early 2008 and mid-2009. Once government removed maize tariffs in mid-2009 and increased imports, the domestic price began declining though still remaining well above international prices. Good production in early 2010 has led to further maize price reductions.

Kenya has also experienced moderate investment flows in the last three years which contributed 2.6 percent to the GDP growth in 2009. The growth in investment was achieved through increased credit supply to the private sector and heavy infrastructure investments by the public sector, part of the stimulus program and planned investments under the government’s Vision 2030 strategy. The current account deficit widened further and negative net exports reduced growth by 2.1 percent (see figure 4).

Kenya’s overall balance of payments returned to surplus in 2009. After declining to -1.6 percent of GDP in 2008, the overall balance of payments reached 3.3 percent of GDP in 2009. This improvement was driven by the surplus in the capital and financial account which increased from 4.0 percent in 2008 to 9.5 percent of GDP in 2009. However, imports and exports contracted reflecting the impact of domestic and external shocks. The current account balance improved to -5.5 percent of GDP in 2009 compared to -6.6 percent in 2008.

Figure 4: Kenya’s Economic Imbalances

Consumption is driving GDP...

...at the expense of a large current account deficit

Source: CBK and World Bank staff estimates
1.2 An Assessment of Kenya’s Crises Management

In the last two years, the Kenyan government has gained a lot of experience in crisis management. The country had to manage four waves of crisis, including the fuel and food crisis, post-election violence, the global financial crisis and a drought. Kenya’s government has managed the global crisis well while the domestic crises have hit the country hardest. In this section, we analyze in particular the government’s macroeconomic response to the global financial crisis, the fiscal stimulus, and the response to rising food prices.

Despite these quadruple shocks, Kenya’s macroeconomic fundamentals continue to improve while microeconomic and institutional challenges have become more pronounced. Inflation has declined to below 5 percent in 2010, and allowed the Central Bank to sharply cut interest rates. A strong fiscal position allowed the government to embark on an ambitious stimulus program focusing on social protection and infrastructure investments. However, the implementation of the stimulus program was disappointing and reinforced Kenya’s challenges in implementing its development budget. The response to the 2009 drought was broadly successful and built around an effective partnership between the government and the international community. At the same time, Kenya’s agricultural policies, especially the inefficiencies in the National Cereals and Produce Board (NCPB), have created a large burden on the government’s effort to accelerate growth and reduce poverty.

CBK continued implementing expansionary monetary policy and consistently reduced the Central Bank Rate (CBR) rate by 150 basis points in 2009. The CBK adopted this policy to stimulate the economy and broadly achieved the intended results. The Treasury bill rate declined by 156 basis points which also helped the government to finance the fiscal stimulus program at lower interest rates (see figure 5). These measures helped to expand credit supply by another 7.2 percent of GDP in 2009 to stimulate the economy.

![Figure 5: A Stable Macroeconomic Environment](source: CBK and World Bank staff estimates)

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**Figure 5: A Stable Macroeconomic Environment**

Inflation declined sharply, ... T-Bill rates (91 days) respond to counter cyclical monetary policy ...

...and the exchange rate remained stable

Source: CBK and World Bank staff estimates
Kenya’s sharp decline in inflation has allowed the Central Bank to lower its policy rate which has not been fully translated into lower commercial bank lending rates, yet. Kenya’s inflation rate has declined substantially from 19 percent end 2008 to below 5 percent in March 2010.³ Commercial Banks have been slower to lower interest rates because of an additional risk premium in the context of the global financial crisis and Kenya’s sluggish economic performance. As a result, the spread between commercial bank lending and deposit rates remained relatively high, in spite of the decline in the CBR (see figure 6). However, even more aggressive Central Bank policies that reduced its lending rates much further in 2010 have started to lead to lower overall lending rates for commercial banks, as other compensating factors such as cost of funds and credit risk have also started to subside. Overall the banking sector remains stable registering high capital adequacy, high liquidity ratios and declining share of nonperforming loans to total loans (from 7.1 percent in 2008 to 6.8 percent by the end of 2009).

Credit to the private sector increased substantially by 5.4 percent of GDP in 2009. Most of this credit went to investments in the service and construction sectors which have shown the greatest response when credit terms become more attractive. Credit to households contracted by about -1.0 percent of GDP in 2009 (reflecting increased credit risk by banks), while credit to government increased by 2.8 percent of GDP in 2009 in line with the stimulus package (see figure 6).

The government also responded to the global downturn by formulating a Kshs 22 billion (US$ 300 million, 0.9 percent of GDP) fiscal stimulus program. The fiscal stimulus focused mainly on social sectors, including social protection and infrastructure investments. The global crisis provided an opportunity to implement critical public investments that Kenya would also need in normal times. The fiscal stimulus was complemented by other measures that responded to the domestic food crisis, such as duty exemption on maize.

For the fiscal year 2009/10 revenues fell short of program targets, although indirect domestic taxes exceeded the budget estimates. The highest short-fall in revenues stemmed from trade taxes as a result of duty exemption on imported maize. The strong revenue performance for indirect taxes, especially VAT, has continued through the first quarter of 2010. As the government continues to face difficulty in implementing its development budget, the overall fiscal deficit for FY2009/10 is likely to be below 5 percent (compared to 6.6 percent in the budget).

³ The numbers reflect the government’s new computation methodology, introduced in October 2009, which brought the Kenyan measurement in line with international standard.
The State of Kenya’s Economy

The implementation of the fiscal stimulus has proven as difficult as the regular development budget. By end-March 2010, about Kshs 13 billion, 57 percent of the program, had been disbursed (see figure 7). The bulk of the funds were allocated to education, public health and rural infrastructure. The low levels of disbursements can be attributed to problems in the education sector following allegations of corruption in programs administered by the Ministry of Education. With only 3 months to the end of the fiscal year, it is unlikely that the full stimulus will be implemented.

While the government’s response to the financial crisis was very strong, the response to the food crisis was belated and weak. Kenya has traditionally followed a high maize price policy which benefits a small number of maize farmers. However, in 2009 the prices reached levels never seen before. Kenya’s maize prices increased sharply since the onset of the global food crisis in 2008. However in 2009, when international maize prices declined, Kenya’s consumers had to pay ever higher prices, on average double the international price. While domestic shocks (political violence and drought) contributed to the sharp increase of maize prices, Kenya’s agricultural policies also played an important role.

The most recent and prominent example of poor policy was the government’s “subsidized maize scheme”. In May 2008, at a time when global and local maize prices had almost doubled compared to a year earlier, the government established a complicated subsidy scheme aimed at stabilizing the price of maize. Instead of opening the market for imports, the government opted for a maize scheme that tasked NCPB to import three million 90kg-bags for the strategic grain reserve and to distribute the maize at prices fixed at Kshs 1,700 per bag to maize millers. This price level was equivalent to a 50 percent subsidy and millers were expected to forward the subsidy to consumers.

The implementation of this policy achieved the opposite results it intended: maize prices kept on rising at a time when global prices retreated to pre-crisis levels. The subsidy scheme failed because all economic incentives were aligned against its implementation. Most market players had the option to sell subsidized maize at market prices and Kenya did not have the institutional strength to enforce subsidies across Kenya. If governments with weak implementation capacity try to set prices different from the market, it often results in more opportunities for corruption, instead of benefits for the poor.

In the end, a small number of groups benefitted from the allocation of the low price maize. As expected the scheme created opportunities for corruption and misconduct. According to a conservative estimate (PriceWaterhouseCoopers), at least 27 percent of the maize did not go to millers but directly to traders who then sold the maize at a substantial margin. In addition, 50 percent of all maize allocations of the scheme’s first phase went

![Figure 7: Fiscal Stimulus: 57 percent disbursment after nine months](source: Ministry of Finance; Status: End March 2010)

![Figure 8: Maize prices are coming down after Kenyans paid a high price](source: World Bank commodity price data-stream; Regional Agricultural Trade Intelligence Network)
to only 10 companies, including a transport company which was not known to be an active player in Kenya’s maize markets. By March 2009, when maize prices reached record highs (close to US$ 400 per metric ton) and double the international prices, the system broke down and government abandoned it. By end 2009 prices started to decline due to the suspension of the duty on maize imports and good rains which led to a bumper harvest in early 2010 (see figure 8).

2. Outlook for 2010 and 2011 — the Recovery Continues

Towards the end of 2009 Kenya’s economy started to recover more strongly and this positive momentum has been sustained into the first months of 2010. Favorable weather, a relatively stable domestic environment, and pro-active government policies led to mostly positive developments in the economy, for example:

- **Agriculture production improved.** As a result of strong rains in early 2010, agricultural output rebounded. Production of various commodities increased including the staples, maize and beans, which led to decline in prices.

- **Tourism back at 2007 levels.** Tourist arrivals registered a 18.9 percent growth in the first quarter of 2010 compared to the same period last year and equaled 2007 arrivals.

- **Inflation and interest rates declined.** In the first quarter of 2010, inflation declined further to 4.6 percent after it reached 5.6 percent in the fourth quarter of 2009. The interest rate of the standard Treasury bill (91 days) declined as well to average at 6.2 percent.

- **Credit increased.** Credit grew by 20 percent in the first quarter of 2010, with credit to public sector growth of 44 percent and to private sector growth of 14 percent.

- **Fiscal position remained stable.** The fiscal position remained strong and the fiscal deficit is likely to be lower at 4 - 4.5 percent, more than 2 percent below the budget. Revenues remain broadly on target by end-December, recording a performance rate of 97 percent, and a revenue growth of 11.7 percent. However, expenditures will fall short of initial plans due to the government’s difficulties in implementing both its development budget and its domestic stimulus package (see previous section).

- **Stock market rebounded.** The Nairobi Stock Exchange (NSE) index rebounded and reached close to 4300 points in May 2010, up from a low of 2500 points in February 2009. This recovery was primarily due to foreign investment, which indicates the improved confidence in the Kenya market as a whole. Since the beginning of the financial crisis, the NSE has moved in parallel with the Dow Jones. And since early 2010, the NSE has outperformed the Dow Jones.

Building on these broadly positive trends, the World Bank is revising its growth projection for 2010 upward to 4.0 percent.

There is even the possibility that Kenya grows at a rate above 4 percent in 2010, especially if agriculture and manufacturing rebound very strongly which would depend mainly on continued favorable weather (see figure 9). This positive trend registers an important improvement compared to the sluggish performance of the last two years. And for the first time since 2007 the average income of Ken-

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**Figure 9:** Growth will rebound: high growth is possible in 2011 if Kenya does not experience shocks

Source: World Bank Staff Estimates
The State of Kenya's Economy

GDP will rise by about 1.3 percent. In the absence of any new shocks, the World Bank estimates that the recovery will accelerate in 2011 to 4.9 percent which would bring Kenya back into the range of high growth experienced between 2003 and 2007. But if Kenya experiences another exogenous shock, political volatility, or a less conducive external environment, growth could be more subdued at around 3.0 percent.

Consumption will continue to be the key driver for growth, benefitting from higher agricultural incomes and weaker inflationary pressures. Private consumption growth is projected to grow at 3.2 percent. Government consumption will increase by 4.1 percent, partly explained by the (delayed) implementation of the economic stimulus program (see table 1).

The highest growth will be in investment in the near term as countercyclical fiscal and monetary policies start to pay off. Investment is projected to grow by 8.4 percent in 2010, accelerating to 11.9 percent in 2011. Public sector investment will continue to play a catalytic role with heavy investments in infrastructure, particularly roads and energy, crowding in private sector investment, which would also benefit from lower interest rates.

Exports will recover in 2010 reflecting the more positive regional and global environment, but the current account deficit will remain large. The demand for Kenyan exports will resume, especially in Europe and Sub Sahara Africa, the destinations of more than 60 percent of Kenya’s exports. Kenya’s export market growth is projected at 5.2 percent in 2010, accelerating to about 6.5 percent in 2011-2012. Kenya’s merchandise exports will grow much less rapidly than world merchandise exports, and indeed than developing countries’ merchandise exports, translating into a continued loss of market share for Kenyan exports, and for manufacturing exports in particular. A strong recovery in tourism, albeit from a low base, will boost service exports.

Strong domestic demand and higher international commodity prices will accelerate import growth which in turn will perpetuate the structural current account deficit. In 2010, imports and exports will recover; the surplus in the service account will not be sufficient to offset the deficit in the goods trade. The current account deficit is projected to reach 6.6 percent of GDP in 2010 before it will narrow slightly in 2011 to 6.0 percent (see table 1).

The economic recovery will be felt across all sectors. Agriculture is expected to rebound the strongest while services will continue to drive the economy, for the following reasons:

- **Agriculture.** The sector is rain fed and is expected to enjoy a good year as most parts of the country will receive above average rainfall. The good harvest will cap the pressure on domestic food prices. Furthermore, government investment in irrigation will also increase food supply boosting consumption.

- **Industry.** Output will normalize in 2010, benefitting from more normal power provision as well

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Table 1: Key Indicators 2007-2012 (Base Case)

<table>
<thead>
<tr>
<th>Variable</th>
<th>2007</th>
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<th>2009</th>
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<th>2011</th>
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<td>3.2</td>
<td>3.9</td>
<td>4.2</td>
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<tr>
<td>Government Consumption</td>
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<td>3.7</td>
<td>5.5</td>
<td>4.1</td>
<td>3.4</td>
<td>4.0</td>
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<tr>
<td>Gross Fixed Investment</td>
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<td>0.6</td>
<td>6.7</td>
<td>8.5</td>
<td>11.8</td>
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<td>6.2</td>
<td>7.6</td>
<td>5.5</td>
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<td>-0.2</td>
<td>5.5</td>
<td>6.1</td>
<td>6.6</td>
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<td>-6.6</td>
<td>-5.5</td>
<td>-6.6</td>
<td>-6.0</td>
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<tr>
<td>Population Growth</td>
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<td>2.8</td>
<td>2.7</td>
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<tr>
<td>Statistical Discrepancy (share of GDP)</td>
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<td>-1.3</td>
<td>-1.3</td>
<td>-1.3</td>
<td>-1.3</td>
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</table>

Source: World Bank Staff estimates; GNFS: Goods and Non Factor Services

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* Growth in the Euro area is projected at 0.9 percent in 2010 and 1.5 percent in 2011. Growth in the EU is projected at 1.1 percent and 1.8 percent in 2010 and 2011 (Global Economic Prospects, January 2010).
as increased credit supply to the private sector. Construction continues to lead economic recovery, stemming also from high public investment in infrastructure.

- **Services.** Transport, communications, tourism and domestic trade are the major sectors driving the economy and are also leading the economic recovery. Tourism arrivals show a positive trend and together with aggressive market diversification by government and the 2010 FIFA World Cup in South Africa, the sector is expected to perform strongly.

**Figure 10: In the next two years, Kenya’s growth will be similar to the SSA average**

If realized, Kenya’s growth rates will be close to the average for Sub Saharan Africa of 4.4 percent in 2010 and 5.0 percent in 2011. Nevertheless, for the third consecutive year, Kenya’s growth will continue to lag behind its neighbors. Kenya’s expected growth performance will be significantly lower than the projected growth rates for Uganda, Tanzania, Ethiopia, Rwanda and Ghana (see figure 10). However, the strong growth rates of Kenya’s neighbors create opportunities for increased market manufacturing exports, as well as an increase in transport exports.

The projected recovery remains fragile due to the risk of political instability in the run up to the 2010 constitution referendum. In the last two years domestic shocks have severely interrupted Kenya’s quest for growth. Therefore, the outcome from the constitution review process is a critical determinant for Kenya’s economic performance in 2010 and 2011. These domestic shocks, especially political instability, remain Kenya’s most important risk to sustained growth and poverty reduction. In the coming months, the first important test will be a peaceful referendum on the new constitution, which will in turn give a first indication of the political risks heading towards the 2012 national elections.

**The sovereign debt crisis in Greece and the recent closing of Europe’s airspace also highlight the potential of continued international risks.** Even though Kenya’s economy is less dependent on exports than in the past, Kenya’s highest value exports, especially horticulture and tourism, remain very concentrated and depend on European markets. This high degree of export concentration makes Kenya vulnerable to localized shocks and points to the need to further diversify export markets. A continuation and spreading of the Greek sovereign debt crisis could generate a general flight to developed countries which would result in an increase of borrowing costs for developing countries. In addition, the ongoing depreciation of the euro against other currencies, including the Kenya Shilling, made Kenya’s exports to Europe already 7 percent more expensive since the Greek debt crisis begun in March. If this crisis degenerates into a new global downturn, investment across the world would fall, bringing the world economy into a double dip scenario, which would also again impact on African economies.

**3. Running on One Engine — Analyzing Kenya’s Economic Imbalances**

**3.1 Taking Stock of a Poor Export Performance**

Over the last 50 years, Kenya has neglected its export sector. In 1960, exports represented 40 percent of Kenya’s economy. This share of global integration was artificially high as it was also the result of Kenya’s colonial status and the resulting exports to Britain. However, since the mid-sixties Kenya’s exports declined more than expected. It bottomed at 20 percent of GDP in the mid 1980s, before the sector partly recovered to 27 percent by the end 2000s. Many of the world’s successful economies – including Ireland, China, Korea and Chile – followed the opposite strategy and considerably increased their exports in GDP over the same...
period. Korea, for example, which had similar levels of income to Kenya in 1960, increased its exports from almost zero percent in 1960 to more than 55 percent today.

At independence Kenya had a relatively sophisticated industrial base and a vibrant export sector; a strong foundation for turning these sectors into major engines of growth. However, Kenya has turned inward, neglecting to stay competitive in its manufacturing sub-sector, and also losing market share in agriculture exports. Government interventions in commodity exports, especially through marketing boards, created disincentives for farmers to produce and led to a long-term decline in the coffee sector from which Kenya has yet to recover. In the few episodes when the country grew strongly, such as between 2003 and 2007, the driver was domestic consumption which has fuelled the growth of non-tradables, especially the service sector, which is now also representing an increasing share in Kenya’s exports.

Kenya gradually lost export shares in the global market and Sub Sahara Africa. In 1970 Kenya’s export shares represented 0.12 percent of global exports, but this has continuously declined reaching only 0.04 percent in 2008. Kenya’s export growth lagged behind the average for Sub Sahara Africa. Its share of exports in the region declined from 3.7 percent in 1970 to 2.2 percent in 2008. Kenya’s traditional strength in service exports has also been eroded over time declining from a global share of 0.21 percent in 1970 to 0.06 percent in 2000 before it recovered slightly to 0.09 percent in 2009 (see figure 11).

3.2 The 2000s — Economic Imbalances Widen Despite Better Growth Performance

Over the last decade Kenya’s economic performance improved averaging 3.7 percent, despite a series of negative shocks in the last two years. However, the key driver of the growth continued to be domestic demand, especially private consumption which accounts for about 75 percent of GDP. The share of exports in GDP increased only marginally while imports soared. As a result the contribution of “net exports” (exports minus imports) to growth was negative and widening (see figure 12). Kenya’s growth thus heavily relied on one engine, domestic demand. Although the external account remains broadly sustainable, the domestic shocks of 2008 and 2009 have demonstrated Kenya’s vulnerabilities. If the economy relies heavily on domestic consumption, it can grind to a halt when negative domestic shocks hit the economy.

Ten years ago, Kenya’s exports could pay for two thirds of its imports — today, exports pay for less than half of its imports. Furthermore, Kenya’s competitiveness—measured through the Terms of Trade—has equally deteriorated, declining from 100 in 2001, to 83 by 2007 before improving marginally in 2008 and 2009. Kenya’s Terms of Trade are now substantially lower than those for Uganda and Tanzania. The strength of the domestic sector and the weakness in exports have created a large and growing current account deficit which had reached 5.5 percent of GDP by end 2009. This current account deficit was mainly financed by increasing short term financial inflows (see section 1).

Figure 11: Kenya’s Share in World Exports of Goods and Services. 1970-2008

Source: World Bank WDI

Kenya has turned inward, neglecting to stay competitive in its manufacturing sub-sector, and also losing market share in agriculture exports.

1 Terms of trade are defined as the ratio of export unit value indexes to import unit value indexes (see World Bank 2010. World Development Indicators)
While the exports of goods have shown mixed results, service exports have recovered and increased from 8 percent in 2000 to 12 percent of GDP in 2009. Total exports increased from 22 percent in 2000 to 28 percent in 2005, but have stagnated since. This strong increase between 2000 and 2005 was mainly due to the increase in services exports from 8 to 10 percent of GDP, as well as the increase in manufactured exports, from about 3 percent in 2000 to close to 6 percent in 2005 (part of the increase in manufactured exports between 2003-2005 is due to the increase in the export capacity of the Export Processing Zone). However, the exports of manufactured goods have stagnated since 2005 as a share of GDP, while the exports of non-manufactured goods (agricultural and mineral exports) have slightly decreased. By contrast, service exports increased to 12 percent of GDP in 2009 from 10 percent in 2005 (reaching levels previously attained in the 1990-1995 period).

There are also some glimmers of hope for Kenya’s exports because of the ongoing diversifications in the country’s export package. Over the last decade, for example, Kenya has moved towards higher value products and there is also potential to develop new products. Comparing Kenya’s export package between 2003 and 2007 Kenya gained comparative advantage in chemicals and allied products, stones plaster and cement and food (See Annex 3).

But Kenya can do even better. By one measure of diversification which ranks countries by the number of products they have “a Revealed Comparative Advantage (RCA) in”, Kenya scores above-average with 747 products. This is a key asset the country can build on to further strengthen its goods and/or manufactured exports. Countries with diverse exports have more diverse capabilities as an economy, and hence are more likely to innovate and expand exports to include new product lines.

If recent trends continue, service exports will maintain their growth momentum. Kenya’s service exports are built around its traditional strengths of transport (especially Kenya Airways) and travel which account for 90 percent of the total. Continued growth in Kenya’s neighboring countries, especially Uganda and Ethiopia, will create opportunity for transit services which are expected to improve as ongoing improvements in Kenya’s road infrastructure are completed. Kenya could also see an expansion in tourism, if it succeeds in further diversifying its source markets. One of the newer and more successful service exports is business outsourcing. Starting from a low base and benefitting from recent investments in fiber optic cables which have greatly improved internet connectivity and reliability, Kenya is developing state of the art call centers that have begun attracting global customers.

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4 According to World Bank Staff Calculations, based on the CEPII BACI database (2007). See also Annex 3.
3.3 Kenya’s Economy Has Been Transformed — Differently Than Expected

Over the last decade, Kenya’s economy has experienced a significant structural transformation. As in other emerging economies, the role of agriculture in the economy has been declining from 32 percent (2000) to 26 percent (2009). However, this decline in agriculture has been almost exclusively absorbed by the service sector which increased its share of GDP from 50 percent in 2000 to 55 percent of GDP in 2009. Meanwhile the contribution of the industrial sector to GDP remained broadly the same from 2000 to 2009 at 19 percent.

The incentives for the Kenyan private sector are directed towards the domestic market. As a result, sectors like telecommunications and wholesale & retail trade experienced the highest growth rates during the last decade. Both sectors are now larger than Kenya’s manufacturing sector. To achieve and sustain high levels of growth in the coming years it is important to restart and accelerate the second engine twining Kenya’s vibrant and expanding service sector with a re-energized manufacturing sector that can increase its performance as a source of export growth.

Kenya’s economic transformation of the last decade was fuelled by rapid growth in tradable goods and services. Although the share of service exports increased over the decade, there was limited diversification and the service sector’s exports are still dominated by transport and travel. Between 2000 and 2009, the sectors that recorded average growth rates in excess of 4.0 percent are largely non-tradable while the tradable sectors like agriculture and industry were below the 3.7 percent average growth rate (see figure 13). To increase and sustain broad-based economic growth the structure of production will require reorientation towards the production of tradable goods and services. This can be achieved through incentives to diversify and increase the share of service exports, restart manufactured exports, and gradually reduce the share of government and private consumption in aggregate demand.

Manufacturing has been the growth engine in many emerging developing countries, especially in Asia — but not in Kenya. In 2000, manufacturing was the second largest sub-sector of the economy. In 2004, transport and communication overtook manufacturing. The sector grew at an annual average growth of 7.0 percent, led by an exceptional annual rate of 19 percent in telecommunication throughout the decade.

Figure 13: A decade of sectoral transformation (growth by sectors, 2000-2009)

![Diagram showing sectoral growth and GDP share]

Source: KNBS and World Bank staff estimates
Note: GDP at basic constant 2001 prices
While Kenya’s agricultural sector declined in economic importance there have been important shifts within the sector. Most notably, horticultural has become Kenya’s major export sector, producing flowers and vegetables for European markets. At the same time, exports of the main traditional cash crops, coffee and tea, have mostly stagnated. Over the last decade agriculture grew at low rates, averaging only 1.7 percent per annum. Manufacturing fared better with a per annum growth rate of 3.3 percent but remained below the average of all sectors. In most high growth countries, especially in Asia, manufacturing has been leading economic growth — in Kenya it has been lagging the service sectors. However, manufacturing continues to be the principle tradable sector of emerging economies, and has also the potential to increase Kenya’s export competitiveness.

Kenya’s poor record in industrial production partly explains the economy’s poor export performance despite improvements between 2000 and 2005. Strong domestic demand and poor incentives for export create an environment where investments flow to non-tradable goods, such as real estate and construction, diverting resources (land, labor and capital) from the tradable sectors of the economy.

Kenya’s future growth path will be largely influenced by how it helps to restart the other engines of its economy. Kenya is in a good geographical position with its port and major distribution routes to neighboring countries and global growth poles. There are several strategies already in place which would help Kenya start the other engines of growth, including Vision 2030, the Medium Term Plan 2008-2012, the Private Sector Development Strategy, the Master Plan for Kenya’s Industrial Development, and the National Trade Policy which has already been drafted. However these have not translated into a robust, prioritized and targeted industrial policy for Kenya.

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A secure investment climate and better infrastructure are the essential ingredients for achieving sustained growth. The government has already put a lot of effort in grading roads and launching energy projects, even though implementation has often been slow. Port investments are also critical to ensure Mombasa meets Kenya’s growing import needs without incurring increased costs from port constraints (see also special section in this report). Once transport costs decline and reliable energy supply is secured, Kenya will be able to attract new and larger manufacturing investments.