Chapter 5

Kenya—Weak Governance Hobbles Economy

Recent economic trends in Kenya have been disappointing, with GDP growth declining since the mid-1990s and falling substantially below the population growth rate, estimated at 2.4%. In 2000 real economic growth turned negative, dropping to –0.3%—its lowest level since independence—from 1.4% in 1999 and 1.8% in 1998. These rates are far below government targets of 2.7% for fiscal 2001, 3.5% for fiscal 2002, and 5.0% for fiscal 2003. Agriculture, which traditionally accounts for the largest share of GDP, shrank 2.4% in 2000, while real manufacturing output fell 1.5%. The balance of payments worsened, with current account and trade deficits increasing. Deteriorating economic and social conditions are also reflected in other key measures. Poverty has increased, and income inequality and social indicators show worrisome trends.

"Macroeconomic management has been relatively strong in recent years"

Kenya's macroeconomic management has been relatively strong in recent years, with inflation rates and fiscal deficits within their targets (except in 2000). The challenge is translating these achievements into growth. The main problem is weak governance—as indicated by extensive corruption, weak rule of law, escalating insecurity, and poor infrastructure. Governance problems have undermined private sector activities, as reflected in falling investment. Gross fixed capital formation fell from 21% of GDP in 1995 to 15% in 1999.

Crucial prerequisites for the success of the macroeconomic strategy, identified in Kenya's 2001 Poverty Reduction Strategy Paper (PRSP), include:

- Making clear progress on governance problems to improve the environment for private sector activities.
- Allocating more public resources to improve infrastructure and security.
- Maintaining macroeconomic stability by, among other efforts, reducing domestic debt and real interest rates.

Recent macroeconomic performance—real GDP up 1.8% in 2001

In 1997 Kenya's economic growth began slowing considerably, culminating in a 0.3% contraction in real GDP in 2000 (table 5.1). In 1999–2001 real GDP growth averaged just 1% a year—less than half the already low average growth of 2.7% in 1996–98. A moderate recovery emerged in 2001, however, with real GDP expected to increase 1.8%.

Table 5.1
Changes in real GDP and sectoral output, Kenya, 1996–2001 (percent)

Indicator	1996	1997	1998	1999	2000	2001[a]	1996–98	1999–2001
Real GDP	4.1	2.4	1.8	1.4	–0.3	1.8	2.7	1.0
Real GDP per capita	–0.3	–0.6	–1.1	–1.5	–2.6	–0.6	–0.7	–1.6
Real agricultural output		1.0	1.5	1.2	–2.4	2.0	1.2[b]	0.3
Real manufacturing output		1.9	1.4	1.0	–1.5	1.2	1.7[b]	0.2

a. Estimated.

b. Average for 1997–98.

***Source:** Kenya, Central Bureau of Statistics, 1998-2001; EIU 2001.*

“Agriculture accounted for about 25% of GDP in 1996–2001, and manufacturing for about 13%”

The slowdown in GDP growth meant that real GDP per capita continued to suffer, falling by 1.6% a year in 1999–2001—faster than the 0.7% annual drop in 1996–98. In 2000 real GDP per capita fell 2.6%, the largest decline in recent years, but in 2001 the rate of decline slowed to 0.6%.

The sectoral composition of GDP has not changed in recent years. Agriculture accounted for about 25% of GDP in 1996–2001, and manufacturing for about 13%. These shares, along with the share of the services sector, varied by less than 1 percentage point during this period.

Performance by sector—composition unchanged

The persistent decline in real GDP growth since 1997 was caused by weak performance in key economic sectors. Of the four main contributors to GDP, only two—financial services and trade, restaurants, and hotels—recorded positive growth in 2000. Meanwhile, output in the other two—agriculture and manufacturing—contracted 2.4% and 1.5%.

Agriculture. Agriculture is crucial to Kenya’s economy, making large contributions to output, employment, and exports. Thus its recent weak performance had major repercussions. Production of maize, a staple, dropped from 296,000 tonnes in 1996 to 201,000 tonnes in 2000 (table 5.2). Wheat production was even more volatile, rising from 130,000 tonnes in 1996 to 177,000 tonnes in 1998—then plummeting to 53,000 tonnes in 1999 and recovering slightly to 71,000 tonnes in 2000. Dairy production displayed the same pattern.

Such fluctuations have enormous financial implications. Because most Kenyans consume maize and wheat, large supply shortfalls lead to huge import bills for the government. In 2000, for example, the decline in maize production led to the import of 409,000 tonnes of maize valued at 4.7 billion Kenyan shillings (about $62 million at the 2000 exchange rate). Similarly, that year 635,000 tonnes of wheat were imported at a cost of 7 billion Kenyan shillings (about $92 million at the 2000 exchange rate).

Table 5.2

Major agricultural products, Kenya, 1996–2000

Product	1996 Production (thousands of tonnes)	1997 Production (thousands of tonnes)	1997 Annual change (percent)	1998 Production (thousands of tonnes)	1998 Annual change (percent)	1999 Production (thousands of tonnes)	1999 Annual change (percent)	2000 Production (thousands of tonnes)	2000 Annual change (percent)
Maize	295.5	204.6	–30.8	218.0	6.5	223.5	2.5	201.2	–10.0
Wheat	130.0	124.2	–4.5	176.7	42.3	52.9	–70.1	70.5	33.3
Coffee	103.2	68.0	–34.1	51.3	–24.6	64.3	25.3	98.0	52.4
Tea	257.2	220.7	–14.2	294.2	33.3	248.8	–15.4	236.3	–5.0
Cattle[a]	1,219	1,320	8.3	1,800	36.4	1,805	0.3	1,908	5.7
Dairy[b]	257	197	–23.3	126	–36.0	180	42.9	137	–23.9

a. Production measured in thousands of heads of cattle and calves.

b. Production measured in millions of litres.

Source: *Kenya, Central Bureau of Statistics.*

Output of export crops also fluctuated. Production of tea—the largest foreign exchange earner among all of Kenya's exports—fell 14% in 1997, rose 33% in 1998, and declined 15% in 1999 and 5% in 2000. Coffee production also fluctuated considerably. In the first seven months of 2001 tea production is estimated to have increased, while coffee production declined.

Because Kenya's agriculture is largely rainfed, it is extremely vulnerable to weather conditions—which is one reason output is so volatile. Agricultural production suffered from the drought that began in 1998 and continued through the first half of 2000. Better weather in 2001 led to increased production of most domestically consumed and export crops.

But factors other than weather also contribute to agriculture's poor performance. Poor infrastructure, especially roads, makes it difficult to market produce and expensive to distribute farm inputs. In addition, in 2000 higher power tariffs and fuel prices raised production costs considerably—yet the prices of many crops fell. All these factors likely dampened farmers' incentives for production.

Kenya's PRSP, issued in 2001, indicates that agriculture needs to grow by 4–6% a year to make a meaningful contribution to poverty reduction. The paper argues that the sector could expand by more than 5% a year if the constraints facing it are addressed. Besides those noted above, the paper points to inadequate supplies of quality seeds, inappropriate production techniques, lack of access to credit for most small farmers, expensive farm inputs, poor rural infrastructure (especially feeder roads, power supplies, and market facilities), inconsistent policies, weak institutions and laws governing the sector, and an inability to control pests and diseases that affect crops and livestock. Thus the government needs to implement policies that target these constraints.

Manufacturing. Real manufacturing output has stagnated, growing by an average of just 0.2% a year in 1999–2001 (see table 5.1). Output actually fell 1.5% in 2000, then recovered slightly in 2001. Such growth rates are especially disappointing given the targets set in Kenya's industrialization programme. This programme recognized that manufacturing needs to grow faster than agriculture and eventually become the economy's engine of growth.

> *Inflation fell from 6.6% in 1998 to 3.5% in 1999, but rose to 6.2% in 2000*

Some of the factors contributing to manufacturing's weak performance have been external to the sector. These include the drought and its attendant power shortages, which led to higher power tariffs and rationed power supplies—especially in 2000, when prolonged power rationing slowed down the entire economy. As a result the demand for manufactured goods dropped considerably. Manufacturing also suffered from the high costs of domestic investment resulting from poor infrastructure, water shortages, heavy dependence on imported inputs and machinery, and reduced supplies of raw materials.

Services. Services account for more than half of Kenya's GDP and two-thirds of formal employment. Key subsectors are tourism and travel, financial services, communication services, and transport services. In recent years tourism alone has been the third largest contributor to GDP after agriculture and manufacturing. Tourism has also become the largest earner of foreign exchange after tea.

The government's most recent development plan projected that tourism would grow 8.4% a year, with tourist arrivals increasing from 764,000 in 1997 to 1,160,000 in 2001. In 1999 Kenya received 969,300 international visitors—equivalent to 0.15% of the world market and 3.5% of the African market. Still, for several reasons tourism has been weaker than in the first half of the 1990s. Although no tourists were hurt in the tribal clashes that preceded the 1997 general election, tourism is extremely sensitive to events that affect the actual or perceived security of visitors. Poor weather, deteriorating roads, and increased competition from other African countries also harm tourism. The industry has been recovering, however, with a 10% increase in international arrivals in the first eight months of 2001. But the September 11 terrorist bombings in the United States may have dampened this recovery over the rest of 2001.

Performance has been mixed in other service subsectors. The recovery in tourism helped trade and restaurant services, which grew 1.9% in fiscal 2001 compared with 1% in fiscal 2000. Transport and communication services also improved marginally, mainly due to the licensing of a second mobile telephone provider and an increase in mobile telephone subscribers. But building and construction services have continued to perform poorly, reflecting a slump in the real estate market and limited public sector construction projects.

Price movements—inflation back down, shilling stabilizing

Inflation. Inflation fell from 6.6% in 1998 to 3.5% in 1999. But with rising prices for food, fuel, and power, inflation rose to 6.2% in 2000. To contain inflation, in 2001 the Central Bank of Kenya restrained the expansion of the money supply. Indeed, in the second half of 2001 M3 fell about 2%. (The Central Bank defines M3, broad or reserve money, as currency held by the nonbank public and Kenyan shilling deposits held by banks and

nonbank financial institutions.) This move, combined with prudent fiscal policy, eased the pressure on prices—and in 2001 inflation fell to an estimated 3.3%.

Exchange rates. Kenya has maintained a floating exchange rate since 1993. The Central Bank allows the shilling's value to be determined by the interbank market but intervenes in the event of extreme volatility. Since its flotation the shilling's value has varied considerably, reflecting external and internal pressures. The real effective exchange rate has been depreciating since 1997, when the International Monetary Fund (IMF) suspended its Enhanced Structural Adjustment Facility. Within three months of the suspension, foreign investors repatriated more than $250 million and the shilling depreciated 20% against the U.S. dollar. But in recent years pressure on the shilling has eased as a result of larger foreign exchange receipts from tea, horticulture, and tourism, as well as weaker corporate demand for foreign exchange. In 2000 the shilling's depreciation against the U.S. dollar slowed to 8.4%, and in 2001 to 4.1%.

> *“The current account deficit is expected to widen from 2.4% of GDP in 2000 to 2.6% in 2001”*

To achieve stable prices, the government needs to strengthen export promotion efforts and attract long-term capital flows into the economy. Many analysts believe that the shilling exchange rate is artificially high because of speculative short-term flows attracted by high interest rates. Exporters in particular complain about the drop in export receipts caused by an overvalued shilling. The Central Bank's response is that its job is not to influence the direction of the exchange rate, but to maintain stable conditions in the market.

Balance of payments and foreign debt—foreign exchange reserves up to 3.5 months of import cover

In 2000 Kenya's imports grew 11.4%, but in 2001 import growth slowed to an estimated 4.7%. In contrast, exports grew just 1.4% in 2000 and contracted by an estimated 4.1% in 2001. As a result the current account deficit is expected to widen from 2.4% of GDP in 2000 to 2.6% in 2001.

Kenya's external imbalance is partly caused by a narrow range of merchandise exports and by international price shocks. In 2000 coffee, tea, horticulture, and petroleum products accounted for nearly two-thirds of merchandise exports. Between the first quarter of 1999 and the fourth quarter of 2001 international coffee prices slumped from $0.80 to $0.25 a pound for robusta and from $1.10 to $0.55 a pound for arabica. In addition, tea prices fell in 1999 (by 12.8%) and 2001 (by 15.1%), though they rose slightly in 2000 (by 5.8%). Lower coffee and tea prices offset higher revenue from horticultural exports—which have become the most important agricultural export after tea—and from increased tourism earnings and net transfers. In addition, short-term outflows increased by about $280 million between June 2000 and June 2001, partly because of lower interest rates on government paper. Portfolio investments through the Nairobi Stock Exchange also registered net outflows in 1999 and 2000.

Foreign exchange reserves, targeted to cover 4.0 months of imports, stood at $955 million in June 2001—equivalent to 3.5 months of coverage. This was an improvement over June 2000 reserves of $808 million, equivalent to 3.3 months of import coverage.

Kenya's balance of payments is volatile and heavily influenced by exogenous factors. Fluctuating world market prices continue to affect traditional exports such as coffee and tea. World prices of crude oil, a major import, also exert a strong influence. And tourism earnings have not been as high as expected because of an influx of low-budget tourists. Prospects would improve with the revival of the IMF's structural adjustment programme, which would increase confidence in the economy and encourage foreign direct investment and long-term capital flows.

"Fluctuating world market prices continue to affect traditional exports"

Since 1996 Kenya's external debt has fluctuated around $6.0 billion, ranging from $5.7 billion in 2001 to $6.9 billion in 1998. Decent export earnings in 1996–98 and continued concessional flows from donors have kept debt close to sustainable levels. Although Kenya has been able to service its debt in a fairly timely manner, tightening liquidity and high debt service have forced it to reschedule debt twice through the Paris Club (representing official creditors). The most recent rescheduling occurred in fiscal 2001, when the government was granted a 10-year grace period on bilateral debt secured before 1991. The government is still negotiating its $5 billion in debt with the London Club (representing commercial creditors).

Monetary policy and the financial sector

Monetary and financial policies have focused on two objectives. The first is achieving and maintaining stable prices; the second is fostering the liquidity, solvency, proper functioning, and stability of the financial system. Other goals of monetary policy include efficiently managing foreign exchange reserves and promoting a well-functioning system of payments, clearing, and settlement.

Monetary policy—tighter

The Central Bank uses several instruments in conducting monetary policy, with quantitative credit guidelines being the most common. Interventions in the money market include close monitoring of minimum statutory cash ratios and of net sales of government securities to regulate domestic liquidity. Given that the main goal of monetary policy is to achieve stable prices, money supply targets are based on the real GDP growth rate. Thus, given the persistent slowdown in economic growth in recent years, the Central Bank has maintained a tight monetary policy.

The Central Bank's monetary policy focuses on M3. In fiscal 2000 the money supply was targeted to expand by 8% or less. This target was to be achieved through cash ratios, open market operations, and discount and overnight lending by the Central Bank as the lender of last resort. This target, predicated on GDP growth of 2.5%, was intended to increase bank lending to support economic recovery. But with the continued economic slowdown, private sector demand for bank credit slackened. In response the Central Bank adopted a tighter monetary policy to absorb excess liquidity. In 1999 M3 increased by 2.6%, and in 2000 by just 0.8%.

Financial sector—struggling

At the end of 2001, 48 commercial banks were operating in Kenya. But 8 major banks—2 foreign-owned and 6 state-owned—dominate the banking sector, accounting for 71% of the market at the end of 2000. The other banks are small and rather unstable.

Banks continue to struggle with nonperforming loans, which in July 2001 accounted for 42 percent of the loan portfolio (table 5.3). As a result banks have continued provisioning for bad and doubtful debts, lowering profits. In June 2000 the Central Bank began requiring that all banks work with it to agree on the size of such provisions, which subsequently dropped from 67.7 billion shillings in September 2000 to 66.0 billion in September 2001.

> *The Banking Act was amended to give the Central Bank more power to enforce bank laws and regulations*

The number of banks liquidated or placed under statutory management reflects the poor performance of the banking sector. Since 2000 five banks have been placed under statutory management and one building society has been placed under an investigator. Depositor committees were formed to help restructure the banks under statutory management. Three were reopened, but one was liquidated after a year. Similarly, Delphis Bank, a small bank, was placed under statutory management in April 2001, and debt recovery is ongoing.

Poor bank performance has mainly been caused by mismanagement, insider lending, and slow loan recovery. These problems, in turn, are the result of an inefficient court system, inadequate regulatory powers for the Central Bank, and the slowdown in economic activity. Several steps have been taken to address some of these problems. In 1999 the Banking Act was amended to give the Central Bank more power to enforce bank laws and regulations. The act now restricts insider lending, places strict requirements on lending and provisioning for nonperforming assets, and strengthens the Central Bank's supervision department. The Central Bank has also been empowered with cease and desist provisions and can impose financial penalties for failure to comply with the law. In addition, the minimum capital of banks and nonbank financial institutions has been raised. Capital requirements were initially raised to 200 million shillings for banks and 150 million shillings for nonbank financial institutions, then to 500 million and 375 million shillings.

In July 2000 prudential regulation was strengthened further, requiring that:

- Boards of directors eliminate all executive chairs to improve corporate governance.
- Banks maintain core capital of no less than 8% of the sum of their risk-adjusted assets and risk-adjusted off-balance-sheet items.
- Banks maintain core capital of no less than 8% of their deposit liabilities.
- Banks maintain total capital (core and supplementary) of no less than 12% of their risk-adjusted off-balance-sheet items.

Moreover, all banks must now publish their audited accounts in newspapers by 31 March of each year. Published audited accounts for 2000 show that the measures applied by the Central Bank are yielding results: banks' financial performance seems to be improving. Still, bank runs remain a significant risk. This risk is compounded by economic stagnation. Thus regulatory authorities need to maintain regulatory vigilance.

Table 5.3

Nonperforming loans and loan loss provisions, Kenya, June 2000 and July 2001 (billions of Kenyan shillings unless otherwise indicated)

Indicator	June 2000	July 2001
Total loans (gross)	289.8	301.9
Nonperforming loans	113.5	126.2
Provisions made for nonperforming loans	63.6	77.5
Net nonperforming loans (2–3)	49.9	48.7
Value of securities (estimated)	36.2	39.7
Net exposure (4–5)	13.7	9.0
Nonperforming loans/total loans (percent)	39.2	41.8
Net nonperforming loans/total loans (percent)	17.2	16.1
Net exposure/total loans (percent)	4.7	3.0
Provisions/nonperforming loans (percent)	56.0	61.4

Source: *Kenya, Central Bank,* Monthly Economic Review, *various issues.*

Interest rates—high

"High interest rates have strongly discouraged long-term investment and constrained Kenya's ability to grow"

In recent years excessively high interest rates have strongly discouraged long-term investment and constrained Kenya's ability to grow. With nominal rates ranging from 20–30%, the private sector has been unable to borrow. In addition, the 11–18 percentage point spread between lending and deposit rates is much higher than the 5 point spread common in other developing countries.

High interest rates can be traced to 1993, when the Central Bank raised the discount rate on Treasury bills to more than 70%. After a lag other interest rates also increased, including interbank rates and the lending and deposit rates of commercial banks. In response to increased demand, the rate on Treasury bills has since declined, reaching 13.5% in 2000 and about 12% in 2001. Correspondingly, interest rates on commercial bank loans fell from 25.2% in 1999 to 19.6% in 2000, and rates on deposits fell from 6.2% to 4.5%.

Growing pressure from key economic players led Parliament to adopt the Central Bank of Kenya (Amendment) Act (commonly known as the Donde Act), which entered into force in August 2001. The act allows the Central Bank to regulate interest rates. More specifically, it:

- Sets the maximum lending rate that commercial banks and other financial institutions can charge at 4 percentage points above the 91-day Treasury Bill rate, as long as the interest charged does not exceed the principal amount loaned.
- Sets the minimum interest rate that commercial banks and other financial institutions pay on deposits in interest-earning accounts to 70% of the 91-day Treasury Bill rate.
- Prohibits banks and financial institutions from levying charges other than statutory charges and interest on loans.

The act's provisions on interest rates apply retrospectively to 1 January 2001.

The act also established a Monetary Policy Advisory Committee. This committee is composed of four Central Bank employees, two ex officio members of the Treasury, and five other members—at least two of whom must be women—appointed by the minister of finance. The committee's main function is to advise the Central Bank on monetary policy, including the volume of 91-day Treasury bills. The committee is also expected to perform other functions as prescribed by the minister.

The government and commercial banks have aggressively contested the Donde Act, arguing that it does not address the root causes of the interest rate problem. Donors have also expressed concern about the legislation. Banks have gone to court to stop the implementation of the act, claiming that it is unconstitutional and that its retroactive application to secured loans will deny them legitimate returns. The government, meanwhile, has argued that interest rate controls will only lead to costly distortions in the financial sector. In fact, one such distortion has already occurred: commercial banks have sharply reduced lending to the private sector and increased their demand for Treasury bills. As a result economic operators have found it increasingly difficult to borrow despite relatively low interest rates. If not corrected soon, this lending behaviour could have serious economic repercussions.

> ***"The budget system experienced some major problems that threatened fiscal balance in the short run"***

Fiscal policy and domestic debt

During 1997–2001 the Kenyan government pursued prudent fiscal policy. The budget system, however, experienced some major problems that threatened fiscal balance in the short run. These problems included considerable arbitrariness in the budget process, a bloated public sector with a correspondingly high wage bill, and large budget deficits financed by short-term domestic borrowing. In recent years debt service and wage obligations ate up more than half the budget, squeezing out other recurrent spending and capital investment. Thus it is extremely difficult for public spending to foster growth. Indeed, although the government collected nearly a quarter of GDP in revenue, the budget was unable to ensure sufficient provision of basic economic and social infrastructure to support productive activities.

Fiscal policy—making public spending more effective

To make public spending more effective, in 2000 the government adopted the Medium Term Expenditure Framework. The framework seeks to:

- Allocate spending to agreed priorities, identified as those with the greatest potential effect on economic growth and poverty reduction.
- Link the three-year budget programme to longer-term objectives.
- Make funding for priority projects and programmes more predictable over a three-year period.
- Formulate the budget through a more consultative process, involving all ministries, departments, and other economic stakeholders in identifying priorities to be funded to achieve national objectives.

The priorities relevant to the framework are outlined in the Full Poverty Reduction Strategy Paper (Full PRSP) prepared by the Kenyan government in consultation with donors. That paper, which has formed the basis for negotiations with the World Bank and the IMF on a new programme under the Poverty Reduction and Growth Facility, is a product of broadly based, in-depth consultations among key players in the economy. (The IMF approved Kenya's initial Poverty Reduction and Growth Facility programme in August 2000 but suspended it at the end of that year for noncompliance with agreed implementation measures.) The priorities identified in the poverty paper are to be implemented through the Medium Term Expenditure Framework over the next three years.

> *The government has sought to define a realistic three-year macroeconomic and fiscal framework*

Accordingly, the government has sought to define a realistic three-year macroeconomic and fiscal framework as the basis for forecasting tax revenues and grants as well as for setting spending ceilings for each sector. In line with these resource ceilings, which have received approval at the highest level of government, detailed budgets are prepared for ministries and departments.

Unlike previous government budgets, which spread resources thinly over a large number of projects, the Medium Term Expenditure Framework aims to focus resources on high-priority programmes and provide adequate resources for operations and maintenance. Thus the framework has become the main instrument for increasing the effectiveness and efficiency of public resource use. In addition, as part of efforts to address poor management of public spending and service delivery, the government is publishing a quarterly budget review that monitors implementation of the budget plan.

Domestic debt—nearly $3 billion

Kenya's domestic public debt is nearly $3 billion, and each year interest payments consume about 12% of government revenue. Moreover, most of this debt is in 91-day Treasury bills—forcing the government to take continuous recourse to the market to roll over the debt. High debt is one of the main reasons the government cannot afford sufficient public services.

In fiscal 2001 the budget deficit totalled 20 billion shillings (about $250 million). The government desperately needs budget support to avoid financing the deficit through more domestic borrowing. Accordingly, the government urgently needs to expedite the trigger actions for the resumption of an IMF–World Bank programme. If this support is not secured soon, attempts to lower public debt to sustainable levels may be futile. The government also faces the daunting challenge of supporting sustained economic growth without increasing overall public spending. The government must consider accelerating its privatization programme, especially in telecommunications, and using the proceeds to retire part of the domestic debt.

External policies—regional integration and tariffs

In October 2000 Kenya joined the free trade area formed by the Common Market for Eastern and Southern Africa (COMESA). Membership creates opportunities for increased exports in several sectors. Kenya's exports to COMESA members increased from 51 billion shillings in 1997 to 57 billion shillings in 2000. Indeed, the COMESA region has overtaken the European Union as the main destination of Kenya's exports, with its share increasing from 43% of the total in 1997 to 45% in 2000.

> ***Kenya's trade outlook will be influenced by its tariff structure***

Although there is enormous potential for increasing exports to the East African Community (EAC), there is a growing feeling among the EAC's two other members—Tanzania and Uganda—that Kenya needs to buy more from them to ease the huge trade imbalance favouring Kenya. Unless this situation is addressed, Kenya's exports to Tanzania and Uganda may be undermined by nontariff barriers and other tariff-like charges—a development that is raising concern among exporters. Exports to the two countries account for 61% of Kenya's exports to other African countries. Whereas most exports to the European Union are primary products, manufactured goods dominate exports to the EAC and COMESA. Given Kenya's goal of diversifying exports away from traditional products, the COMESA and EAC markets should be safeguarded.

Membership in the COMESA free trade area exposes Kenya to potentially stiff competition from stronger economies such as Egypt and Mauritius. Vulnerable goods include sugar, wheat, and rice, imports of which have already increased from the COMESA region. But it is suspected that some of these imports may be originating in other areas and entering fraudulently as COMESA imports. Customs authorities need to tighten verification procedures, allowing only items that qualify to enter Kenya.

Other markets offering opportunities for increased Kenyan exports include the United States—especially with the passing of the African Growth and Opportunity Act (AGOA) by the U.S. Congress—and the European Union. Kenya has secured investment commitments worth an estimated 500 million shillings since being designated as a beneficiary of the AGOA. Over the next few years the act is expected to almost double Kenya's export earnings, from 2.7 billion to 5.2 billion shillings.

Kenya's trade outlook will also be influenced by its tariff structure. In 1999 Kenya had only five non-zero tariff bands. But suspended duties were levied on 30 items considered sensitive. The suspended duties were applied in addition to normal duties and so were equivalent to customs duties. The suspended duties nullified the benefits of reduced COMESA tariffs because the reductions were based only on normal duties. Under pressure from the IMF, World Bank, World Trade Organization, and its trading partners in the region, Kenya was forced to eliminate suspended duties. In fiscal 2001 suspended duties were merged with normal duties to form nine non-zero tariff bands ranging from 2.5% to 100%.

In line with agreements with COMESA and EAC members, and as part of the IMF's Poverty Reduction and Growth Facility programme (currently suspended), Kenya will rationalize its tariff structure over the next four years. Already, imports from COMESA members

that meet the rules on origin are duty free on a reciprocal basis. In addition, imports from Tanzania and Uganda receive a 90% tariff reduction on a nonreciprocal basis—an arrangement intended to narrow the huge trade imbalance favouring Kenya. Ultimately, Kenya's maximum tariff will be lowered to 25% and the number of non-zero tariff bands reduced to three.

Imports from COMESA members that meet the rules on origin are duty free on a reciprocal basis

Social sector developments

The main challenges for Kenya's social sector policies include reducing poverty, increasing enrolments, and expanding access to health care.

Poverty—15 million poor

In 1997 just over half of Kenyans lived below the poverty line (table 5.4). At the same time, more than three-quarters of rural and urban poor people could not afford private health care and so depended on public health facilities. Yet nearly three-fifths of poor people did not seek public health care because drugs were not available. Education indicators are also weak for poor people: 13% of the urban poor and 29% of the rural poor have never attended school—and education's high cost is cited as the main reason.

In short, Kenya's poor are malnourished, have little education, and do not have access to proper medical care. As a result they suffer from high unemployment and mortality rates. In 2001 the number of poor Kenyans increased to an estimated 15 million. Thus the country's most crucial challenge is reviving economic growth and reducing poverty.

Education—enrolment rates below norm

During 1998–2001 Kenya spent more than 7% of its GNP and 18% of its government budget on education. Yet gross enrolment rates at the primary and secondary levels are below the norm for such high spending. More worrisome, gross primary enrolment fell about 4 percentage points in 2000 (table 5.5). The introduction of school fees, combined with stagnant and falling incomes, was the main cause of the decline.

Moreover, the quality of education has fallen due to insufficient resources. In fiscal 2001 recurrent spending accounted for 98% of spending by the Ministry of Education. Administrative costs consumed 82% of recurrent spending, with most used for teacher wages. The remaining funds are inadequate to provide sufficient educational equipment, supplies, and services.

Health—life expectancy gains reversed

In fiscal 2001 health accounted for 15% of recurrent government spending on social services, second only to education. In addition, the private sector and nongovernmental organizations increased their investments in health care facilities. As a result the number of hospitals rose 7.1%, health centres 1.3%, and dispensaries 2.5%. As noted, however, many Kenyans do not seek health care. Poor people's access to health care has worsened because of falling incomes, the introduction of user charges in government facilities, and the unavailability and high cost of drugs.

Table 5.4
Various measures of poverty in rural and urban areas, Kenya, 1997 (percent)

Area/poverty measure	Headcount ratio: Households	Headcount ratio: Individuals
Rural areas		
Food poverty	43	50
Absolute poverty	46	53
Hardcore poverty	30	35
Urban areas		
Food poverty	32	38
Absolute poverty	43	50
Hardcore poverty	6	8

Source: *Kenya, Central Bureau of Statistics 1997.*

Table 5.5
School enrolments and life expectancy, Kenya, 1995–2000

Indicator	1995	1996	1997	1998	1999	2000
Enrolment (percent)						
Primary school	84.9	85.9	87.0	88.0	89.0	85.0
Secondary school	24.4	25.1	25.8	26.4	27.1	29.1
Tertiary school	1.9	2.0	2.0	2.1	2.1	2.2
Life expectancy (years)		55.0	54.0	52.1	47.7	48.9

Source: *World Health Organization 2001; World Bank 2001.*

Making matters worse, HIV/AIDS has reversed gains in life expectancy. The disease is the main reason for the drop in life expectancy from 55 years in 1996 to 49 years in 2000 (see table 5.5). In 2000 the national HIV prevalence rate reached 13.5%. With more than 1 in 10 adults infected with HIV, the cost of the epidemic is expected to total more than $2 billion over the next five years. The government responded by establishing a National AIDS Control Council to strengthen capacity and coordination. AIDS committees have also been established in all political constituencies, including provinces and districts.

> *The quality of education has fallen due to insufficient resources*

Institutional reforms and governance

Poor economic governance is the main impediment to Kenya's development. Poorly managed public resources, widespread corruption, and the public sector's inability to deliver services efficiently have undermined development over the years. Citing these reasons, in 1997 the IMF suspended its Enhanced Structural Adjustment Facility. As noted, this move crippled Kenya's balance of payments position because external investors repatriated about $250 million—leading to a 20% depreciation in the shilling and a 9 percentage point increase in the Treasury bill rate, from 18% to 27%.

In 2000 the government began implementing a major public sector reform programme

Similarly, in 1998 the World Bank suspended a structural adjustment credit of $87 million to Kenya, arguing that the government was not committed to agreed actions. The Bank subsequently placed Kenya in its low-case lending group, limiting available support to nonlending programmes aimed at improving economic governance and financial management and accountability. The Bank also indicated that unless the public sector improved its spending management and project implementation capacity, conventional lending was unlikely to be effective.

In 2000 the World Bank agreed to resume lending, providing a total of $150 million as an Economic and Public Sector Reform Credit. The funds were to be released in three instalments of $50 million, with the first made in September 2000. But with the IMF's suspension of its Poverty Reduction and Growth Facility at the end of 2000, the Bank did not disburse the second and third instalments.

Kenya is in the midst of consultations with the IMF on the Poverty Reduction and Growth Facility. IMF approval would lead to SDR 20 million (about $16 million) in budget support as part of the facility approved in July 2000. To obtain this approval, Kenya basically needs to establish a constitutional Anti-Corruption and Economic Crimes Authority. The previous Anti-Corruption Authority was declared unconstitutional because the establishment of an independent corruption authority was considered to usurp the powers of the attorney general. The revised law was introduced in Parliament but defeated, and six months must pass before it can be reintroduced. To demonstrate Kenya's commitment to containing corruption, however, Kenya's president has established a corruption-fighting unit in the police force.

In addition, to address governance challenges, the government has embarked on an ambitious programme that involves restructuring the public sector, reforming the management of public spending, and strengthening public sector accountability. The programme's main elements are public sector reform, local government reform, and privatization.

Public sector reform—performance-oriented management

In 2000 the government began implementing a major public sector reform programme focused on establishing performance-oriented public sector management. The main elements of the reform are a public service management programme, legal and judicial reform, efforts to enhance integrity and accountability, and efforts to increase interaction with civil society. The first task was to restructure the government around a limited number of core functions. Thus the number of ministries was cut from 28 to 15 and some permanent secretaries were eliminated. These steps were followed in fiscal 2001 by a fairly successful staff retrenchment programme, combined with improved pay and benefits for remaining staff.

Local government reform—autonomous authorities

Kenya's central government has developed a decentralization strategy aimed at assigning responsibility for local services to autonomous local authorities. Two mechanisms have been implemented to achieve this goal: the Local Authority Transfer Fund and

Financial Control Management Boards. The fund transfers 5% of income tax revenue to local authorities. A local authority service charge has been phased out, but local authorities must meet strict requirements to obtain financing from the transfer fund.

Privatization—divesting large enterprises

Kenya's public enterprise reform programme is focused on divesting large infrastructure and service enterprises, especially Telkom Kenya, Kenya Railways, Kenya Ports Authority, and Kenya Pipeline Corporation. The government has committed to a number of measures in reforming and privatizing state-owned enterprises.

Public enterprise reform and privatization are key conditions for World Bank and IMF loans. But privatization has fallen short of expectations in terms of speed and achievement, as with the telecommunications company. The World Bank and other development partners consider this a reflection of the government's weak commitment to privatization, but the government argues that the long, complex privatization process is responsible for the delays.

"Economic outcomes will be even better if the IMF and the World Bank resume assistance to Kenya"

Outlook for 2002—real GDP growth to rise to 2.5%

Kenya's economy should continue to recover in 2002. Growth will be stronger in agriculture, while manufacturing is expected to grow twice as fast as in 2001—partly as a result of better power supplies, the elimination of some tariffs, and reductions in others. Reflecting these developments, real GDP is projected to grow 2.5%. With the domestic economy recovering, exports and imports will expand, causing the current account deficit to increase slightly from 2.6% of GDP in 2001 to 2.8% in 2002. Inflation will also edge upward, reaching 3.8%.

Economic outcomes will be even better if the IMF and the World Bank resume assistance to Kenya. Such assistance would not only provide additional resources, it would also send a positive signal to other donors and private investors. Thus in the coming year the government should make a concerted effort to improve its relationship with both institutions.

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