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Kenya and Uganda: An Assessment of Macroeconomic and Debt Sustainability Prospects

MARCH 2010

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Kenya and Uganda: An Assessment of Macroeconomic and Debt Sustainability Prospects[1]

[1] The opinions expressed in this report are those of the authors and do not represent the views of JICA. The authors of the report are A. Basu, R. Blake, A. Petersen and W. Mahler from the Centennial Group Holdings. The report benefited from extensive comments and suggestions from J. T. Boorman. Ehui Adovor provided valuable research assistance for the project.

Part I Kenya

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Summary and Conclusions

After a long period of stagnation, Kenya achieved an impressive economic recovery with accelerating growth rates during 2003-07. This recovery was broad based across sectors, and supported by a stable political environment, macroeconomic stability and slow but encouraging progress in structural reform (particularly in public finance management, privatization and regulatory reforms). Growth was accompanied by rising trends in the ratios of savings and investment to GDP and substantial growth in exports, tourism receipts, inward private remittances and inflows of foreign direct investment (FDI). Kenya was also able to appreciably reduce its external public debt (through net repayments) and increase its gross official foreign reserves. Unlike its neighbors – Tanzania and Uganda – this impressive economic performance was achieved without any debt forgiveness and with little or no foreign aid (due mainly to continued donor concerns about pervasive corruption).

Unfortunately, soon after the December 2007 Presidential elections the economy was buffeted by a combination of external and domestic shocks. Dispute over the election results led to a political crisis marked by widespread violence that triggered severe economic dislocation. Poor rainfall caused a severe drought, which sharply reduced agricultural output and hurt the livestock sector. Subsequently, the global financial turmoil and economic slowdown has led to declines in exports, tourism receipts, inflows of private remittances and net capital inflows (especially FDI). These shocks have caused sharp drops in savings and investment ratios to GDP, weakened the external current account and the external reserve position. As a result of rising fuel and food prices, the external terms of trade declined, and inflationary pressures-- already aggravated by the drought and the lagged effects of lax monetary policy-- reached high double-digit levels.

Thus far the international global crisis has had limited impact on the banking system and the capital market. The authorities have succeeded in strengthening significantly the financial soundness of the banking sector over the period 2002-2008. Bank capital increased well above the recommended minimum (of 8 percent) and the ratio of non-performing loans to total loans has declined. Nonetheless, the quality of the loan portfolio is likely to deteriorate somewhat for banks exposed to the export and tourism sectors. Although the effects of the economic downturn are not as yet reflected in the available banking data, the latter do suggest that the banking system may have strengthened its ability to cope with future adverse developments due to the improvements observed through 2008. In the capital market, equity prices fell by some 40 percent in the second half of 2008 as portfolio investor confidence declined. While broadly in line with developments in major international exchanges, developments on the Nairobi exchange was also influenced by allegations of fraud among certain stockbrokers. The exit of foreign investors from the stock market was particularly pronounced in the last quarter of 2008. More recently, stock prices have trended moderately upwards.

Although a coalition Government has been in office for some time, internal dissension appears to have stalled decision making on key issues such as constitutional reform and accountability of senior political figures for the post-election violence. Uncertainties resulting from this as well as continued concerns about corruption have made it difficult for Kenya to mobilize external donor support for its economic recovery strategy (ERS) and public investment program (IP). The political situation is also clouded by the risks of regional conflicts in Somalia and potentially also in Sudan. The former could lead to an increase in the influx of refugees and armed thugs that would disrupt both the already scarce supplies of food and firewood and worsen the law and order situation. The latter would disrupt Kenya's exports of manufactured and agricultural products to that country.

On the economic front the authorities face several daunting challenges.

- With the slump in the economy and domestic savings and investment, there is a pressing need to increase public expenditures for health, education, key infrastructure and domestic relief operations in areas affected by the drought and the post-election violence. Unfortunately, resources are lacking for two reasons. First, given the weak growth environment for 2009/10 it was not considered prudent to have any increase in tax rates or in non-tax rates; in fact there were selective reductions in some excise and customs duty rates and some food grain products were exempted from VAT. Second, there is little or no firm commitment that larger amounts of foreign aid would be forthcoming to meet the needs of Kenya.
- As the existing inflationary pressures have been aggravated by the depreciation of the exchange rate in recent months, the monetary authorities are facing the difficult task of dealing with two conflicting objectives – stimulating economic recovery and reducing inflationary pressures. This task has been made even more difficult by a rising fiscal deficit and the resulting increase the domestic public debt.
- The coalition Government needs to address more actively in a united endeavor to act decisively on several issues. These include further credible actions to tackle corruption at high levels, press ahead with the privatization program and fast track regulatory reforms to boost investor confidence and reduce the costs of doing business.

If the coalition Government can be nudged by domestic civil society groups, responsible elderly statesmen, African leaders and the international community to forge a more cooperative governing team, Kenya has the potential to stage another impressive economic recovery. We see this potential recovery for the following reasons:

- There could be progress in implementing pending structural reforms as was the case during the last period of political stability (2003-07).
- Some measure of confidence would return with progress towards political stability and that could complement the effects of reforms to trigger the recovery of FDI inflows, inward private remittances and tourism receipts.
- The hesitancy of donors to be forthcoming with aid commitments would most likely be somewhat reduced, more so if some measures are also taken to deal with corruption. Indeed, even if some donors initially responded by providing the necessary support for capacity building and technical assistance in key areas of public sector project

management (for example, the evaluation, selection, implementation and monitoring of essential infrastructure projects), progress could be made towards alleviating key bottlenecks to launching infrastructure projects.

- As ratios of GDP, exports and revenues, Kenya's external debt stock (in present value terms) and debt service payments are currently relatively low (in fact, well below the relevant policy/CPIA- based thresholds for these indicators used for IMF/IDA DSAs). Hence, there is certainly ample scope for donors to provide concessional loans, particularly if the institutional capacity for productively using the increased resources can be concurrently developed.

Assessments of Kenya's macroeconomic medium- and long-term outlook have had to be repeatedly revised by both the Kenyan authorities and the IMF, given the uncertainties surrounding the severity and duration of the global financial turmoil and economic slowdown. Initially, the Government had formulated an ambitious long-term investment program in the context of its Vision 2030 plan. It envisaged raising the investment/GDP ratio to 32.6 percent and the savings/GDP ratio to 27.7 percent by fiscal year 2012/13 to achieve a growth rate of 10 percent by that year. The implicit ICOR (the incremental capital-output ratio) was assumed to be only 3.3 based on projected gains in productivity due to infrastructure investments and structural reforms aimed at developing the private sector. The external current account deficit would be reduced by 2 percentage points to 5 percent over the same period. Inflation would be reduced to 5 percent by 2009/10. Once the authorities had assessed the effects on the economy of the post-election crisis, the drought and the global economic slowdown, they prepared much less optimistic macroeconomic forecasts, including a 6 percent growth rate underpinned by much lower ratios of savings (19 percent) and investment (23.3 percent) to GDP. The revised growth forecast implied a noticeably higher ICOR (of 4.3). Although the IMF's initial macroeconomic forecasts in its 2008 DSA were roughly in line with the authorities' revised forecasts, it made major revisions to its macroeconomic forecasts for the 2009 DSA. Its May 2009 forecasts for the ratios of investment, savings, exports and imports to GDP were noticeably lower than those used for its previous (2008) DSA exercise.

Faced with the same uncertainties, we were cautious in developing our baseline macroeconomic scenario which differs from the IMF in the following respects:

- Our growth forecasts are lower because the long rains in April to June 2009 have been poorer than earlier expected and as a result agricultural recovery will be hurt.
- We expect the global economy to be somewhat weaker than earlier expected (in line with IMF and World Bank assessments). This is likely to result in slower growth rates in exports and real GDP and hence, a slower pace of economic recovery than assumed in the IMF scenario. We expect higher current account deficits than in the IMF DSA, even though we have assumed a slower growth rate of imports in line with our lower GDP growth assumption.
- Finally, while the IMF assumed a moderate depreciation of the Ksh against the US dollar (to about Ksh84/$) in 2009 it projected a subsequent appreciation of the Kenyan Shilling to Ksh 74.3/$. We have used the more depreciated exchange rate throughout the projection period in our scenario. In deciding to do this we took into account several

factors including (i) emerging cost pressures in the coffee sector, (ii) the non-negligible cumulative real effective appreciation of the exchange rate (even if one applies a reasonable discount to the over-estimated domestic inflation data), and (iii) the pressures on the exchange rate that are very likely to arise due to the generally weak outlook for the external current account, FDI and other private and official capital inflows in the current global environment. In these circumstances, the authorities would have to imprudently use its foreign reserves to defend the exchange rate against likely market pressures. We have assumed that the authorities will not try to defend the rate against market pressures. (This being said, under Kenya's managed floating rate system, an appreciation of the exchange rate would be considered a normal outcome if the external current and capital were to improve noticeably.)

- We project larger budget deficits during 2011-12, because we expect expenditure/GDP ratios to remain high as a result of populist expenditure measures emerging in the years leading up to the 2012 elections.

Despite the above differences in baseline scenarios, we agree with the IMF/IDA assessment that Kenya faces a low degree of debt distress. This is because in our less optimistic scenario the time paths of all projected external debt indicators are well below the applicable CPIA-based thresholds under the baseline as well as the alternative scenarios and related stress tests. Accordingly, the notable difference between our and the IMF's DSA results is that the external DSA results show that over the projection period (2009-29) the key debt stock ratios to GDP, exports and revenue, and the debt service ratios to exports and revenues resulting from our baseline scenario are all generally higher than those resulting from the IMF baseline scenario. The same is true for the alternative scenarios and stress tests. This is because in our scenario the time paths for the growth forecasts are lower, the ratios of the fiscal deficits and external deficits to GDP are higher, and the exchange rate is more depreciated.

In general these results suggest that the Government has a very manageable external debt burden. This is mainly because it has had very limited support from the international donor community and has made net repayments over the years. Also, most of its debt is owed to multilateral and bilateral official creditors; only about 2 percent is owed to commercial creditors (basically disputed claims that are currently under negotiation). As a result, the average interest rate is very low, and the average grace and maturity periods are fairly long reflecting the highly concessional terms of loans from bilateral and multilateral creditors. Consequently, the external debt service burden is quite low. As Kenya's external debt burden was assessed to be sustainable, it did not have access to HIPC and MDRI debt relief. It is also worth noting that, the currency composition of the external debt is well diversified.

Kenya has an ample margin for new foreign borrowing. Since the relatively positive results of both our and the IMF's external DSAs were obtained after including a long stream of annual drawings of commercial foreign loans, it is worth noting that reasonable amounts of commercial foreign borrowing would not jeopardize Kenya's debt sustainability. Nonetheless, the justification for such borrowing would need to be carefully assessed with due regard to exploring less costly alternatives. We assessed the

impact on the external DSA results of replacing the annual amounts of commercial loan disbursements with similar amounts of concessional Yen loans (with the same disbursement profile). The latter would yield some savings because the time paths of the debt stock and debt service indicators with commercial loans included in the DSA are noticeably higher than the corresponding time paths of these indicators derived with yen loans replacing the commercial loan.

While Kenya's external debt burden is clearly very manageable, the results for public debt sustainability suggest some need for caution in managing the total public debt (including both external and domestic). This is mainly because a relatively large share of revenues is being used for debt servicing at the expense of development outlays. Both commercial foreign borrowing and domestic borrowing (which is all on commercial terms) would increase debt service payments more than an equivalent amount of concessional foreign borrowing. There is also some need to be cautious in increasing the domestic public debt so as to avoid pushing domestic interest rates to levels that would begin to crowd out the private sector. It is also worth noting that the domestic debt service burden may worsen when (i) there is a final determination of the contingent liabilities for 24 parastatals and the National Social Security Fund (now being studied by a consultant firm), and (ii) the Government decides on steps to deal with the accumulated claims against the Government's pay-as-you-go pension scheme for civil servants. In these circumstances, it would make sense to adopt some prudent fiscal guidelines for public sector borrowing.

These guidelines could usefully focus on sound management of public debt and public expenditure:

- Foreign borrowing, especially commercial foreign borrowing, should be justified in terms of their contribution to productive or productivity-enhancing projects, and accompanied by adequate safeguards against the misuse of funds.

- It would be important for the authorities to persevere with their efforts to improve efficiency of public expenditure and revenue collection, and better prioritize the use of existing public resources.

- Relying on concessional foreign borrowing could provide multiple benefits for Kenya. In addition to providing concessional financing for projects, donors could assist with capacity building and technical assistance to address the absorptive capacity constraints and develop the project management institutions and skills that Kenya needs. Access to concessional assistance would also help Kenya's efforts to prudently manage the domestic public debt, as it could be helpful in containing upward pressures on domestic interest rates, improving public debt dynamics, increasing the fiscal space for priority public expenditures, and avoiding "crowding out" the private sector.

- Kenya's foreign borrowing should be consistent with its Medium-term Budget forecasts and Development Expenditure Programs. This is essential because they provide a

framework for effective coordination among government, donors and creditors and for mobilizing the necessary financing from the international donor community.

- Finally, Kenya would also have to guard against the risk of falling prey to private lenders who might find it opportune to benefit from free-riding (by lending on non-concessional terms while IDA and bilateral creditors are disbursing concessional loans). To address such free-riding concerns, consideration should be given to putting in place an appropriate legal framework that provides clear criteria for limiting the public sector's access to non-concessional loans from either commercial or official creditors.

While the Government sees a need to substantially scale up its development **spending, it faces significant institutional and capacity constraints to achieve such a scaling up.** It needs to (i) build an adequate capacity to assess the viability of potential public investments, (ii) establish a value-for money function within the government, (iii) develop the skills and internal governmental processes to ensure that project selection is based on a careful cost-benefit analysis, and (iv) put in place well trained staff who can manage, monitor and evaluate the implementation of major development projects. Moreover, the capacity to implement some productivity-enhancing projects, especially large infrastructure projects, is often constrained by problems in mobilizing the required financing, engaging the necessary managerial and technical know-how and obtaining the appropriate policy assurances and regulatory safeguards required for their successful implementation.

To address these constraints, Kenya could benefit from the following:

- The authorities could approach the donor community, including the World Bank and JICA, to obtain the much needed support for creating the institutions and capacities for managing its development projects and programs.

- When there are constraints (as noted above) to implementing large productivity-enhancing projects, especially infrastructure, a joint involvement of the Kenyan Government, the private sector and official and bilateral donors could be an efficient way of addressing the constraints and moving ahead with the project. This is because the various stakeholders in the project can contribute to removing the constraints. Each participant in the project can contribute to the necessary financing and be involved in fair risk sharing. The Government can provide assurances regarding its policies with regard to the pricing of the services or goods derived from the project, and the regulatory environment. Private investors could provide a part of the financing as well as the managerial and technical know-how required for implementing the project. Multilateral development financing institutions such as the World Bank could help the Government explore ways to use IFC, IDA and MIGA guarantees, and options for leveraging private finance for infrastructure investments. Bilateral official agencies could also help to catalyze financing from a variety of sources for such projects, if they are deemed to be a financially viable long term project.

- Kenya should work with the IFC to boost foreign direct investment in the private sector.

In addition, Kenya should seek help from donors -- especially multilateral aid agencies -- who can provide concessional loans for not only financing public sector projects but also for supporting private investment. The latter could involve the following:

- As noted above, such loans could facilitate much needed foreign direct investment through co-financing, equity participation and/or guarantees. This being said, because of perceived weaknesses of governance of many private sector entities in Kenya, it will be important to ensure that the private entities to be considered for such loans have strong internal governance, accurate and reliable accounting, and complete transparency.

- Such loans could catalyze funding from a variety of sources (potentially through syndicated lending, parallel lending and other forms of concerted international lending operations) for essential infrastructure and major sectoral and regional development projects.

Given its large financing needs and the difficulties of mobilizing substantial resources in the current global environment, Kenya would be best served by adopting a balanced external financing strategy for its investment program. In addition to mobilizing concessional foreign aid, this should include parallel efforts to encourage inward private remittances, and attract FDI through further improvements in the business environment and investment climate. These external resource mobilization efforts would have to be complemented by concrete steps to improve the efficiency of public expenditure and revenue mobilization, advance the privatization program, and boost domestic private savings.

Kenya has a good payments record. Following the Paris Club's 2004 debt treatments, the rescheduled claims including the rescheduled arrears were all fully repaid after the agreements on debt treatments were in place. Although Kenya's low-income level led it to be considered under the Enhanced HIPC initiative, it was deemed not to qualify because of the sustainable level of its debt. It has regularly met its obligations to creditors, except for disputed arrears to commercial creditors (of about $91 million at end-2008). These arrears stem from non-payment on commercial export credits for security-related contracts, many of which have been found by Kenya's Comptroller and Auditor-General to be fraudulent or deeply flawed (these projects are often referred to as the "Anglo-Leasing" scandal). The authorities disputed the validity of the claims based on the contracts not being fulfilled. To provide a basis for the resolution of the disputes, they are having an external audit done by PricewaterhouseCoopers to determine the value of the goods and services supplied.

Section I. Overview of Recent Macroeconomic Developments and Outlook

1. Recent macroeconomic developments

(a) Growth performance

1. During the 1990s growth had averaged around 2 percent on a slightly declining trend. Kenya's growth performance was significantly below that of its neighbors and of that of Sub-Saharan Africa (Table 1). Kenya's Ministry of State for Planning and Vision 2030 has been quite candid and critical about the Government's record of both economic performance and policy implementation in its End Term Review of the Economic Recovery Strategy (ERS) for Wealth Creation (Box 1).

Section I Table 1. Real rates growth of GDP for selected African countries 1997-2008
(In percent)

	1997-2002	2003-2007	2003	2004	2005	2006	2007	2008
Kenya	1.9	5.3	2.8	4.6	5.9	6.4	7.1	1.7
Tanzania	4.8	7.2	6.9	7.8	7.4	6.7	7.1	7.4
Uganda	6.1	7.8	6.5	6.8	6.3	10.8	8.4	9.0
Sub-Saharan Africa	4.1	6.3	5.1	7.2	6.2	6.4	6.9	5.5

Source: IMF: Regional Economic Outlook for Sub-Saharan Africa; October 2009

Section I Box 1. Kenya's Economic Performance Until 2002

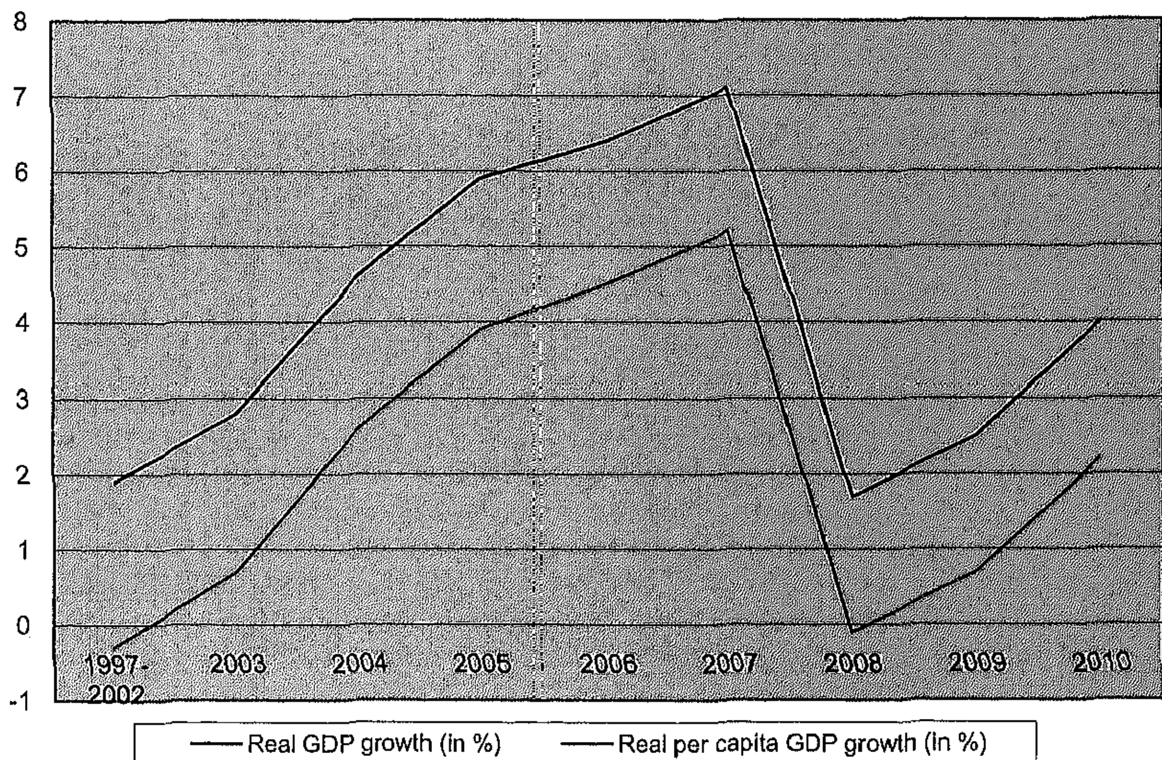
"The Kenyan economy performed poorly and remained in a depressed state for more than two decades running to 2002. The government had previously formulated economic, social and administrative reforms but the commitments to implement them remained weak. In some instances, implementation was carried out haphazardly leading to stalled projects and programs that failed to achieve the set goals and objectives despite high financial costs.

In the 1990s, most of Kenya's economic fundamentals stagnated or even deteriorated. As a result, the real GDP growth declined, for example, to 2.6 percent during 1992-96: down to 1.3 percent during 1997-2001 and then to 1.2 percent in 2002."

Quote from End Term Review of the Economic Recovery Strategy for Wealth Creation (ERS) 2003-2007; Office of the Prime Minister, Ministry of State for Planning and Vision 2030

2. **The incoming "National Rainbow Coalition" government that assumed power in 2002, after peaceful and democratic elections, developed an Economic Recovery Strategy (ERS) that was largely successful in turning the economy around, and achieved several of its goals.** In particular, Kenya's real GDP growth rate improved gradually from 0.5 percent in 2002 to 7 percent in 2007, and by that year Kenya had achieved growth rates comparable to other good performers in Africa. As a result, per capita income increased over the period (Chart 1) and the incidence of poverty declined from 56.8 percent in 2002 to 45.9 percent in 2006, slightly more than the targeted decline of 5 percentage points.

Section I Chart 1: Real GDP growth and Per Capita real GDP growth



3. **Not all the objectives of the ERS were met. The authorities had noted in their** "End Term Review" that in a majority of cases there was an inadequate flow of budgetary resources to meet the targeted objectives. However, the under-performance also reflected institutional and capacity constraints in implementing and managing development projects and programs. Therefore, the latter as well as financial constraints had to be taken into account in reformulating the ERS strategy. The ERS was revised in consultation with development partners by drawing up an Investment Programme (ERS-IP). However, the emergence of the Anglo-Leasing scandal in the early phase of implementation derailed donor support for the Investment Programme. Also, the

legislative process led to delays in introducing key reforms and political differences arose over the draft constitution.

4. **In spite of shortcomings, the period 2003-2007 represented a decisive break with the past.** The strong performance over the period reflected several factors. Most notably:

- Progress in critical areas of financial management, governance and the business climate.
- A rising trend in the investment/GDP ratio, accompanied by a more gradual increase in the savings/GDP ratio
- A rising trend in the ratio of exports of goods and services to GDP, especially tourism receipts, as well as in the ratio of inward remittances to GDP. In addition to household consumption, remittances have supported private investments, mostly in real estate.

5. **Real GDP growth was relatively broad-based.** However, growth rates trended upwards more rapidly in mining and manufacturing, wholesale and retail trade, hotels and restaurants, transport and communications, and financial intermediation. In particular, in 2007 the trade, hotel and restaurants, and transport and communication sectors registered growth rates of as much as 11.5, 16.3, and 15.1 percent, respectively, in real terms.

6. **The recovery of Kenya's growth rates over the period 2003-07, following a long period of stagnation, was halted in 2008 by a combination of several shocks.** In 2008, the economy was buffeted by domestic and external economic shocks, which combined to reduce the real rate of growth to 1.7 percent. The shocks included: (i) the post-election political crisis, which triggered widespread economic dislocations; (ii) poor and erratic rainfall, which reduced agricultural production; (iii) the surge in fuel and food prices, which led to a deterioration in the external terms of trade; and (iv) the global financial crisis and economic slowdown, which had severe secondary effects on the Kenyan economy.

7. **The end-2007 presidential elections were closely contested, and the release of results on December 30 led to an outbreak of violence and Kenya's worst humanitarian crisis since independence.** The opposition party and its supporters rejected the declared victory of incumbent President Mwai Kibaki, alleging it was the result of rampant rigging. Protests degenerated into widespread violence as decades of economic frustration and ethnic rivalry spiraled out of control. Estimates indicate that in all, more than 1,200 people were killed and some 350,000 displaced into temporary camps, with an equal number seeking refuge with friends or relatives. Asked by the African Union to intermediate, former UN Secretary General Kofi Annan was instrumental in helping forge a coalition government that led to the stop of violence.

8. **Crop output declined in 2008 both because the post-election violence caused substantial internal displacement of people and other productive resources and the rainfall was poor and erratic during the rainy seasons (especially in the "short rains" period November-December).** In the long rains season (late March to early June 2008),

uneven and sporadic rainfall distribution resulted in reduced pasture and crop production. The decline of output in the agriculture and forestry sector was broad based, and the sector's value added declined by 5.1 in real terms during 2008.

9. **The political unrest reduced output for previously food-secure farmers and small traders, and limited the access to food for market-dependent, rural households.** Poor and erratic rains caused crop failures in the central highlands, southern parts of the Rift Valley highlands as well as in the areas of agro-pastoral and marginal livelihoods. Maize output during the 2008 long rains season declined by 12 percent compared to the previous year due to crop losses of 60 percent in the regions with poor rainfall. As long rains maize production accounts for close to 85 percent of total annual national maize output, this reduction had a significant effect on overall maize production. Maize is the main staple food in Kenya and its shortfall is tantamount to food insecurity.

10. **Poor rainfall also triggered a severe depletion of water resources and adversely affected the livestock sector.** It accelerated early livestock migrations and left sedentary household members without milk and animal products; and also weakened the condition of the livestock and made them more vulnerable to disease.

11. **Production of key export crops declined in 2008.** Tea output fell by 6.4 percent and coffee production dropped by 26 percent. Post-election violence, poor rainfall and poor payments to farmers are reported to have led to the lower production of tea. Coffee production is reported to have been hampered by the high cost of production resulting from the higher prices of fertilizers, chemicals, and labor and farm implements. Finally, the export volume of horticultural products rose only marginally (0.5 percent), well below recent growth rates. The main reason for the lackluster horticulture exports was a decline in overseas demand, because of the international economic crisis.

12. **Economic activity also slowed down in other sectors.** Compared with 2007, growth rates were noticeably lower in several key sectors, including in agriculture and fishing, manufacturing (especially, in the agro-based sub-sectors), electricity and water (reflecting a decline in hydro power and thermal power generation), and transport and communications. The growth rate was negative in the hotels and restaurants sector, mainly due to a sharp reduction in tourist arrivals (by about 31 percent). Overall, the real rate of growth of the non-agricultural sectors fell to 3.2 percent.

(b) Investment and Savings developments

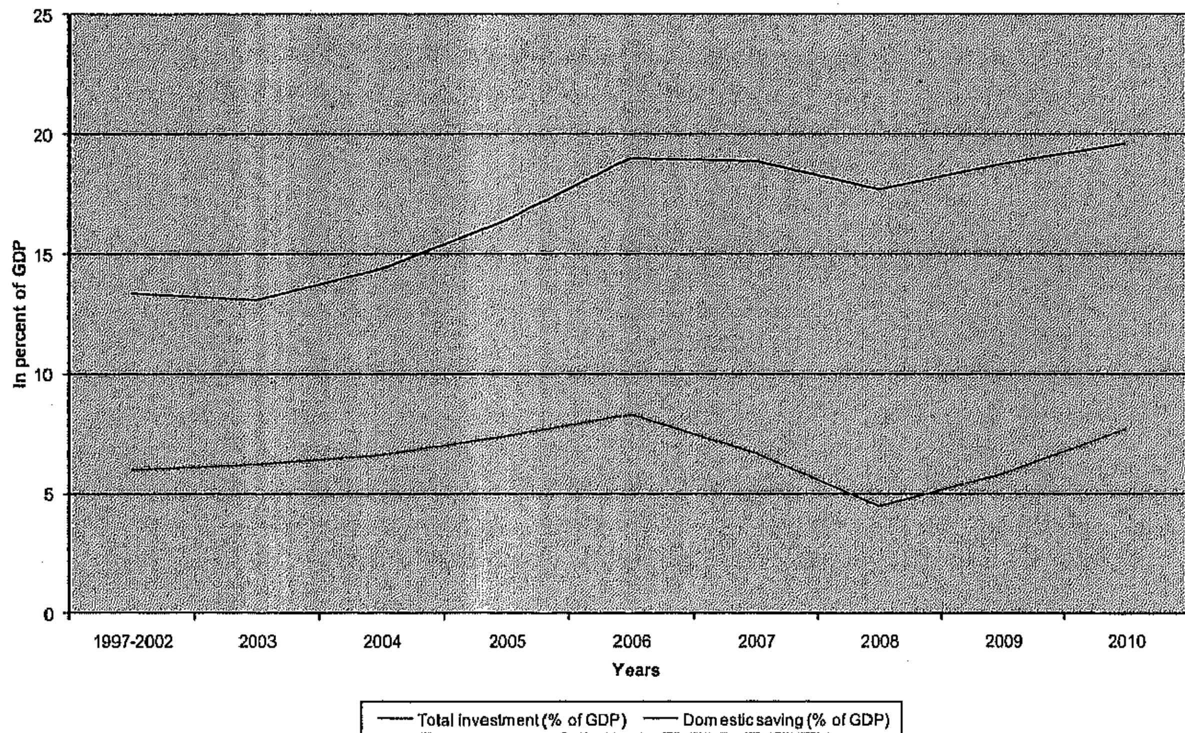
13. **Between 2003 and 2007, Kenya's investment/GDP ratio trended upward from 13.1 percent to 18.9 percent (Table 2 and Chart 2).** Kenya's investment effort, however, fell short of that of its neighbors as well as of the average for sub-Saharan Africa. In the case of Tanzania, the investment to GDP ratio rose to 29.6 percent in 2007 whereas the ratio for Uganda was 22 percent, similar to the average for sub-Saharan Africa. The difference in investment effort is in part explained by a relatively lower degree of donor support for Kenya. The investment to GDP ratio dropped to 17.7 percent in 2008, in part because of delays caused by the crisis early in the year.

Section I Table 2. Investment in selected African countries 1997-2008
(In percent GDP)

	1997-2002	2003-2007	2003	2004	2005	2006	2007	2008
Kenya	13.4	16.3	13.1	14.4	16.4	19.0	18.9	17.7
Tanzania	15.3	24.8	19.2	22.6	25.1	27.6	29.6	29.8
Uganda	18.8	21.4	21.0	20.2	22.4	21.2	22.1	23.5
Sub-Saharan Africa	18.7	20.4	19.3	19.9	19.9	21.1	22.0	22.2

Source: IMF: Regional Economic Outlook for Sub-Saharan Africa; October 2009.

Section 1 Chart 2



4. **The gross domestic savings/ GDP ratio over the 2002-07 period averaged only 7 percent (Table 3).** This is significantly less than the savings effort registered in neighboring countries and in sub-Saharan Africa as a whole.

Section I Table 3. Domestic savings in selected African countries 1997-2008
(In percent GDP)

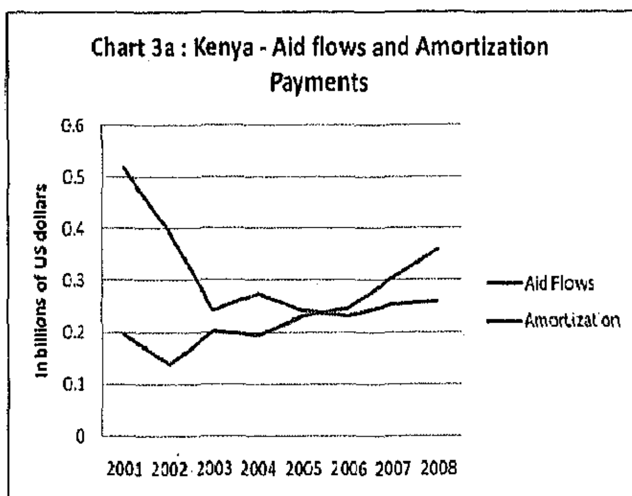
	1997-2002	2003-2007	2003	2004	2005	2006	2007	2008
Kenya	6.0	7.0	6.2	6.6	7.4	8.3	6.7	4.5
Tanzania	7.7	14.9	14.9	16.2	16.2	14.5	12.8	16.2
Uganda	7.7	9.2	7.2	10.1	11.7	8.1	8.8	6.4
Sub-Saharan Africa	18.3	22.7	19.3	21.3	22.8	25.5	24.5	25.0

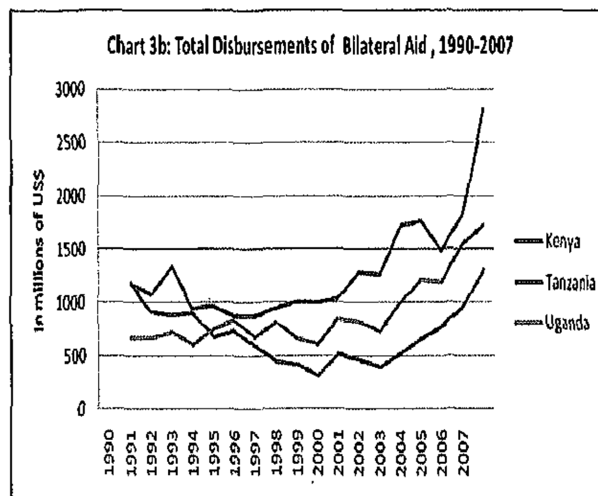
Source: IMF: Regional Economic Outlook for Sub-Saharan Africa; October 2009

15. **Signifying the low domestic savings rate, the bulk of the investments have been financed from abroad.** Foreign investors and private foreign remittances were the main contributors of investment funds, as access to donor support was relatively limited

16. **Reflecting concerns over governance issues, donors have sharply limited support of Kenya.** Concerns were focused on the slow progress of judiciary follow up to the Goldenberg affair and later the Anglo-Leasing scandal with no prosecutions of several high level officials alleged to be involved and interminable proceedings against the key people under prosecution. Also, broader perceptions persisted that corruption was rife. As a result, although aid inflows to Kenya (based on OECD-DAC data) appear to have picked up in recent years, comparable data show that Kenya has received far less support than did neighboring countries (Chart 3).

Section I Chart 3. Kenya: Relations with the Donor Community





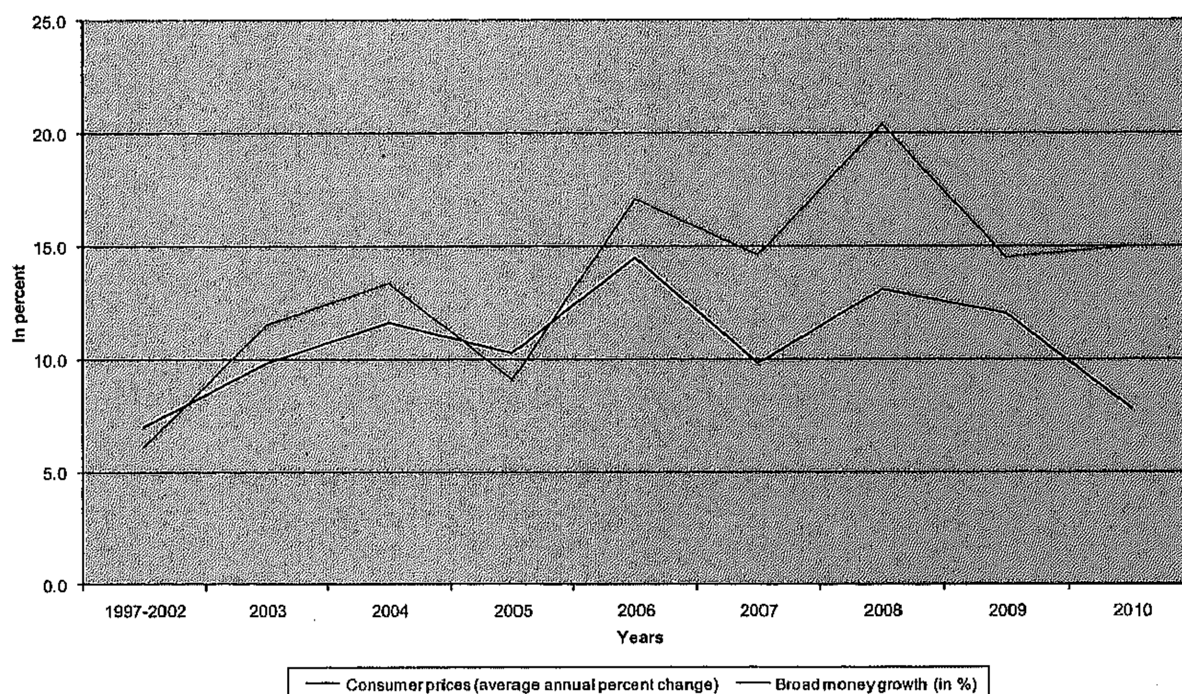
17. **The favorable trends in foreign direct investment and remittance inflows in recent years have partly reflected the improvements in the macroeconomic environment since 2003 and partly the progress made with structural reforms and governance legislation and institutions.** More recently, a perception has emerged that corruption is not as pervasive as before, particularly at the lower levels of the civil service. Moreover, the scores on some corruption indices and ease-of-doing business indices have improved. Business and regulatory reforms focused on elimination of licenses, a government-initiated effort that has earned international recognition and is expected to have a favorable impact on the costs of doing business. New legislation has been enacted in public ethics (e.g., wealth declaration), public financial management (PFM) and oversight, and procurement. Transparency was enhanced through publication of procurement transactions, including in the security area, and court reforms were advanced. PFM improvements included a more streamlined budget process and introduction of a medium-term expenditure framework. Reforms were also made in the parastatal sector, which are discussed below (in sub-section *(e) fiscal performance)*.

18. **Developments so far in 2009 point to a reduction in remittance inflows.** Data for the first half of the year released by the central bank show an 11 percent decline over the same period of 2008. Data is not yet available for foreign direct investment.

(c) Inflationary pressures

19. **Kenya's consumer price index showed a rising trend over the period 2003-07, annually averaging about 11 percent.** There were several factors driving inflation. A poor harvest in 2004 and declining growth rates in agricultural output as a result of the recurrence of poor weather conditions in recent years put pressure on food prices. A rising trend in fuel prices raised transportation costs for the economy as a whole. And an accommodative stance of monetary policy at times contributed to the inflationary pressures (Chart 4).

Section 1 Chart 4



20. **The inflation rate surged in 2008.** The average annual inflation rate increased from 10.5 percent in January 2008 to 26.2 percent by the end of the year. Inflation was led by the steep rise in food prices following food shortages caused by inadequate rainfall and the displacement of people resulting from the political turmoil. The food shortage was also compounded by the presence of more than 260,000 Sudanese and Somali refugees who are camped in two of the most food insecure districts of Kenya (Turkana in the northwest and Garissa in the east). All this added to the already existing pressures on food prices. The surge in world fuel and food prices and the depreciation of the Shilling since the middle of the year also contributed to inflationary pressures. And finally the effects of the earlier accommodating stance of monetary policy were also partly felt. The *overall* inflation rate has risen more rapidly than the *underlying* inflation rate since about March-April 2007, because food and fuel prices have risen more sharply than non-food items. The underlying inflation at end December 2008 was 9.0 percent.

21. **Inflation has fallen since the beginning of 2009.** By end June overall inflation had declined to 17.8 percent, mainly because of lower energy and transportation costs and a deceleration in food prices. Food price inflation nevertheless remained quite high at 23.5 percent. However, the underlying inflation (excluding food prices, energy and transportation costs) has fallen much less, and stood at 8.5 percent at end June 2009.

22. **Inflation has been significantly higher than in neighboring countries (Table 4).** While in part these differences may be explained by more frequent drought conditions

and at times somewhat lax monetary policies. There are also indications that Kenya's price statistics overstate the rate of inflation.

Section I Table 4. Inflation in selected African countries 1997-2009
(Annual average, percent change)

	1997-2002	2003-2007	2003	2004	2005	2006	2007	2008
Kenya	7.0	11.2	9.8	11.6	10.3	14.5	9.8	13.1
Tanzania	8.9	5.4	4.4	4.1	4.4	7.3	7.0	10.3
Uganda	3.7	6.4	5.7	5.0	8.0	6.6	6.8	7.3
Sub-Saharan Africa	13.3	8.4	10.9	7.6	8.9	7.3	7.1	11.6

Source: IMF: Regional Economic Outlook for Sub-Saharan Africa; October 2009

23. **The authorities are in the process of revising the consumer price index, which may lead to some downward revision to inflation numbers.** The authorities were not yet able to quantify likely changes and the new index is not likely to be ready until end 2009. Some observers have indicated that the revision may be significant (see Box 2)

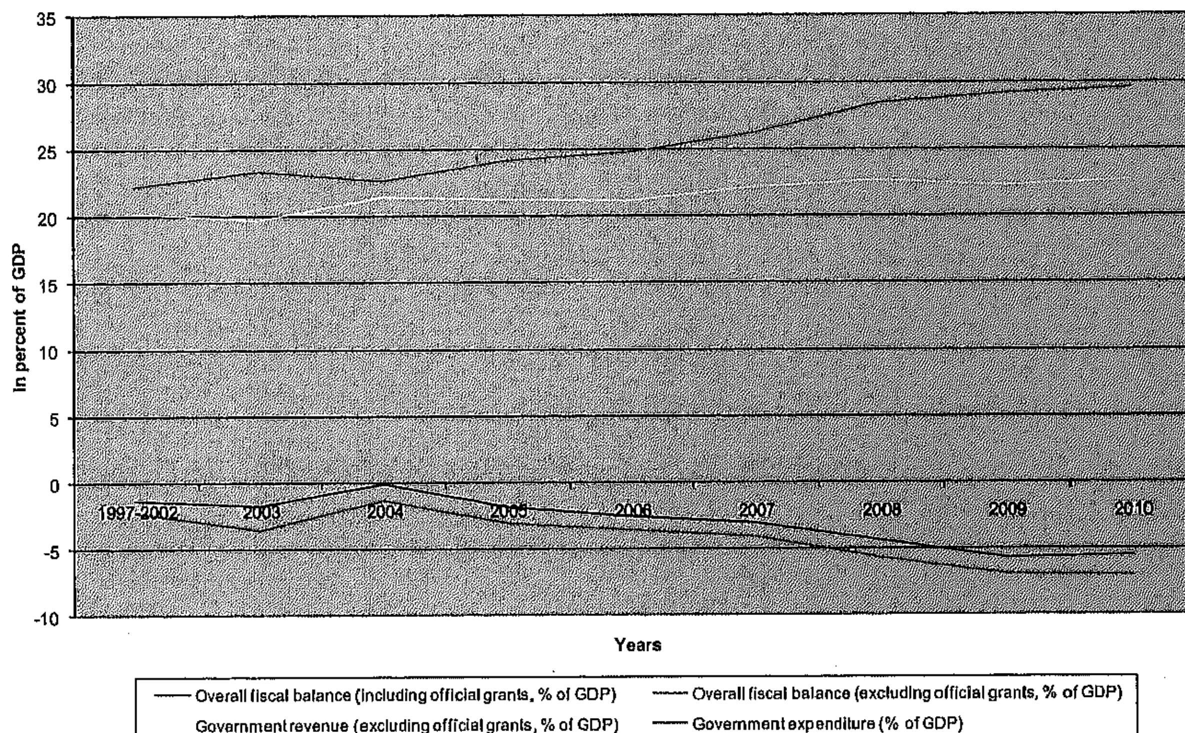
Section I Box 2. Upward Bias in the CPI Inflation Rate

Kenya's official CPI is biased upwards compared to actual inflation. This mainly reflects the chain-linked Carli index used to aggregate individual prices, which creates an upwards bias, especially when price movements are volatile. For this reason, the International Labor Organization's CPI Manual (2004) strongly advises against using the Carli index for compiling the CPI. The IMF has estimated that the overstatement could be by as much as a factor of two over the period 2007 – 2008. In line with recent technical assistance recommendations, the Kenya National Bureau of Statistics plans to switch to a formula consistent with international best practices at end 2009, together with a rebasing and reweighting.

(d) Fiscal performance

24. **The overall deficit remained relatively modest during 2002/03-2006/07.** As a ratio to GDP, the deficit (including grants) after declining from 3.2 percent in 2002/03 (July-June) to 0.1 percent by 2004/05 rose back again to its 2002/03 level during the subsequent two years. While strong revenue performance and structural reforms of the civil service and parastatals have relieved budgetary pressures, the pressing need for higher poverty reducing outlays and development expenditure have made it increasingly difficult to contain the fiscal deficit. Moreover, even modest deficits have led to sustained domestic borrowing and a burden of related interest payments, as net foreign financing was negative in every year except 2000/01, when Kenya obtained a non-concessional Paris Club rescheduling (on Houston terms).

Section 1 Chart 5



25. **Given its very limited access to foreign grants, Kenya has done well to hold its fiscal deficit (excluding grants) well below that of its neighbors.** Table 5 indicates that the fiscal deficit was lower than in neighboring countries both in the period 1997-2002 and in the period 2003-2007.

Section I Table 5. Overall Fiscal Balance in selected African countries 1997-2009
(Excluding grants, percent of GDP)

	1997-2002	2003-2007	2003	2004	2005	2006	2007	2008
Kenya	-2.2	-3.1	-3.6	-1.3	-3.0	-3.6	-4.1	-5.7
Tanzania	-5.5	-9.5	-8.8	-10.6	-11.0	-9.7	-7.6	-10.1
Uganda	-9.1	-7.7	-10.3	-9.2	-8.0	-5.3	-5.6	-4.7
Sub-Saharan Africa (oil importers excl. South Africa)	-6.1	-6.0	-6.9	-6.4	-6.0	-5.7	-5.4	-6.6

Source: IMF: Regional Economic Outlook for Sub-Saharan Africa; October 2009.

26. **The generally prudent fiscal performance reflected in part necessity caused by the lack of donor support but also real reforms.** Civil service reforms reduced positions by nearly a quarter from 1993/94 to 2003/04. Nonstrategic companies were sold and cost-cutting helped to improve the financial performance of parastatal enterprises.

Revenue performance improved as a result of both the pick-up in the economic growth rate and enhanced operations of the Kenya Revenue Authority, especially through the strengthening of tax administration. Indeed at the equivalent of 22 percent of GDP, revenue has significantly exceeded that of neighboring countries. Faced with limited and unpredictable external assistance, the Government has had limited scope for increasing capital expenditure. As noted above (Chart 3), reflecting governance concerns, donor support to Kenya declined between 1990 and 2003 and has been far less than that provided to the neighboring countries Tanzania and Uganda. Over the period 1994/95-2006/07 foreign financing to the budget amounted to a cumulative net repayment of $1 billion.

27. **The deficit widened somewhat in 2005/06 – 2006/07 because of the perceived need to increase poverty-reducing current outlays and capital expenditures, as well as wage bill pressures.** In 2005/06 there were drought related expenses, one-off expenses on the constitutional review and the referendum held in November 2005, increases in outlays for health, and for the improvement of the terms of service of civil servants and teachers. Development expenditures also rose, with a focus on anti-poverty programs. In 2006/07, recurrent expenditures rose due to increased outlays on the improvement of terms of service of civil servants and higher interest payments on domestic debt. Development expenditures increased because of higher spending on the improvement of roads, access to water, energy, and telecommunications.

28. **The fiscal deficit doubled in 2007/08 to the equivalent of 3.6 percent of GDP (including grants).** Revenue performance continued to improve mainly due to higher economic growth, and the implementation of tax administration reforms which increased efficiency and tax compliance. The widening of the deficit was mainly attributable to increases in recurrent spending for the improvement of the terms of service of civil servants, free secondary education, domestic debt service, and the resettlement of internally displaced persons following the post-election crisis. Development expenditure increased, in particular for the improvement of roads, access to water, energy, and telecommunications. Finally there was a shortfall in external grants relative to the budgeted amount, although the total inflow increased due to an improvement in the absorption capacity of external resources.

29. **The overall fiscal deficit rose further in 2008/09 to the equivalent of 5.0 percent of GDP.** Overall, revenue and recurrent expenditure was broadly in line with budgeted levels, but development expenditures fell short of budgeted levels because the absorptive capacity was less than anticipated. As a result, the overall deficit was slightly less than budgeted. The increase in expenditure levels reflected in part costs related to resettlement of those displaced by the earlier violence, security, peace building and reconciliation as well as for programmes to ease supply constraints in the agricultural sector and to address the impact of the drought. Increased allocations were also made for labor intensive construction and other public works. In view of the limited foreign support, the Government had to take significant recourse to domestic borrowing. Domestic borrowing amounted to Ksh 87.7 billion (equivalent to 3.8 percent of GDP) in 2008/09, compared to a reduction in the stock of domestic debt of Ksh 13.9 in the previous fiscal year. The

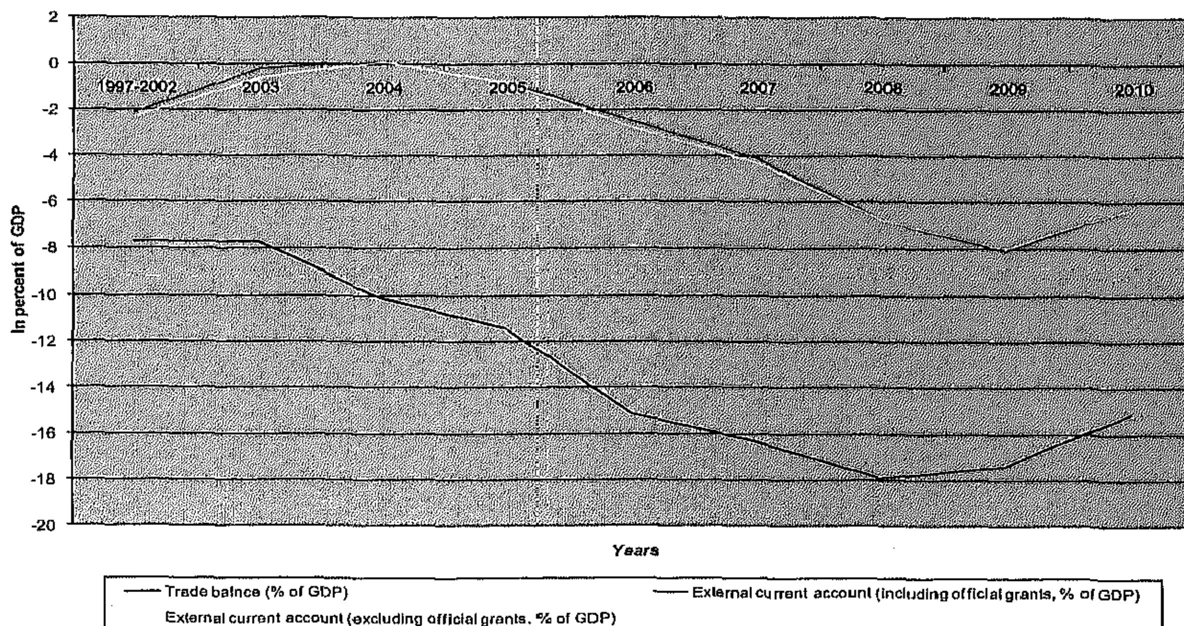
government was able to place the significant increase in treasury bills and bonds without any undue strain on the debt market. However, the banking system liquidity by the end of the fiscal year was very tight, and the central bank had to inject liquidity via its open market operations.

(e) External Performance

30. **During 2003-07, the external accounts were characterized by overall surpluses and a modest build-up in external reserves.** After an almost balanced position in the first three years, the external current account (including grants) recorded increasing but modest deficits, but these were more than offset by capital inflows (Chart 6).

Section 1 Chart 6

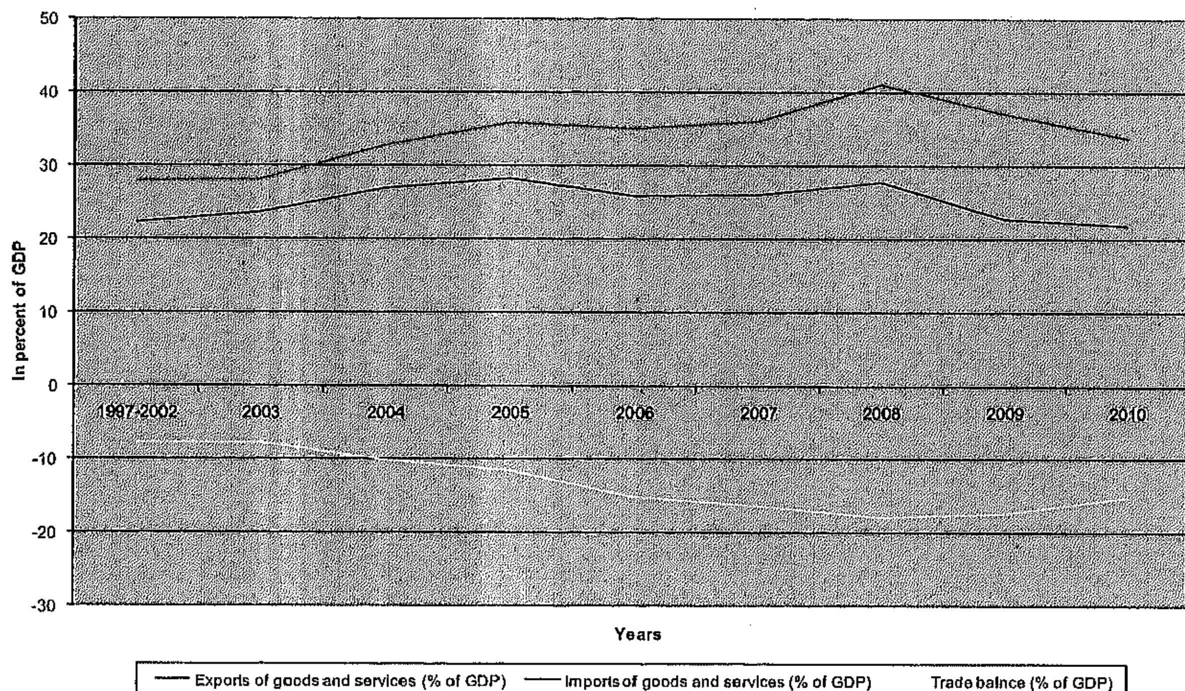
Section I Chart 6: Trade Balnce and External Current Account Balance



31. **There were several structural improvements in the current account.** The dollar value of exports grew at average annual rate of about 14 percent compared with less than 5 percent annually during the previous decade, and its structure became more diversified. As a result of the rapid export growth, Kenya's overall share in world exports increased. The share of coffee and tea in goods exports declined from over 40 percent in 1993 to 21 percent in 2007, with a corresponding rise in the combined share of exports of horticultural and manufactured products (to about 37 percent in 2007).Tourism receipts and inward private remittances from abroad recorded sharply rising trends, increasing by more than twofold and threefold, respectively. These developments represented a further diversification of current account receipts.

32. **Nonetheless, the current account moved into increasing deficits because of a worsening of the trade balance (Chart 7).** Merchandise imports grew significantly more rapidly than exports; the ratio of imports to GDP rose by almost 8 percentage points to reach 36 percent of GDP while the exports/GDP ratio rose by about 2 percentage points to 25.4 percent of GDP. Import growth in real terms reflected the rising trend in the domestic investment/GDP ratio and the pickup in economic activity. However, a key factor explaining the deterioration in the trade account was the declining trend in the external terms of trade, which fell by about 28.5 percent.

Section 1 Chart 7



33. **Surpluses in the capital account, resulting mainly from higher private capital inflows**, were generally more than sufficient to finance the emerging deficits in the current account. Foreign direct investment inflows averaged $ 364 million annually during 2003-07 (including $ 722 million 2006-07) compared with $ 66 million during 1998-2002. A broad range of sectors has benefitted from recent FDI inflows, including food, beverages and tobacco, non-metallic mineral products, chemicals and chemical products, transport and storage, telecommunications, finance and insurance and wholesale trade. Net short-term inflows and errors and omissions which basically reflects under recorded tourism earnings and inward remittances also increased sharply from an annual average inflow of $ 365 million in 1998-2002 to an average annual inflow of $ 635 million during 2006-07.

34. As a result of the net surpluses in the capital account, **Kenya's gross international foreign reserves improved**, covering more than 4 months of imports by end 2007 compared with an annual average of 3 months of imports during 1997-2002.

35. **In 2008 the external current account deficit more than doubled (reaching the equivalent of 6.5 percent of GDP) and the balance of payments registered an overall deficit.** The trade deficit widened by 36 percent as import growth accelerated and exceeded export growth, reflecting increased imports of maize and other foodstuffs, petroleum products, and manufactured goods (including machinery and transport equipment). The drought conditions entailed increased imports of maize, and higher infrastructure spending also increased the needs for imports. The volumes of coffee exports declined and the growth of horticultural exports slowed down. Net tourism receipts decreased by 23 percent as a result of the political turmoil.

Section I Table 6 Kenya: Balance of payments 2007-2009
(in millions of US Dollar)

	2007	2008	Jan-June 2008	Dec-May 2009
CURRENT ACCOUNT	-1106.4	-2018.6	-651	-1069
Trade balance	-4427.1	-5295.1	-2664	-2711
Exports (fob)	4123.0	4972.2	2506	2142
Coffee	166.4	155.2	90	100
Tea	692.6	923.8	439	401
Horticulture	607.5	763.3	434	337
Imports (cif)	-8550.2	-10267.3	-5170	-4853
Oil	-1919.5	-3051.2	-1431	-884
Services	3320.7	3276.6	2012	1642
Of which: tourism	831.4	673.3	351	295
Of which: remittances (net)	1664.2	1903.1	1103	801
CAPITAL & FINANCIAL ACCOUNT	1929.9	1542.9	758	1133
Capital Transfers (net)	323.8	207.2	198	168
Official, medium & long-term (net)	177.2	51.7	48	103
Private, medium & long-term (net)	1074.0	652.0	-496	37
Of which: Foreign direct investment	974.0	656.7		
Short-term (net) incl. errors & omissions	354.7	632.0	1007	825
OVERALL BALANCE	823.4	-457.7	106	64

36. **The capital account surplus was nearly cut in half in 2008.** Net official capital and financial inflows improved somewhat due to increased project related grants and foreign loans to the Government. However, this gain was more than offset by the decline in net private medium and long-term financial inflows, mainly reflecting a sharp decrease in foreign direct investment. In addition, debt service payments increased following the end of the consolidation period under the Paris Club rescheduling agreement and the clearance of arrears on security-related and other contracts. As a result of the overall deficit and the increase in imports, by end 2008, the Central Bank's gross official foreign

exchange reserves had declined to the equivalent of about 3 months of imports of goods and non-factor services, significantly below the authorities' target of about 4 months.

37. **The balance of payments continued to be under pressure in the first half of 2009.** The current account deficit widened by 60 percent compared with the same period of 2008. The trade balance was broadly unchanged. Exports are estimated to have declined by 14 percent with broad based declines (except for tea) led by that for horticulture. Total imports were also lower as a sharp decline in the import of petroleum products, because of price falls, which more than compensated increases elsewhere. The main reasons for the widening deficit were a 27 percent decline in private transfers (remittances) and a 16 percent decline in tourism revenues. The capital account improved, as commercial bank capital flows in the first half of registered a modest positive result whereas they had been sharply negative in the first half of 2008 (at the height of the disturbances). Thus, during the first half of 2009, the overall balance of payment registered a modest surplus. Reserve cover, however, remained at the equivalent of 3 months. The balance of payment is likely to continue being under significant pressure over the next year because of the exogenous shocks that Kenya has suffered. The IMF has estimated that the impact, mainly in the form of lower capital flows, could be equivalent to 7.2 percent of GDP over the 2008/09-2009/10 period (see box 3).

Section I Box 3. Impact of exogenous Shocks on Kenya's Balance of Payments

The IMF has estimated that the impact of the adverse exogenous shocks could be as high as the equivalent of 7.2 percent of GDP over the 2008/09-2009/10 period. In the following table the impact is derived by the IMF as the difference between value projections for the year indicated and the base year value (2007/08). While a clear impact is shown for selected goods exports, for the trade account as a whole, the net impact is positive because of the decline in petroleum product prices. Disregarding petroleum price changes, the negative impact would have been equivalent to 0.8 percent of GDP. The impact of declines in tourism receipts and remittances is equivalent to 0.6 percent of GDP. By far the largest impact stems from projected declines in direct investment (-2.2 percent) and short term capital flows (-4.9 percent)

(Change in millions of US dollars compared with outturn for 2007/08)

	2008/09	2009/10	Cumulative	As a percent of GDP
Goods balance	-130	248	119	0.4
Tea and coffee	83	-103	-20	
Horticulture	-95	-87	-182	
Oil	-101	452	351	
Maize	-56	-55	-112	
Services	-56	-125	-180	-0.6
Tourism	-36	-79	-115	
Remittances	-19	-46	-65	
Net FDI	-234	-425	-658	-2.2
Short term capital	-1064.8	-412	-1477	-4.9
Total impact	-1483	-714	2197	-7.2

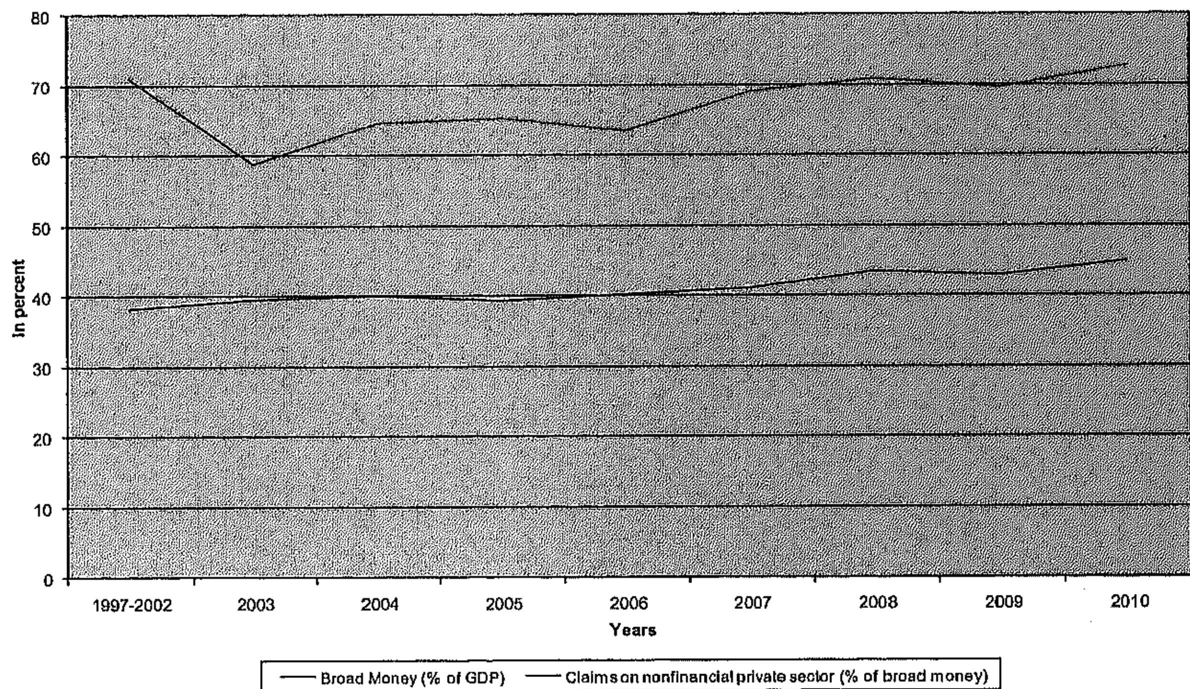
Source IMF. Kenta—Request for Disbursement Under the Rapid-Access Component of the Exogenous Shocks Facility (EBS/09/71)

(f) Monetary, financial sector and exchange rate developments

38. **The growth rate of broad money accelerated during 2003-07.** Broad money expansion substantially exceeded output growth, causing the broad money/GDP ratio to rise from an annual average of 38.3 percent in1997-2002 percent to 41.2 percent by 2007 (Chart 8). The period was marked by rapid growth of bank credit to the private sector, which increased significantly as a share of broad money, and rising inflationary pressures that reached double-digit levels. While inflation was partly due to exogenous factors, monetary policy was also accommodating as foreign exchange inflows were not fully sterilized.

Section I Chart 8

Section I Chart 8: Broad money/GDP ratio and Share of Claims on private sector in Broad Money



39. **Indicators thus point to an increasing financial deepening in Kenya over the period 2003-07.** Indeed, financial deepening as measured by the broad money/GDP ratio exceeded that of neighboring countries by a very significant margin (more than double that of Uganda; table 6). Financial deepening also significantly exceeded that of Sub-Saharan Africa (excluding South Africa and Nigeria).

Section I Table 6. Broad money/GDP ratios in selected African countries 1997-2009(excluding grants, percent of GDP)

	1997-2002	2003-2007	2003	2004	2005	2006	2007	2008
Kenya	*38.3*	*40.0*	*39.5*	*40.1*	*39.3*	*40.3*	*41.1*	*43.6*
Tanzania	16.5	23.3	20.7	21.2	22.2	26.0	26.7	26.7
Uganda	14.6	17.9	19.1	16.9	17.5	18.0	18.1	20.5
Sub-Saharan Africa (excl. Nigeria and South Africa)	24.0	27.5	26.8	26.4	25.7	28.4	30.2	31.8

Source: IMF: Regional Economic Outlook for Sub-Saharan Africa; October 2009

40. **During 2008 the Central Bank announced its intention to limit the growth rates of reserve money and broad money** with the aim of containing nonfood inflation below 6 percent. The 12-month rates of growth in reserve money and broad money have fallen sharply since June 2008, although interest rates on commercial banks' savings deposits have remained substantially negative in real terms. By end 2008, the growth rate of broad money had fallen to 13.4 percent (figure 9). By year-end, the authorities' concern had shifted to support of economic activity, and monetary policy was gradually eased (Box 4).

Section I Box 4: Monetary Policy

The CBK sets targets for both reserve money and broad money (M3). If necessary, banks' liquidity is influenced by open market operations (OMO), mainly through REPOs and reverse REPOs. More recently, **reverse repos** have been used to inject liquidity.

The CBK also sets a "policy rate", the central bank rate (CBR), which is applied to secured overnight loans to commercial banks. The Monetary Policy Committee has gradually decreased the policy rate from 9 percent in the second half of 2008 to 7.75 percent on July 22, 2009. **Reserve requirement** was reduced from 6 to 5 percent in December 1, 2008 and further to 4.5 percent on July 22, 2009. The requirement had been kept at 6 percent since June 2003.

The CBK's monetary policy targets have frequently been exceeded (table 1). For example the original target for reserve money at end-June 2008 was set at 12.7 percent and increased to 18.2 percent in the six monthly reviews, but the actual outcome was 19.3 percent. While exogenous factors have played a large role in the sharp increase in inflation in 2008 (which reached 29 percent in June 2008 compared to the original target of 5 percent) a somewhat loose monetary policy stance is likely to have contributed to inflationary pressures.

Box 3 Table 1. Kenya: Execution of Monetary Policy

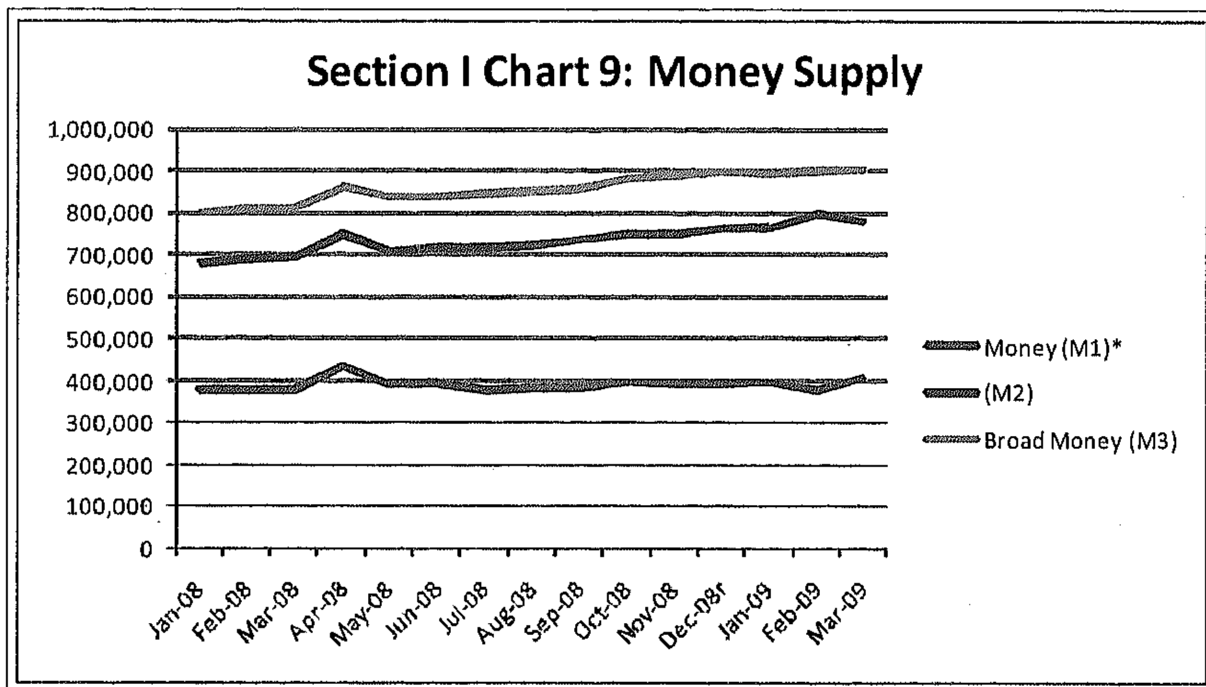
(In percent over the preceding 12-month period)

		June 2006	June 2007	June 2008	December 2008	June 2009
Reserve money	Original target	5	10	12.7	16	16.2
	Revised Target	6.3	14.3	18.2		
	Actual	14.0	17.5	19.3	4.2	
M3	Target	7.8	10	12.7		17.1
	Revised target	10	14	17.5		
	Actual	16.1	18.8	19.3	13.4	
Inflation	Target	5	7	5		7.5
	Actual	10.9	11.1	29.3	27.7	

Source: Central Bank of Kenya—Annual Report 2007/08. Monetary Policy Statements, various issues.

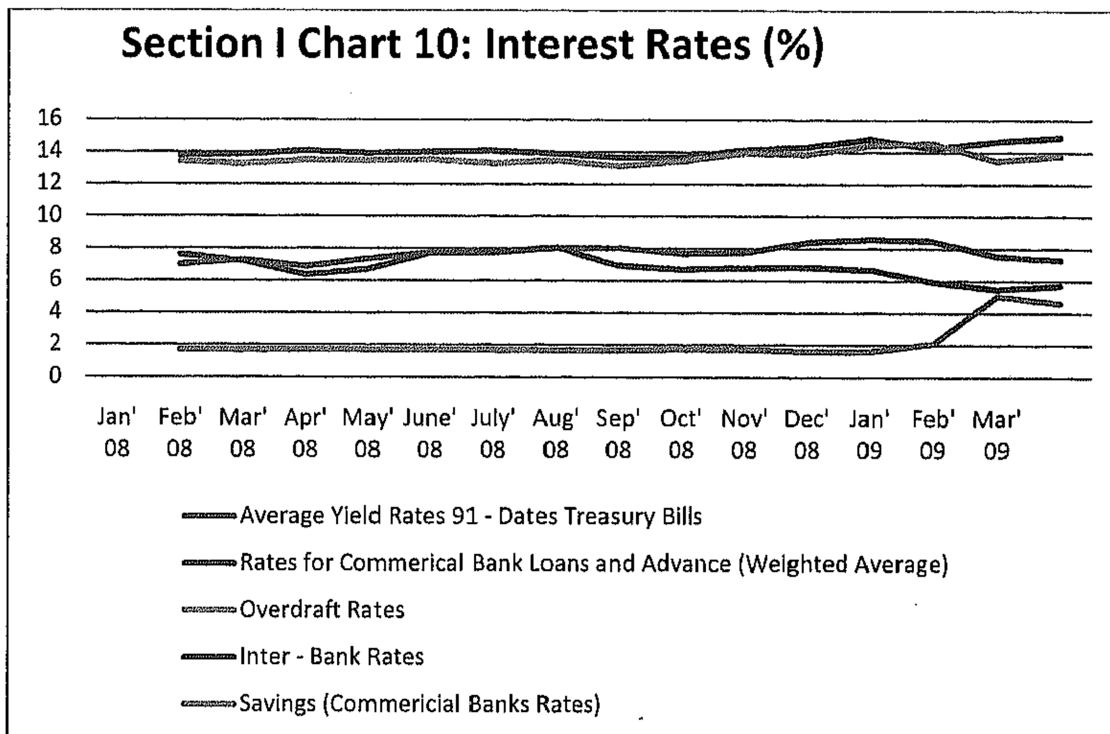
41. **Broad money growth (M3) continued to decline in 2009.** By end April, the growth rate had fallen to 7.5 percent (annual basis) compared with 26.7 percent at end April 2008. The main contributory factors were the sharply lower accumulation of net foreign assets, but growth of credit to the private sector also slowed down, from 29.0 percent in the period ending April 2008 to 12.2 percent in the period ending April 2009. Inflationary pressures have remained strong during the first half of 2009, because the recent slow-down in monetary aggregates affects inflation only after some lag.

Section 1 Chart 9



42. **As a result of the monetary easing, interest rates have moved down since the second half of 2008** (Chart 10). The sharp increase in domestic borrowing by the government has thus not yet put any noticeable pressure on financial markets. In early August the 91 day Treasury bill, reverse repo, and interbank rates stood at 7.3, 3.9, and 3.4 percent, respectively. Interest rates thus remain significantly negative in real terms.

Section I Chart 10: Interest Rates (%)



43. **The authorities have succeeded in strengthening significantly the financial soundness of the banking sector over the period 2002-2008 (Table 7).** The capital adequacy increased by nearly 3 percentage points to 19 percent (compared to the recommended minimum of 8 percent) and the ratio of nonperforming loans to total loans declined from 34.9 percent to 8.4 percent, which nevertheless remains somewhat high according to international norms. Thus far the international global crisis has had little impact on the banking system but the quality of the loan portfolio is likely to deteriorate somewhat, particularly for banks exposed to the export and tourism sectors. Indeed, by end-May 2009, the ratio of non-performing loans had increased to 9.9 percent of loans. Capital adequacy increased slightly to 19.2 percent, however, because of retained earnings.

Section I Table 7. Financial Soundness Indicators

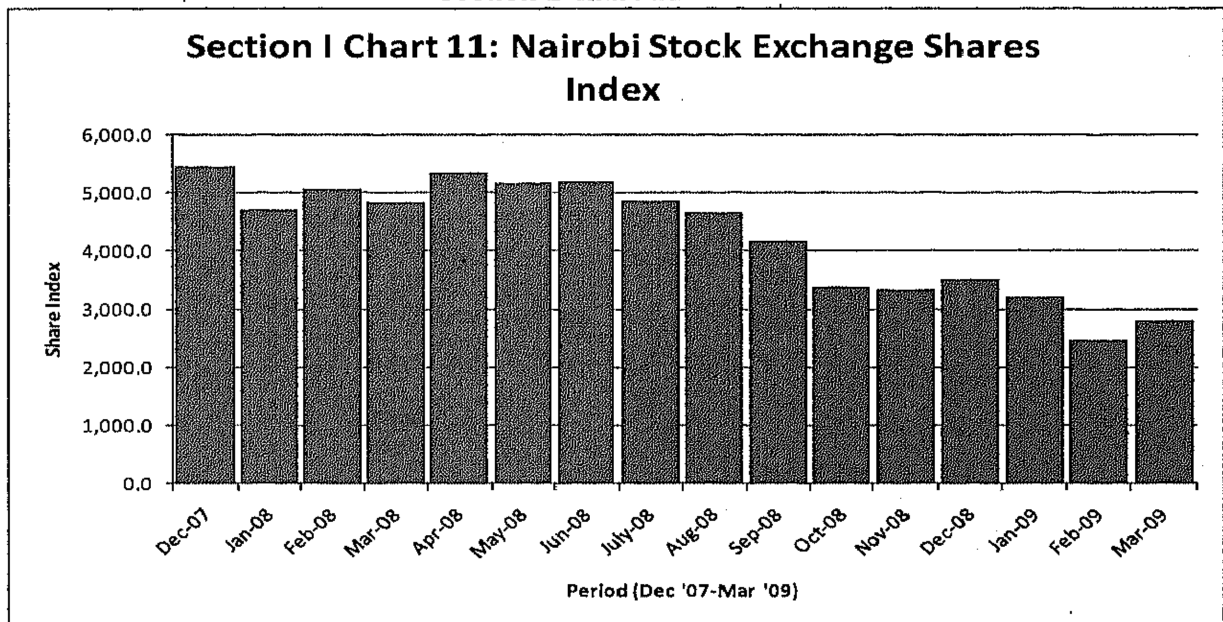
						2008		
	Dec-03	Dec-04	Dec-05	Dec-05	Dec-07	Mar-08	May-08	Dec-08
Capital								
Regulatory capital to risk weighted assets	17.3	16.6	16.4	16.5	18.0	19.5	17.4	18.9
Regulatory Tier 1 Capital to risk weighted assets	16.3	16.2	16.0	16.4	16.8	18.3	16.2	16.9
Asset Composition and Quality								
Non-performing loans to gross loans[1]	34.9	29.3	25.6	21.3	10.9	10.5	9.6	8.4
Non-performing loans net of provisions to total capital	60.7	52.7	40.1	28.6	15.1	15.5	15.4	11.3
Earnings and Profitability								
Return on assets (annualized)	2.3	2.1	2.4	2.8	3.0	3.6	3.2	2.8
Return on equity (annualized)	23.2	22.0	25.0	28.6	27.5	33.3	33.7	25.2
Liquidity								
Liquidity assets to total assets	33.2	32.4	33.1	30.5	35.1	36.1	38.6	34.4
Liquid assets to total short-term liabilities	48.9	41.5	40.6	44.4	40.2	40.2	41.0	37.0
Sensitivity Analysis								
Net open positions in FX to capital	12.0	5.0	6.0	7.1	5.4	7.0	7.3	5.6

Source: **Central Bank of Kenya**

[1]The tables were computed using gross non-performing loans and gross loans

44. **In the capital market, equity prices fell by some 40 percent in the second half of 2008 as portfolio investor confidence declined (Chart 11).** While broadly in line with developments in major international exchanges, developments on the Nairobi exchange was also influenced by allegations of fraud among certain stockbrokers. The exit of foreign investors from the stock market was particularly pronounced in the last quarter of 2008. More recently, stock prices have trended moderately upwards.

Section 1 Chart 11

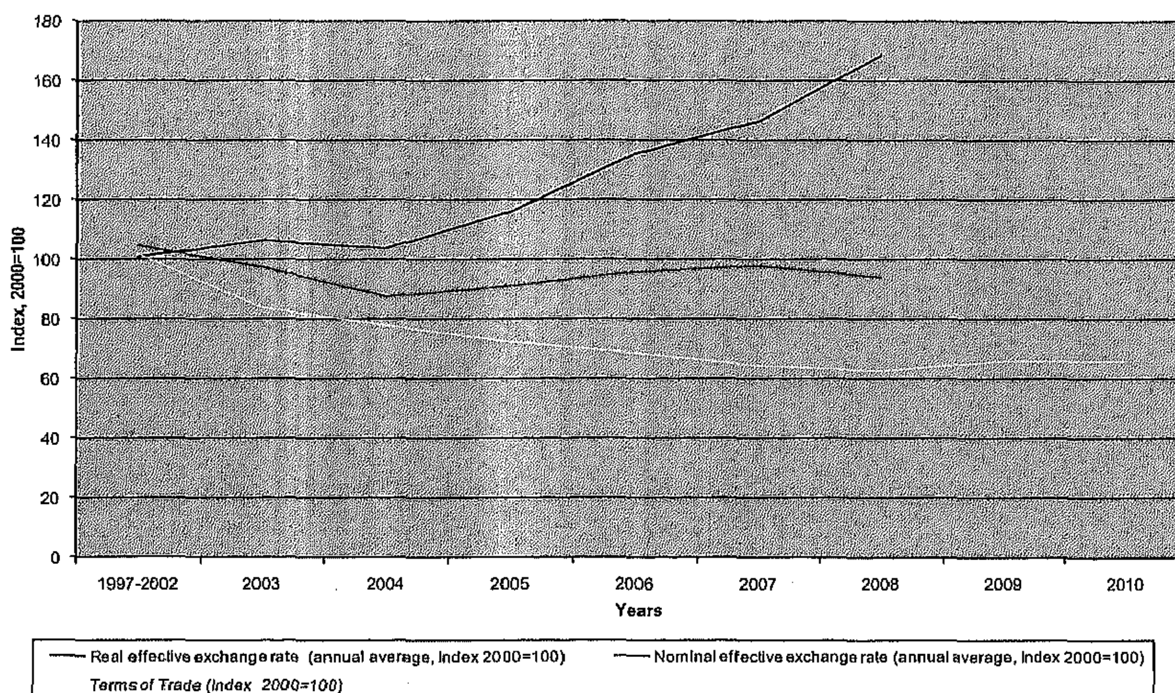


45. **The authorities have tried to maintain a flexible, market-determined exchange rate system with policies based on targeting monetary aggregates in the context of relatively liberalized and volatile capital flows.** In practice, the authorities have often intervened to avoid short-term exchange rate volatility, offset variability in donor flows, effect government debt payments, and meet reserve targets. To address emerging concerns about the real appreciation of the shilling and external competitiveness, they have focused on structural reforms and improvements in infrastructure, as well as export incentives (including manufacturing under bond, export processing zones, and value-added tax exemptions).

46. **The real effective exchange rate appreciated quite markedly over the period 2003-07, especially over the last two years of that period (Chart 12).** However, a recent IMF study (using monthly data for 1990-2007) suggests that movements have been broadly in line with the estimated equilibrium values during the period. The IMF study notes that the shilling's variation has been largely due to productivity developments and terms of trade, and that in the last two years, the appreciation of the shilling was broadly in line with fundamentals such as increased tourism receipts, remittances, and capital flows.

Section 1 Chart 12

Section I Chart 12: Exchange rate and Terms of Trade Indices



47. **The *shilling continued to* appreciate vis-à-vis *major* currencies (the US dollar, the Euro, the Pound Sterling and the Japanese Yen) through May 2008, but subsequently came under pressure.** With the emergence of a balance of payments deficit and a fall in net foreign assets, the shilling depreciated significantly in the second half of the year, even though the Central Bank discontinued the practice of purchasing foreign exchange in the market to balance its sales to the government. For the year as a whole the shilling declined by 24 percent against the US dollar. In real effective terms, the shilling is estimated to have depreciated by about 10 percent in 2008

48. **The shilling was broadly unchanged against the US dollar during the first half of 2009.** However, as the value of the dollar declined, the shilling depreciated slightly in nominal effective terms. During this period, the central bank was able to purchase foreign exchange in the market for a modest build up of foreign reserves without putting pressure on the market because of the very tight liquidity of banks.

49. **As noted above, a 2007 IMF assessment shows that the real effective exchange rate has moved broadly in line with the estimated equilibrium values.** The depreciation during the second half of 2008 and so far in 2009 supports this assessment. As a factor in this assessment, it must also be taken into account that the Kenyan price index is likely overstated so that the real effective exchange rate movement is upwardly biased. Nevertheless, the deterioration in the balance of payments and the global international crisis may well put further downward pressure on the Shilling. The JICA