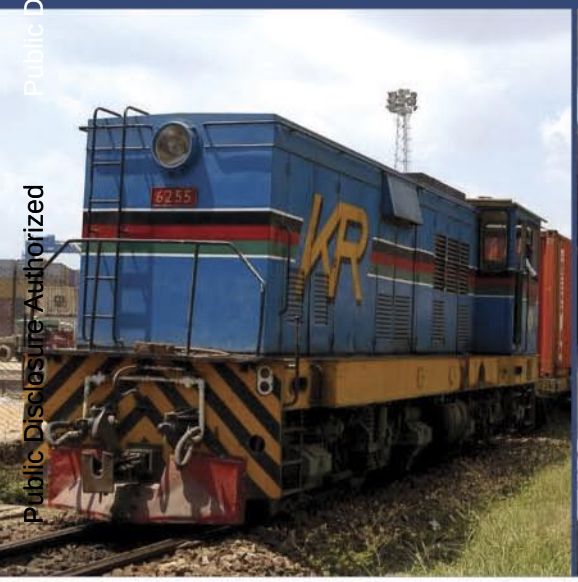
KENYA ECONOMIC UPDATE

June 2010 | Edition No. 2



Running on One Engine: *Kenya's uneven economic performance*

with a special focus on the port of Mombasa

Poverty Reduction and Economic Management Unit Africa Region

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FOREWORD

This is the second edition of the Kenya Economic Update. The launch of this report also marks the passing of 50 years of World Bank presence in Kenya. Over the last 50 years we have built many partnerships with the public, government, academia, private sector, non-government organizations, development agencies and other stakeholders.

These Economic Reports are prepared in close partnership with Kenyan stakeholders and represent a new model of a strong knowledge engagement with our local partners. We are particularly grateful to the Central Bank of Kenya, the Office of the Deputy Prime Minister and Ministry of Finance, the Ministry of Planning and Development, the Kenya Ports Authority, the Kenya Revenue Authority, the Kenya National Bureau of Statistics, and the Kenya Institute of Public Policy and Research Analysis, which have contributed to this report and provided guidance during its preparation.

This report, like its predecessor, provides an update of recent economic trends as well as a special focus on a selected topical issue. The reports aim to support all those who want to improve the economic management of Kenya. They are intended to help inform and stimulate knowledge and debate on topical policy issues, and so to make a contribution to unleashing Kenya's growth potential.

This edition of the Economic Update has three main messages. First, Kenya's economy continues to recover. After two years of low growth, we project 4.0 percent growth in 2010, which means that most Kenyans will again experience an improvement in their living conditions.

Second, Kenya has been "running on one engine" – the theme of this report. Domestic consumption is the main driver of Kenya's economy, while exports have disappointed. Over the last decade, this imbalance has become even more pronounced, as reflected in the sectoral performance of Kenya's economy — several service sectors have now overtaken manufacturing, which stagnated at around 11 percent. For Kenya to achieve and sustain high levels of growth, it will need to restart the export engine.

Third, one of the main reasons for this economic imbalance is Kenya's infrastructure deficit. In this report we highlight the role and performance of the port of Mombasa, East Africa's most important infrastructure asset. Despite some improvements, the port is still underperforming. Reforms have not kept up with the momentum in other African countries and the port remains heavily congested, which explains why it has lost significant business as a transshipment port. Over the next years, the pressure on the port will increase further. East Africa's economies are expected to grow at 5 percent. With oil exploration in Uganda and a stronger attachment of southern Sudan to the region, the port of Mombasa has a great opportunity to become the major regional hub. This is an opportunity that Kenya cannot afford to miss.

Johannes Zutt
World Bank
Country Director for Kenya

ACKNOWLEDGEMENT

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ABBREVIATIONS AND ACRONYMS

CAS	Country Assistance Strategy
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CCK	Communication Commission of Kenya
C&F	Clearing and Forwarding
CFS	Container Freight Services
COMESA	Common Markets of East and Southern Africa
CT	Corporate Tax
DWT	Deadweight
DRC	Democratic Republic of Congo
EAC	East African Community
GDP	Gross Domestic Product
GNFS	Goods and Non-Factor Services
ICT	Information and Communication Technology
KNBS	Kenya National Bureau of Statistics
KPA	Kenya Ports Authority
KRA	Kenya Revenue Authority
NSE	Nairobi Stock Exchange
PAYE	Pay As You Earn
PCBS	Port Community Based System
SSA	Sub-Saharan Africa
TEUs	Twenty-foot equivalent unit
UAE	United Arab Emirates
USA	United States of America
UK	United Kingdom
VAT	Value Added Tax
WB	World Bank
WDI	World Development Indicators

EXECUTIVE SUMMARY

Kenya has entered a new decade with renewed momentum for strong and sustained growth. Being part of Africa's strong recovery after the global crisis and a regional leader in services, Kenya has high hopes for a strong economic performance during this new decade. After two years of low growth, the World Bank projects 4.0 percent growth in 2010 which means that most Kenyans will again experience an improvement in their living conditions. To achieve and sustain high growth over the next decade, Kenya will need to address its economic imbalances, avoid domestic shocks, and manage the impacts of future external crises. The theme of this ***second Kenya Economic Update****, "Running on One Engine", reflects the structural imbalance of Kenya's current economy — Kenya's strong engine is domestic consumption; its weak engine is exports. In order to restart the export engine, Kenya will need to address a number of issues, especially the infrastructure deficit. The port of Mombasa, for example, is Kenya's most important and concentrated infrastructure asset. As the special focus section of this report concludes, the port needs substantial reform and upgrading to reach international standards and to meet the demands of a growing and increasingly integrated East African Community.*

KENYA'S RECOVERY

Kenya's economy continues its path of recovery – slowly but surely. For 2010, the World Bank projects that Kenya's growth rate will reach 4.0 percent, which represents a robust recovery after the four consecutive shocks Kenya experienced in the previous two years. If positive economic trends continue, Kenya could grow at 5 percent in 2011, bringing the country back into the high growth momentum it experienced between 2004 and 2007.

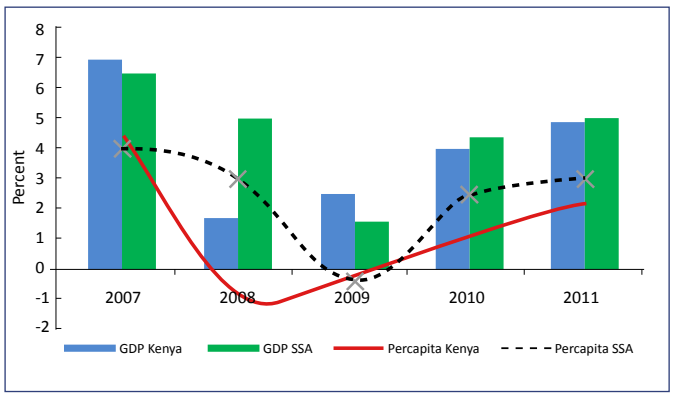
Recent economic developments have been promising and create optimism that Kenya will begin the new decade on an upward growth path. At the end of 2009, Kenya's growth accelerated and this growth momentum continued into 2010. Strong rains have helped in the recovery of the agriculture sector – which had contracted by a combined 7.5 percent in 2008 and 2009. The more stable provision of energy since January 2010 supported a moderate rebound in manufacturing. Services continue to perform strongly with an ICT revolution which continues at the same pace as one year ago. Phone ownership is likely to have exceeded 20 million, which means that statistically every adult in Kenya now owns a phone.

Kenya, along with most of Africa, entered the crisis buoyed by a strong macroeconomic position and subsequently managed the global financial crisis well. A strong fiscal position, banking reforms and declining inflation allowed the government to respond to the crisis proactively by lowering lending rates and preparing a fiscal stimulus package (supporting social protection and infrastructure investments). Many of Kenya's macroeconomic fundamentals improved despite the crisis. Inflation declined further to below 5 percent by end 2009, enabling Kenya to issue domestic debt at lower rates. The share of Non-Performing Loans was also lower in 2009 than in 2007.

Kenya's fiscal challenge today is not mobilizing resources – but effectively implementing its public expenditure program. While Kenya's aggregate fiscal performance remains very strong, the implementation of the fiscal stimulus has proceeded slowly. Domestic revenues remain among the highest in Africa. Deficits over the last decade have been low and with relatively high growth. Kenya has been able to reduce its debt levels from 60 percent (2000) to 40 percent (2008) of GDP despite never having received substantial debt relief. This strong fiscal position allowed the government in 2009 to embark on a fiscal stimulus program of Kshs 22 billion, equal to 1 percent of GDP, which increased the projected fiscal deficit to 6.6 percent. However, nine months into the fiscal year the government has only spent 57 percent of the stimulus, which, when combined with the government's traditional weakness in implementing the development budget, translates into substantial under-spending on Kenya's critical public investment program. As a result, the overall fiscal deficit for FY 2009/2010 is unlikely to exceed 5 percent.

Going forward Kenya can match Africa's growth rates if it avoids domestic shocks and manages the impacts of future external crises. Africa and East Asia have recovered fastest from the 2009 global financial crisis. By 2011, African growth rates are expected to again exceed 5 percent, almost back to pre-crisis levels. Kenya has the potential to grow in line with Africa's average, although per capita growth would be lower (see figure 1). For this to happen, the Kenya Government will need to avoid domestic shocks, for example by successfully managing this year's constitutional referendum process and any future drought. External crises could also adversely affect Kenya's growth prospects. The interruption in commercial air traffic to Europe earlier in 2010, caused by the eruption of the Icelandic volcano, briefly impacted Kenya's horticultural exports. The current crisis in the euro zone, brought on by Greece's debt situation, has led to an appreciation of the Kenya shilling. Over time a weak euro could result in a reduction in horticultural exports to Europe and tourists visiting Kenya from that region. Kenya can mitigate the impacts of these potential external crises by seeking more diversified markets for both its agriculture and its tourism.

Figure 1: Kenya's economy is recovering – slowly but surely



Source: KNBS, World Bank staff estimates

RUNNING ON ONE ENGINE

The drivers of Kenya's economy are not in balance. Even if the country avoids another crisis in the coming years, it will be very difficult for Kenya to achieve high growth over an extended period of time because of its existing economic imbalances. Kenya's strong engine runs on domestic consumption, which accounts for 75 percent of GDP. Kenya's weak engine remains its exports which have been declining sharply in relative importance.

Kenya is among the few developing countries in the world which has seen its external sector shrink rather than grow over the last five decades. Kenya's exports as a share of GDP have declined from 40 percent in 1960 to 26 percent in 2009. While most emerging economies have invested in their export production, Kenya has seen its traditional agriculture exports, mainly coffee and tea, stagnate as a result of weak governance in marketing institutions. Meanwhile, Kenya developed robust horticultural exports (flowers, vegetables) and has seen an increase in its service exports, mainly tourism and air transport, and an emerging outsourcing industry (e.g. call centers). However, these new growth areas were not enough to counter the downward trend in exports as a percent of GDP.

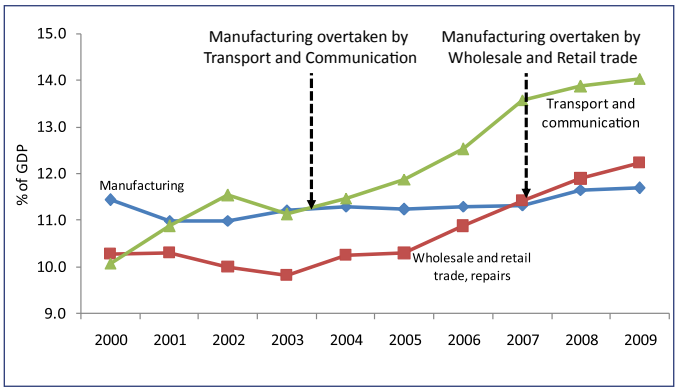
As a result of rapidly increasing imports of basic commodities (fuel, clinker and maize) to support its domestic economy, and stagnating exports, Kenya's trade deficit has been widening in the last years. The current account deficit is financed by increasing capital inflows, which reached a new record of 9.5 percent of GDP by 2009. This is remarkable given the global financial crisis and low FDI into Kenya. These inflows drive investments into construction and services, helped to move Kenya's balance of payments into positive territory and keep the exchange rate stable.

The economic factors causing the imbalance in the external sector can also be seen in Kenya's sectoral growth trends. Sectors which produce goods for the domestic market ("non-tradables") have been doing well, especially the strong service sector. Sectors which produce export goods ("tradables"), have been doing poorly in aggregate, even though some sub-sectors and strong companies have defied the odds, e.g. producers in the horticulture industry.

The sector which has been seriously underperforming over the last decade is manufacturing. In emerging economies, a high performing manufacturing sector is associated with a strong export performance. In 2000, manufacturing was Kenya's second largest economic sector after agriculture. By 2009, manufacturing slipped to fourth place. Over the whole decade the share of manufacturing in the economy remained stable at 11 percent. During the same period, services expanded and two

service sectors overtook manufacturing—in 2004 transport and telecommunication became Kenya's second largest sector, and in 2007 wholesale and retail trade surpassed manufacturing as a percentage of GDP (see figure 2).

Figure 2: Manufacturing falls behind service sectors



Source: KNBS, World Bank staff estimates
Note: GDP constant 2001 prices all industries

To increase and sustain broad-based economic growth the structure of production will require reorientation towards the production of tradable goods and services. This can be achieved through incentives to diversify and increase the share of service exports, restart manufactured exports, and gradually reduce the share of government and private consumption in aggregate demand.

RESTARTING THE EXPORT ENGINE — LEVERAGING THE PORT OF MOMBASA

Restarting Kenya's export engine will require the government to undertake a range of investments and policy initiatives, including those that would improve the efficiency and expand the capacity of the port of Mombasa, the gateway for Kenya's imports of fuel and raw materials. Kenya needs to address a range of inter-related issues around improving efficiency of the port's operations (improved customs and inspection procedures, so called 'soft infrastructure') and expanding capacity to meet the expected high growth in cargo traffic. A better run port, one that has adequate capacity to meet the growing import and export requirements of the region, needs to be an essential part of Kenya's economic growth strategy. Once local and foreign investors see that the government is intent on strengthening operations at the port of Mombasa, they are more likely to make medium-term investments in sectors such as manufacturing.

The port of Mombasa is possibly the single most important piece of infrastructure in East Africa and has the potential to become the critical transport hub for the region. The port is already the lifeline for most of East Africa's raw material and petroleum product imports. In the next years, East Africa's economies are expected to grow at above 5 percent, which will further increase the flow of goods through East African ports. Over the medium term oil exploration in Uganda is expected to result in a flow of equipment imports and eventually exports of oil and petroleum products, which would all pass through Mombasa. Growing economic activity in southern Sudan would result in additional demands for capacity at Mombasa to handle the raw material imports for an emerging economy. In addition the port has untapped potential to be a transit route for new Kenyan manufacturing exports as two-thirds of the containers bringing imports into the port return empty. The port could also serve as a hub for the transshipment of goods within Eastern and Southern Africa.

The port of Mombasa is operating at full capacity and not very efficiently, with the resulting costs rippling through the economy, affecting manufacturing and other import dependent activities. The situation is particularly acute for container traffic, as the absence of reform and new investment will result in increased vessel delays, port congestion surcharges and higher costs to customers. Moreover the use of IT to speed up clearance procedures and introduce greater transparency to port operations should represent a quick and cost-effective solution to improve efficiency.

Port reform is possible; many ports in Africa and elsewhere have demonstrated that improvements can happen fast. In Nigeria, the adoption of the port landlord model in 2006, a form of public-private partnership where the public sector regulates and the private sector invests in and operates the port, has resulted in a dramatic inflow of private investment and a rapid increase in the efficiency of port operations. Ghana also adopted the port landlord model in 2007 as part of its 'Ghana Gateway' program to service its neighboring landlocked

countries as well as meet its own economic needs. The results have been positive with the port of Accra delivering competitive service approaching international standards. Jordan increased port capacity through a low-cost Truck Control System in 2005 which resulted in 25 percent more cargo moving to and from the port of Aqaba with the same number of trucks.

The Government of Kenya needs to take action now to forestall the port of Mombasa from becoming an impediment to economic growth. While plans have been drawn up in the past, the government has failed to comprehensively address the range of issues associated with efficient port administration and operation. The government could improve the performance of the port in a short period of time if it were to implement a number of reforms and investments now. Among the most critical are:

In the next 3 to 6 months

- Identify a coordinating body with a mandate for reform.
- Appoint the managing director of the KPA on a 3-year performance contract.
- Decide on the route for the Mombasa by-pass and start implementation together with the link road from the port.
- Set up a system of incentives to enable full 24-hour port operations by multiple stakeholders.
- Implement the IT Port Community-Based System.
- Approve the concessioning of berths 11-14 through a competitive and transparent process.

In the next 6 to 12 months

- Clarify the timetable for a full landlord port status as well as the role of KPA.
- Clarify the roles and responsibilities of public and private port stakeholders.
- Undertake reforms of customs collections, making them more efficient and transparent.
- Strengthen port operational capacity of the Ministry of Transport.

In summary, Kenya has put in place programs in the last few years that will stimulate the economy and set the stage for renewed growth. However, Kenya has been running on one engine, domestic consumption, while developing a chronic current account deficit. For long-term double - digit growth, Kenya will need a greater response from its export sector, including manufacturing industries. Investment will flow into manufacturing, as it has in telecommunications and other service sectors, if political stability continues in the medium term and the policy environment remains appropriate. A critical incentive will be that the port of Mombasa has seen improvements in its overall capacity and operating efficiency.

The State of Kenya's Economy

The State of Kenya's Economy

This first part of the Kenya Economic Update examines Kenya's recent economic performance and puts these trends in the context of a structural transformation of the economy. Section one describes recent economic developments and evaluates the government's response to the series of economic crises that befell Kenya in 2008 and 2009. It shows that Kenya's economy continues its modest recovery. Section two provides the growth forecast for 2010, showing a slightly more positive projection for the year, in part as a result of the good rains in early 2010 which are critical to agricultural production and the production of hydroelectric power. Section three examines the structural composition of Kenya's recent growth and highlights a continuing (and unsustainable) trend: one where the economy is "flying on one engine" – domestic consumption fueled by imports – while exports have stagnated.

1. Recent Economic Developments

1.1 Highlights over the Last 18 Months

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

> "Last year's growth was mainly driven by services and a strong construction sector

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

In 2009, the agriculture sector disappointed again contracting by 2.4 percent. The sector was hit hard by the drought. The situation was most severe for maize, Kenya's main food staple. Due to shortages and imprudent policies which led to the "maize scandal", prices increased to double of world market levels hitting the poor especially hard.[1] On a more positive note, the livestock sub sector expanded by 3 percent despite the severe drought as a result of policy incentives and micro credit to dairy farmers, which demonstrates the potential of agriculture once appropriate incentives are in place. The export performance among Kenya's key export crops has been mixed and partly benefitted from rising prices:

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

[1] For more details see section 1.2 and the "Special Focus" in World Bank, Kenya Economic Update 1st Edition, December 2009.

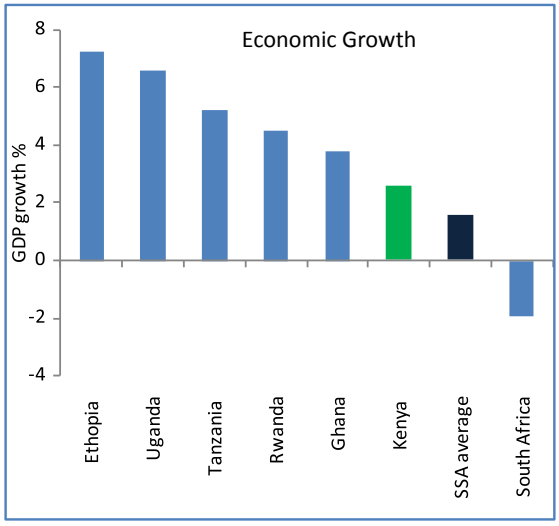
- ***Coffee*** received a double dividend, with both volume and prices increasing. However, coffee accounts for only about 4 percent of Kenya's exports.

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

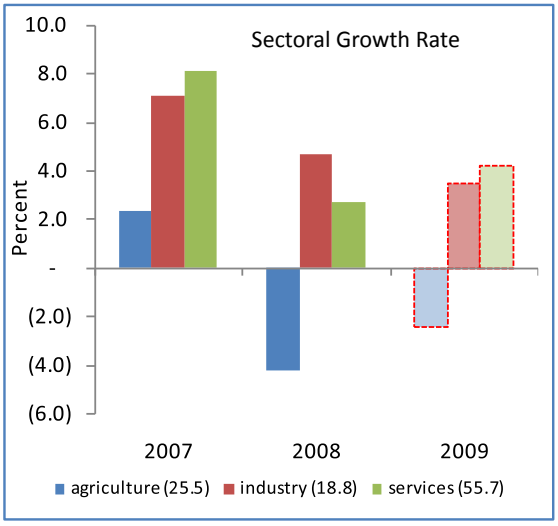
The service sector continues to drive Kenya's economy. Services grew by 4.2 percent led by Communication, Transport and Trade. Tourism rebounded to almost reach 1 million tourists (close to 2007 levels). Kenya's information and communication revo-

Figure 3: Kenya's Economic Performance in 2009

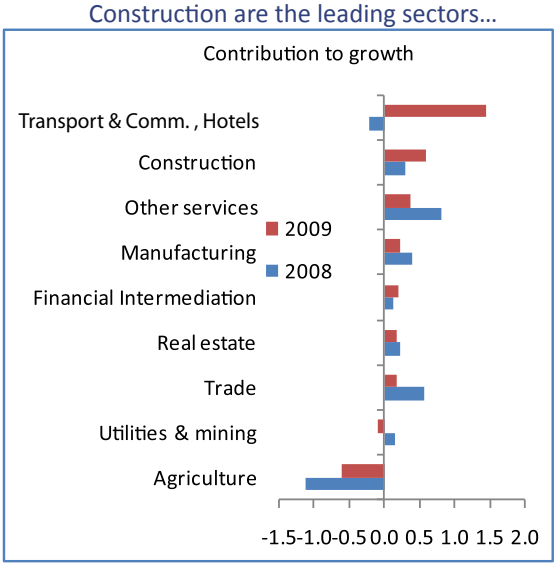
Growth at 2.5 percent...



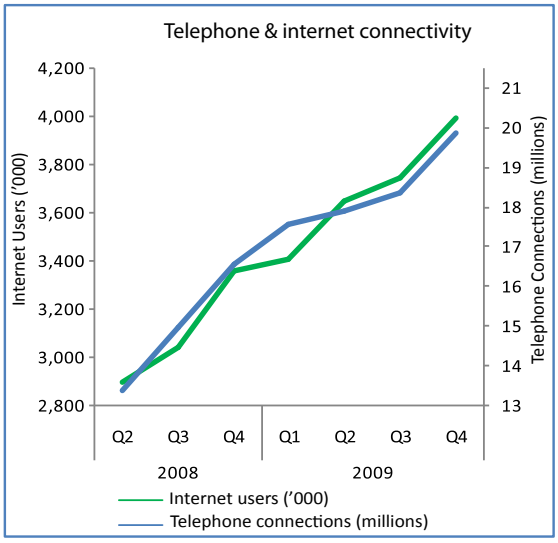
...driven by services, but agriculture contracted again



Transport & Communications, Trade and Construction are the leading sectors...



...and the ICT revolution continues



Source: KNBS, CCK, GEP and World Bank staff estimates

[2] For a summary of all the sectoral shares in the economy and the 2009 growth rates, see Annex 2.

lution continues. Mobile telephone and internet connectivity expanded by another 20 percent. Telephone ownership reached 19.7 million people by end 2009. If this strong growth continues through 2010, statistically every Kenyan above the age of 15 would be connected to mobile services. Internet connectivity had reached 4 million by the end of 2009 (see figure 3).

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

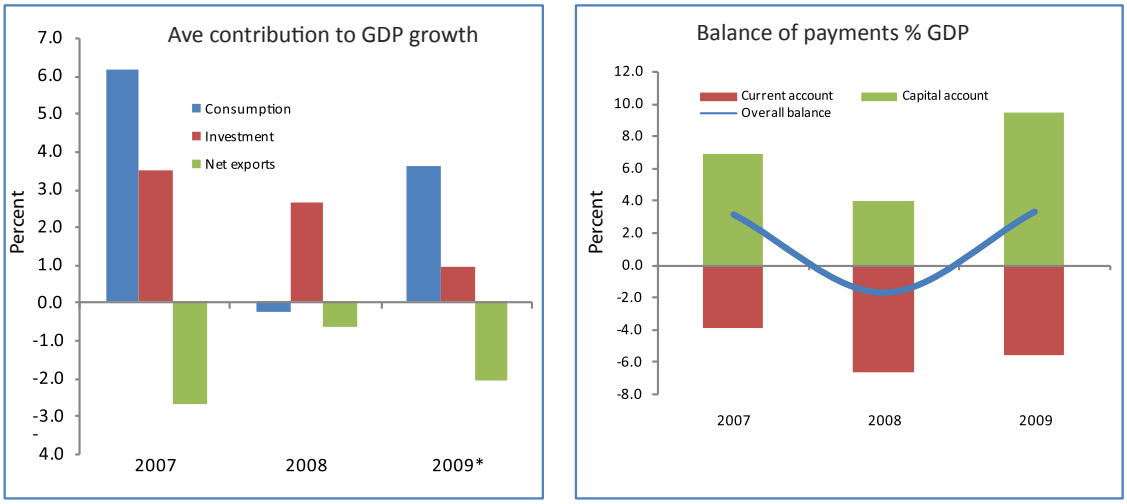
> "Kenya's government has managed the global crisis well while the domestic crises have hit the country hardest

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

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

Figure 4: Kenya's Economic Imbalances

Consumption is driving GDP… …at the expense of a large current account deficit



Source: CBK and World Bank staff estimates

1.2 An Assessment of Kenya's Crises Management

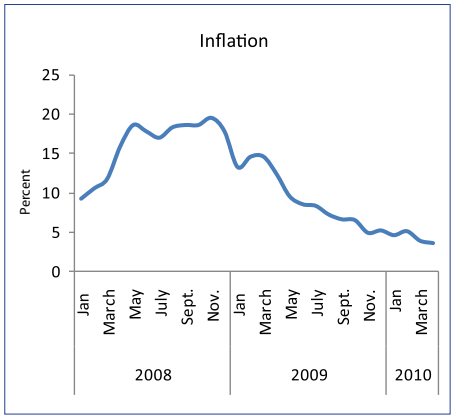
In the last two years, the Kenyan government has gained a lot of experience in crisis management. The country had to manage four waves of crisis, including the fuel and food crisis, post-election violence, the global financial crisis and a drought. Kenya's government has managed the global crisis well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

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

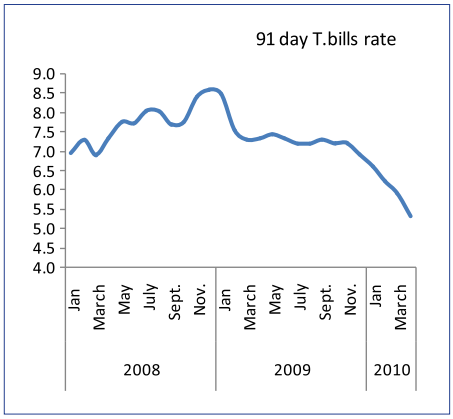
CBK continued implementing expansionary monetary policy and consistently reduced the Central Bank Rate (CBR) rate by 150 basis points in 2009. The CBK adopted this policy to stimulate the economy and broadly achieved the intended results. The Treasury bill rate declined by 156 basis points which also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

Figure 5: A Stable Macroeconomic Environment

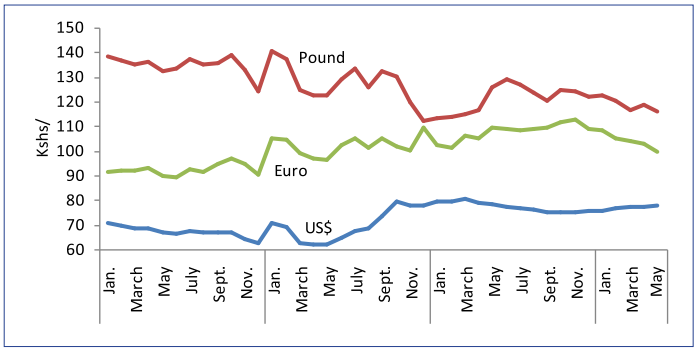
Inflation declined sharply, ...



... T-Bill rates (91 days) respond to counter cyclical monetary policy ...



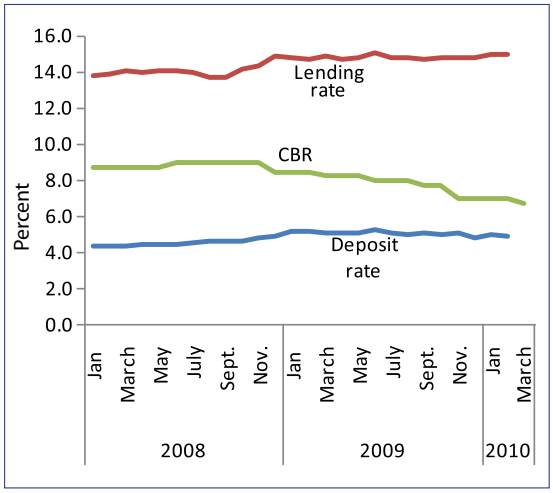
...and the exchange rate remained stable



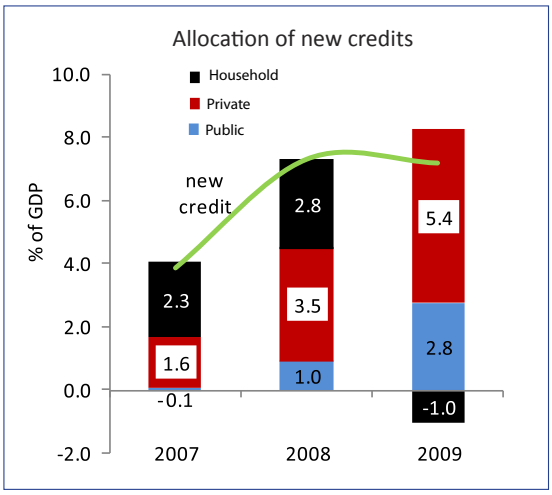
Source: CBK and World Bank staff estimates

Figure 6: Counter Cyclical Monetary Policy

Central Bank Rate reduced by 150 basis points



More credit to the private and public sector



Source: Central Bank Kenya and World Bank staff estimates

Kenya's sharp decline in inflation has allowed the Central Bank to lower its policy rate which has not been fully translated into lower commercial bank lending rates, yet. Kenya's inflation rate has declined substantially from 19 percent end 2008 to below 5 percent in March 2010.[3] Commercial Banks have been slower to lower interest rates because of an additional risk premium in the context of the global financial crisis and Kenya's sluggish economic performance. As a result, the spread between commercial bank lending and deposit rates remained relatively high, in spite of the decline in the CBR (see figure 6). However, even more aggressive Central Bank policies that reduced its lending rates much further in 2010 have started to lead to lower overall lending rates for commercial banks, as other compensating factors such as cost of funds and credit risk have also started to subside. Overall the banking sector remains stable registering high capital adequacy, high liquidity ratios and declining share of nonperforming loans to total loans (from 7.1 percent in 2008 to 6.8 percent by the end of 2009).

> "Kenya has traditionally followed a high maize price policy which benefits a small number of maize farmers

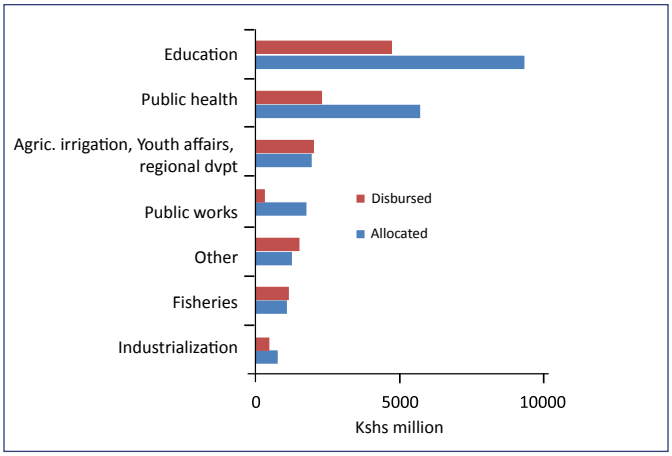
Credit to the private sector increased substantially by 5.4 percent of GDP in 2009. Most of this credit went to investments in the service and construction sectors which have shown the greatest response when credit terms become more attractive. Credit to households contracted by about -1.0 percent of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

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

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

[3] The numbers reflect the government's new computation methodology, introduced in October 2009, which brought the Kenyan measurement in line with international standard.

Figure 7: Fiscal Stimulus: 57 percent disbursment after nine months



Source: Ministry of Finance; Status: End March 2010

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

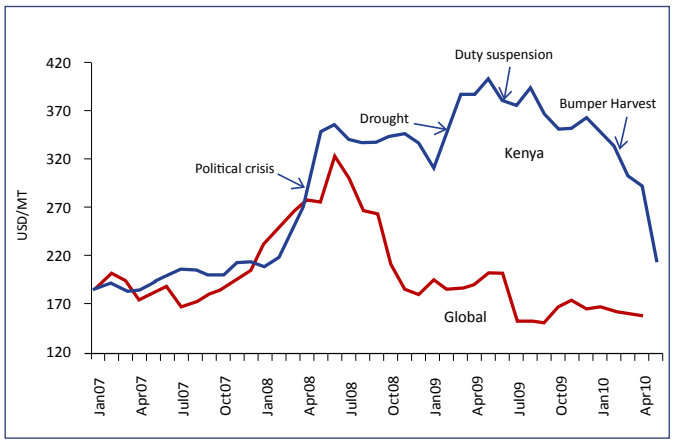
While the government's response to the financial crisis was very strong, the response to the food crisis was belated and weak. Kenya has traditionally followed a high maize price policy which benefits a small number of maize farmers. However, in 2009 the prices reached levels never seen before. Kenya's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

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

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

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

Figure 8: Maize prices are coming down after Kenyans paid a high price



Source: World Bank commodity price data-stream; Regional Agricultural Trade Intelligence Network

to only 10 companies, including a transport company which was not known to be an active player in Kenya's maize markets. By March 2009, when maize prices reached record highs (close to US$ 400 per metric ton) and double the international prices, the system broke down and government abandoned it. By end 2009 prices started to decline due to the suspension of the duty on maize imports and good rains which led to a bumper harvest in early 2010 (see figure 8).

2. Outlook for 2010 and 2011 — the Recovery Continues

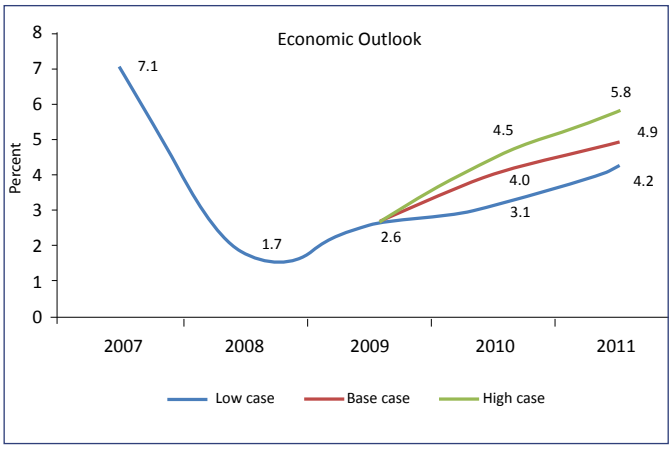
Towards the end of 2009 Kenya's economy started to recover more strongly and this positive momentum has been sustained into the first months of 2010. Favorable weather, a relatively stable domestic environment, and pro-active government policies led to mostly positive developments in the economy, for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

- ***Agriculture production improved.*** As a result of strong rains in early 2010, agricultural output rebounded. Production of various commodities increased including the staples, maize and beans, which led to decline in prices.
- ***Tourism back at 2007 levels.*** Tourist arrivals registered a 18.9 percent growth in the first quarter of 2010 compared to the same period last year and equaled 2007 arrivals.
- ***Inflation and interest rates declined.*** In the first quarter of 2010, inflation declined further to 4.6 percent after it reached 5.6 percent in the fourth quarter of 2009. The interest rate of the standard Treasury bill (91 days) declined as well to average at 6.2 percent.
- ***Credit increased.*** Credit grew by 20 percent in the first quarter of 2010, with credit to public sector growth of 44 percent and to private sector growth of 14 percent.
- ***Fiscal position remained stable.*** The fiscal position remained strong and the fiscal deficit is likely to be lower at 4 - 4.5 percent, more than 2 percent below the budget. Revenues remain broadly on target by end-December, recording a performance rate of 97 percent, and a revenue growth of 11.7 percent. However, expenditures will fall short of initial plans due to the government's difficulties in implementing both its development budget and its domestic stimulus package (see previous section).
- ***Stock market rebounded.*** The Nairobi Stock Exchange (NSE) index rebounded and reached close to 4300 points in May 2010, up from a low of 2500 points in February 2009. This recovery was primarily due to foreign investment, which indicates the improved confidence in the Kenya market as a whole. Since the beginning of the financial crisis, the NSE has moved in parallel with the Dow Jones. And since early 2010, the NSE has outperformed the Dow Jones.

> "The World Bank upgrades its growth forecast to 4.0 percent for 2010

Building on these broadly positive trends, the World Bank is revising its growth projection for 2010 upward to 4.0 percent. There is even the possibility that Kenya grows at a rate above 4 percent in 2010, especially if agriculture and manufacturing rebound very strongly which would depend mainly on continued favorable weather (see figure 9). This positive trend registers an important improvement compared to the sluggish performance of the last two years. And for the first time since 2007 the average income of Ken-

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



Source: World Bank Staff Estimates

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

Variable	2007	2008	2009	2010	2011	2012
GDP	7.0	1.6	2.6	4.0	4.9	5.4
GDP per Capita	4.2	-1.0	-0.2	1.3	2.2	2.8
Private Consumption	7.3	-0.4	3.8	3.2	3.9	4.2
Government Consumption	7.2	3.7	5.5	4.1	3.4	4.0
Gross Fixed Investment	13.3	8.9	0.6	6.7	8.5	11.8
Exports, GNFS	6.0	7.5	-7.0	6.2	7.6	5.5
Imports, GNFS	12.7	6.6	-0.2	5.5	6.1	6.6
Current account Balance (% of GDP) nominal	-3.8	-6.6	-5.5	-6.6	-6.0	-5.1
Population Growth	2.7	2.7	2.8	2.7	2.7	2.6
Statistical Discrepancy (share of GDP)	-0.9	-1.3	-1.3	-1.3	-1.3	-1.3

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

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

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

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

Exports will recover in 2010 reflecting the more positive regional and global environment, but the current account deficit will remain large. The demand for Kenyan exports will resume, especially in Europe and Sub Sahara Africa, the destinations of more than 60 percent of Kenya's exports.[4] Kenya's export market growth is projected at 5.2 percent in 2010, accelerating to about 6.5 percent in 2011-2012. Kenya's merchandise exports will grow much less rapidly than world merchandise exports, and indeed than developing countries' merchandise exports, translating into a continued loss of market share for Kenyan exports, and for manufacturing exports in particular. A strong recovery in tourism, albeit from a low base, will boost service exports.

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

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

- ***Agriculture.*** The sector is rain fed and is expected to enjoy a good year as most parts of the country will receive above average rainfall. The good harvest will cap the pressure on domestic food prices. Furthermore, government investment in irrigation will also increase food supply boosting consumption.
- ***Industry.*** Output will normalize in 2010, benefitting from more normal power provision as well

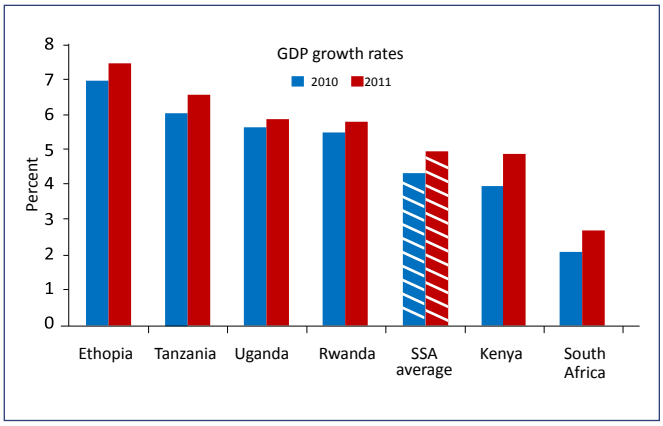
[4] Growth in the Euro area is projected at 0.9 percent in 2010 and 1.5 percent in 2011. Growth in the EU is projected at 1.1 percent and 1.8 percent in 2010 and 2011 (Global Economic Prospects, January 2010).

as increased credit supply to the private sector. Construction continues to lead economic recovery, stemming also from high public investment in infrastructure.

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

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

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



Source: World Bank GEP

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

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

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

3.1 Taking Stock of a Poor Export Performance

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

period. Korea, for example, which had similar levels of income to Kenya in 1960, increased its exports from almost zero percent in 1960 to more than 55 percent today.

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

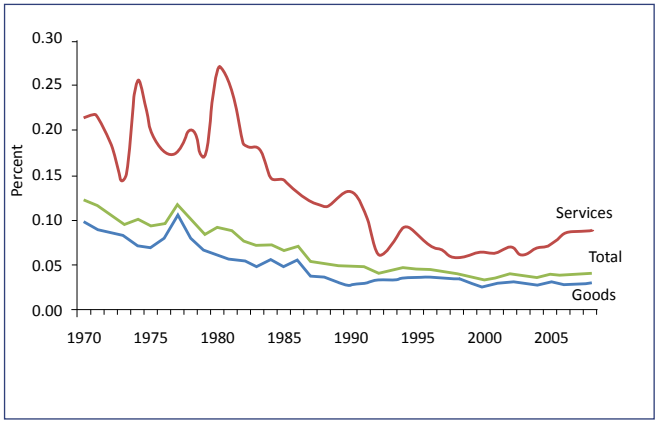
> "Kenya has turned inward, neglecting to stay competitive in its manufacturing sub-sector, and also losing market share in agriculture exports

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

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

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

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



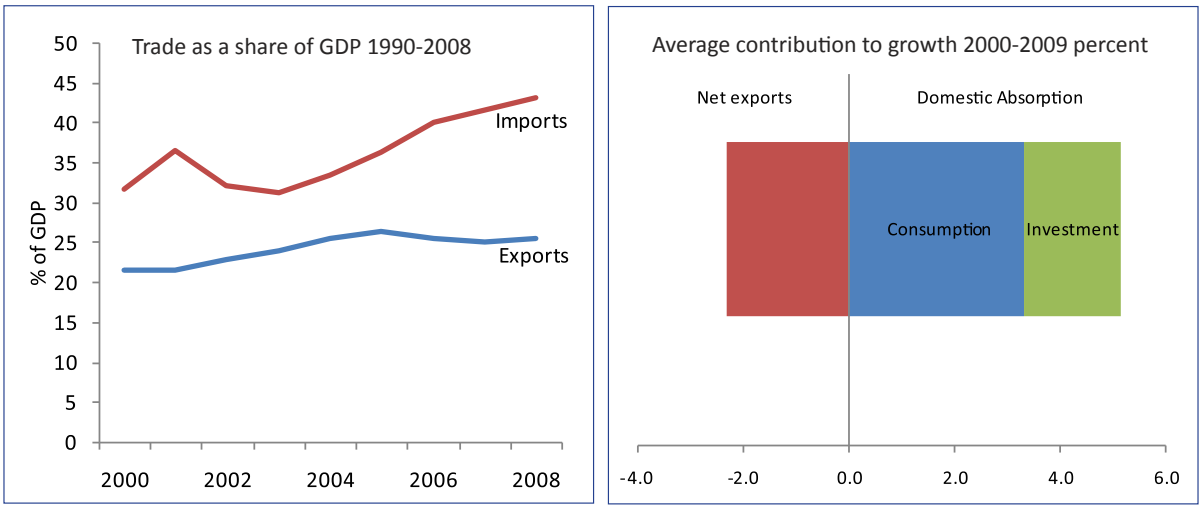
Source: World Bank WDI

Ten years ago, Kenya's exports could pay for two thirds of its imports — today, exports pay for less than half of its imports. Furthermore, Kenya's competitiveness–measured through the Terms of Trade[5]–has equally deteriorated, declining from 100 in 2001, to 83 by 2007 before improving marginally in 2008 and 2009. Kenya's Terms of Trade are now substantially lower than those for Uganda and Tanzania. The strength of the domestic sector and the weakness in exports have created a large and growing current account deficit which had reached 5.5 percent of GDP by end 2009. This current account deficit was mainly financed by increasing short term financial inflows (see section 1).

[5] Terms of trade are defined as the ratio of export unit value indexes to import unit value indexes (see World Bank 2010. World Development Indicators)

Figure 12: Rising Imports and Strong domestic demand

Rapid growth in imports ... ... contributes to an increasing current account account deficit



Source: WDI and World Bank staff estimates

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

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

But Kenya can do even better. By one measure of diversification which ranks countries by the number of products they have "a Revealed Comparative Advantage (RCA) in", Kenya scores above-average with 747 products[6]. This is a key asset the country can build on to further strengthen its goods and/or manufactured exports. Countries with diverse exports have more diverse capabilities as an economy, and hence are more likely to innovate and expand exports to include new product lines.

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

[6] According to World Bank Staff Calculations, based on the CEPII BACI database (2007). See also Annex 3.

3.3 Kenya's Economy Has Been Transformed — Differently Than Expected

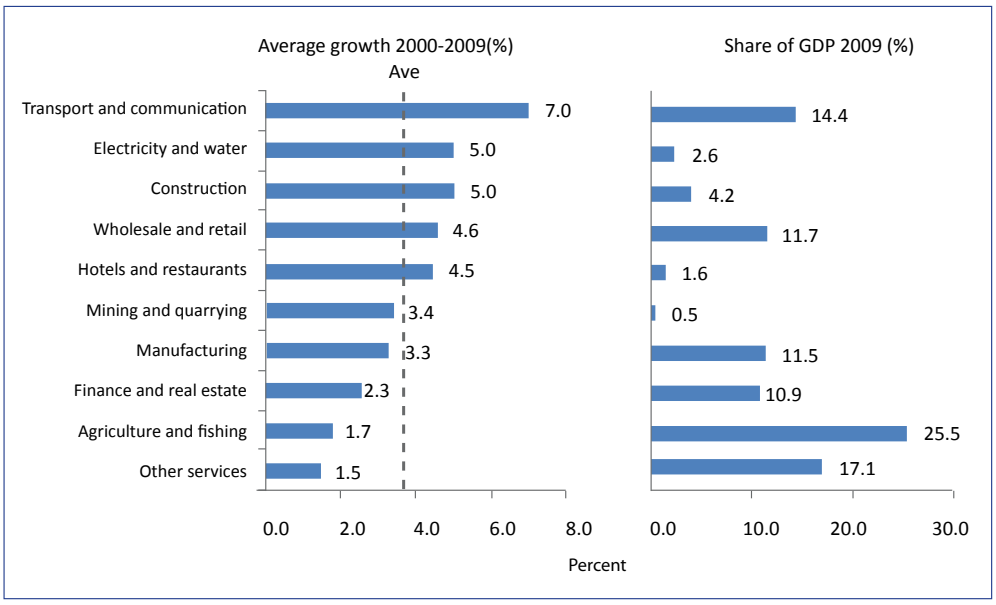
Over the last decade, Kenya's economy has experienced a significant structural transformation. As in other emerging economies, the role of agriculture in the economy has been declining from 32 percent (2000) to 26 percent (2009). However, this decline in agriculture has been almost exclusively absorbed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

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

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

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

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



Source: KNBS and World Bank staff estimates
Note: GDP at basic constant 2001 prices

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

"In most high growth countries, especially in Asia, manufacturing has been leading economic growth — in Kenya it has been lagging the service sectors

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

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

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

The Port of Mombasa

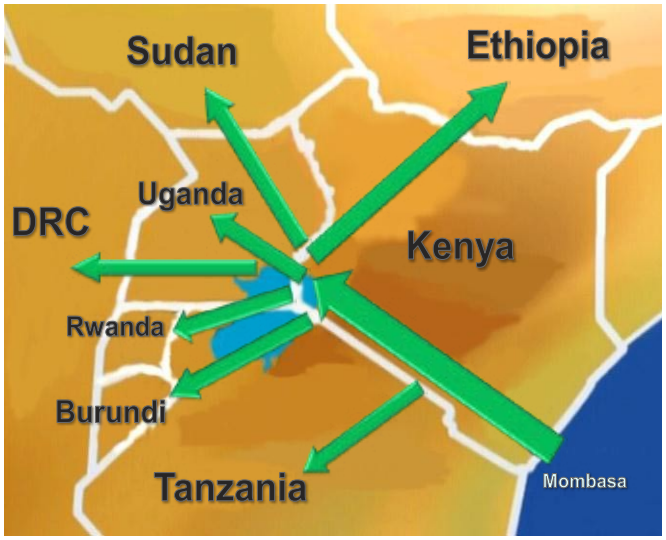
Special Focus – The Port of Mombasa

This special focus section provides an analysis of the port of Mombasa. The port has strategic importance far beyond the borders of Kenya. As the largest port in East Africa, it is the main gateway for the import and export of goods not only for Kenya but also to countries of the East African Community (EAC), the Democratic Republic of Congo (DRC), southern Sudan and southern Ethiopia. Inefficiency of port operations and constraints on capacity are threatening the growth of Kenya and its neighbors. It is a problem which is set to get worse very quickly unless decisive action is taken now. The report concludes with a series of specific follow-up actions for government to consider and suggests that unless investments and reforms at the port are implemented quickly, the port will not be able to support projected increases in imports, and to a lesser extent, exports, in 2011 and beyond.

1. The Significance of the Port

The Port of Mombasa is the largest in East Africa and a vital gateway for imports to Kenya and its neighboring countries (see figure 14). The imports that pass through the port of Mombasa are critical to Kenya's economic growth, and to the economic well-being of its neighbors. Liquid bulk items, mostly petroleum, oil and lubricants, are the single greatest import item by weight. Without these imports, Kenya's economy (and most other countries of the EAC), which depends on imports for all of its petroleum needs, would grind to a halt. The next four largest items by weight, maize clinker, wheat, iron and steel, are critical in meeting the country's food needs and in supporting its vibrant construction industry.

Figure 14: Mombasa – The gateway to East Africa



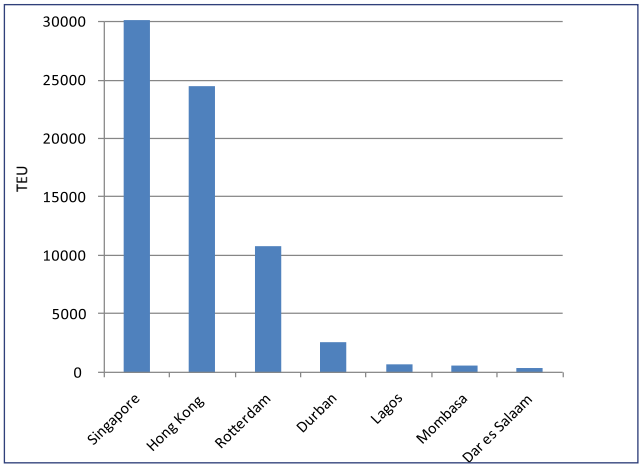
Source: Kenya Ports Authority

Imports into Mombasa have been rising continuously since 2005, with the exception of 2008. Imports of liquid bulk (principally petroleum) has been rising at an average annual rate of 9.7 percent, containerized cargo 11.5 percent and dry bulk (mostly maize, clinker and wheat) at 23 percent (see Annex 11). The weight of goods imported in containers has risen by 55 percent since 2005. The rate of growth of containerized cargo slowed in 2008, reflecting the slowdown in Kenya's economy. Imports of liquid bulk and dry bulk rose significantly in 2009 due to the additional energy needs brought about by prolonged drought conditions. Imported petroleum continues to be required to supplement Kenya's fall in hydropower output, whilst imported maize to cover food shortfalls was responsible for the significant rise in dry bulk.

Despite the strong import growth, the overall volumes handled in Mombasa are low by international standards. In 2008, Mombasa handled 616,000 Twenty Foot Equivalent Units (TEU, which is the standard measurement of port activity). This represents double the volume of Dar es Salaam, but less than a quarter of Durban and only 2-2.5 percent of the volumes which go through the busiest ports in the world, Singapore and Hong Kong (see figure 15).

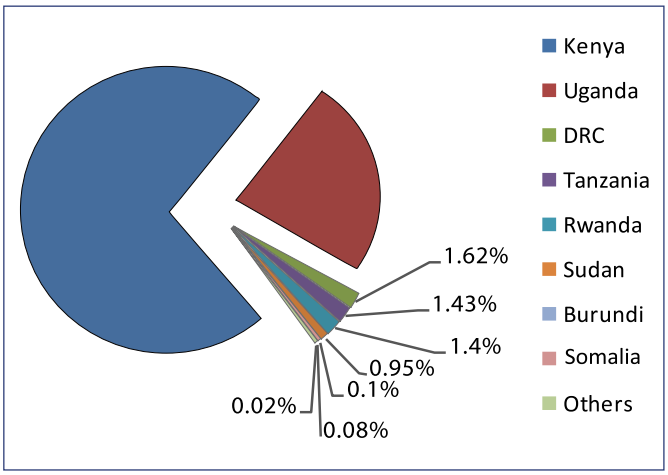
In 2009 imports made up 87 percent of the total weight of goods handled by the port. Mombasa is the major channel for the importation of oil and raw industrial materials for Kenya's manufacturing sector. Of all imports to Mombasa, 72 percent were

Figure 15: Singapore ships 50 times more goods than Mombasa (in thousands TEU)



Source: Containerization International online (www.ci-online.co.uk), 20-05-2010

Figure 16: Mombasa goods go mainly to Kenya and Uganda



Source: Kenya Ports Authority, Annual Review and Bulletin of Statistics, 2009.

destined for the Kenyan market, with the remainder transiting to a number of neighboring countries. Since 2005 the weight of transit goods has risen 38 percent from 3,202 to 4,412 ('000'DWT). Uganda was the largest market for transit goods in 2009 consuming 80 percent, with eastern DRC the second largest destination (see figure 16).

The port of Mombasa is also a barometer of Kenya's imbalance: exports represent only 13 percent of the total volume of goods handled by the port. Horticultural products, significant to the Kenyan economy, are airlifted and most of Kenya's manufactured goods are exported overland to

Of the roughly 300,000 containers imported full in 2009, only about 96,000 or one-third were exported full, with the remaining two-thirds exported empty

neighboring countries. Most exports shipped from Mombasa originate in Kenya, some 85 percent of the total. Uganda represents the second largest exporter accounting for 12 percent of Mombasa's exports. The majority of exports are containerized, though of the roughly 300,000 containers imported full in 2009, only about 96,000 or one-third were exported full, with the remaining two-thirds exported empty[1].

The volume of transshipment goods handled by the port has steadily declined in recent years. Today, these goods only represent a minimal aspect of port operations (less than 1 percent of the total goods handled in 2009). The Kenya Port Authority (KPA) is currently turning down transshipment business due to capacity constraints, thus limiting Mombasa's potential role as a regional hub port.

> "KPA is currently turning down transshipment business due to capacity constraints

The gradual reduction in trade barriers in recent years within the EAC has increased the importance of infrastructure in determining the competitive advantage of domestic industries. Port and road infrastructure is at the heart of regional integration. As a critical link in the logistical chain and the major channel for the importation of raw industrial goods for manufacturing in Kenya and its neighbors, the operational effectiveness of the port of Mombasa has a direct influence on the competitiveness of Kenya businesses and the wider cost of goods in the EAC.

[1] Kenya Ports Authority, Annual Review and Bulletin of Statistics, 2009.

2. Operating at Full Capacity and at Low Efficiency

The port of Mombasa has exceeded its design capacity, yet it is expected to handle growing imports and exports. It is already operating at maximum capacity for both general and containerized cargo, and will suffer progressive declines in operational effectiveness unless both capacity and efficiency issues are urgently addressed. In terms of capacity, container imports at the port have risen on average 10 percent each year since 2005[2], despite relatively low GDP growth rates in 2007-2008. With growth in the East African economies predicted to reach 5 percent per annum or more over the next five years, this trend looks set to continue. And big engineering projects in the region will also add significantly to demand. Tullow Oil, for example, estimate the need to import 200,000 tonnes of containerized cargo annually from 2011 to exploit oil resources in Uganda — an additional 5 percent by weight of current containerized imports. In terms of efficiency, several key issues need to be addressed for both imports and exports that relate to the excessive time it takes to move goods through the port, and inefficiencies caused by the management of trucks loading and unloading goods, collection of custom duties, inspections, etc.

> “The Mombasa port is facing, in the immediate term, very serious capacity problems

The operational capacity for containerized cargo is particularly acute. With seasonal growth expected in the second half of 2010 and additional further growth in 2011, the Mombasa port is facing, in the immediate term, very serious capacity problems. Short-term immediate impact will be an increase in vessel delays, port congestion surcharges, and slower throughput of the port (when congested), causing significant cargo delays and higher costs to importers. Exporters will also experience increased costs because of possible unscheduled delays at the port, disappointing customers who have based their own business decisions on fixed delivery schedules. Overall, the capacity issues at the port of Mombasa could act as a brake on growing trade within the region.

Looking ahead, exports, especially from newly discovered oil countries could become a significant part of port operations in the medium term. The highest growth rates in Africa ports over the past few years have been experienced in oil-exporting countries, such as Nigeria and Cameroon. Recent oil discoveries in Uganda will most likely have a big impact on the volume of raw and manufactured products exported through Mombasa. Reserves in Uganda are conservatively estimated at 800 million barrels. Even with refinery capacity in Uganda to satisfy regional demand for petroleum and petroleum products, around 150,000 to 200,000 barrels per day would need to be exported. In addition, oil discoveries on the western side of the Albertine Basin in eastern DRC are also anticipated. Again, Mombasa would seem the most obvious port option given it represents the shortest route to export, but would require significant investment in new storage capacity at the port. Finally, a referendum in 2011 could see southern Sudan breakaway from the north, which would likely place greater emphasis on trade routes south, such as Mombasa, as the southern Sudanese seek access to the sea along the Northern Corridor.

The Government of Kenya needs to address a range of issues related to increasing the port's physical or 'hard' infrastructure, and to improving the management of port operations, the 'soft' infrastructure. There are broadly three areas which impact on port performance: a) a port's ability to service ships at the quayside (or at berth), b) yard capacity (to store goods before collection) and c) clearance and transfer:

a) Quayside Efficiency

Two main factors affect quayside efficiency — the amount of time a ship is kept waiting to enter the port and, once at the berth, how quickly the goods can be handled to and from the ship. Shipping lines will tend to serve Mombasa with their less performing and less costly ships because uncertainty, in total port call time, threatens the integrity of shipping schedules which are critical to their business performance. In 2009 the average ship waiting time in

[2] TEUs Twenty Foot Equivalent Units

Mombasa was 2.3 days and the average number of port days for a containerized vessel was 3.1 days. The ratio between the waiting time and time at berth, called the waiting ratio, reaches on average 74 percent for container vessels at Mombasa. Full containerships will typically not tolerate more than a 10 percent waiting ratio. If they do, they will charge demurrage fees, or add a freight surcharge to the destination. Large waiting ratios are a major deterrent to shipping lines.

> “For Kenya to benefit from the reductions in costs related to global shipping, the port will need to be modernized and to operate more efficiently

But more than that, part of the problem is the relatively small size of the volume of goods passing through Mombasa. This has led to smaller container and other vessels operating in Mombasa compared with the super container ships and oil tankers that service major global ports. Greater efficiency at Mombasa, better regional integration along the Northern Corridor, and increased capacity for transshipment business are important factors which will attract more ships and increase port traffic. For Kenya to benefit from the reductions in costs related to global shipping, the port will need to be modernized and to operate more efficiently. Annex 12 describes in detail Mombasa's relatively poor connection with global trade routes.

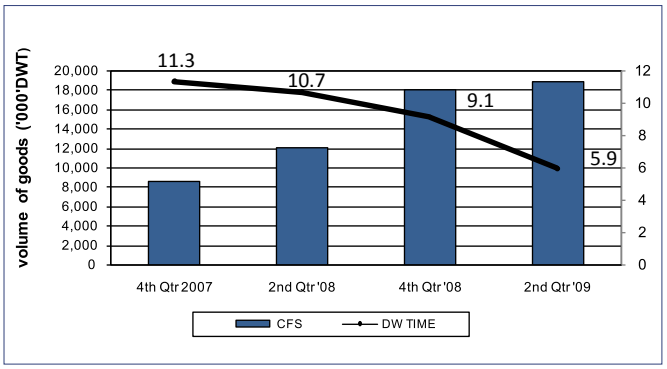
Variation in terminal performance at the port is very costly to shipping lines as they are unable to plan ahead. In recent years the KPA has invested in updating its handling systems at its container terminal, but much of these investments are outdated and not properly maintained. Ship-to-shore, gantry equipped, state-of-the-art container terminals will offer as a minimum 40 moves per hour per ship, with a more common objective being 60 and above. Despite the move to 24 hour port operations KPA registered on average 14 moves per hour in 2009, with a lot of variation depending on labour availability and the state of the equipment.

b) Yard Capacity

Dockside congestion and high dwell times remain a problem. Whilst KPA can claim some success in reducing dockside congestion - the average current dwell time is around 5.7 days[3], depending on where the goods are destined – it does not compare favorably with international standards which are typically 1-3 days. Mombasa has been struggling with congestion for some time due to a limited space on the dockside to store containers and other goods. The situation is compounded by slow customs clearance procedures which mean that existing yard capacity is not used efficiently. The solution for imports to Kenya was the transfer of cargo to privately operated inland container depots, so called 'Container Freight Services' (CFS)s in and around Mombasa town, from where containers are stored and eventually cleared. KPA figures for dwell time do not account for the large volume of domestic goods moved to CFSs.

There has been a large transfer of goods destined for the Kenyan market from KPA facilities to CFS operations since 2007 (from just over 8 million to almost 12 million DWT - see figure 17). KPA quote a dwell time from 11.3 days in 2007 to 5.9 days in the second quarter of 2009, though the indicator does not give a complete picture of port operations for domestic goods. Domestic cargo moves rather quickly from KPA facilities (average 3.7 days[4]) to CFSs where it typically spends 11 days[5]. Transit cargo (which does not enter CFSs), spends longer at

Figure 17: Dwell time declines while CFSs grow



Source: Transit Transport Co-Ordination Authority of the Northern Corridor, 2009

[3] KPA, Container Dwell Time Study for the Port of Mombasa, March 2010
[4] KPA, Container Dwell Time Study for the Port of Mombasa, March 2010
[5] World Bank analysis 2010 following interviews with CFS operators and the private sector

dockside undergoing inspection. KPA estimate the current dwell time for transit cargo to be on average 7.5 days.

c) Clearance and Transfer

Cargo clearance procedures at the port continue to be slow and open to opportunities for corruption. The current lack of real time information on cargo is a major constraint on supply chain performance. The introduction of a Ports Community-Based System (PCBS) which would significantly increase efficiency and reduce corruption has been in progress for over 1.5 years so far with no completion date set. The use of modern customs practices, information systems and integrated IT systems in port operations should represent a major goal for Kenya, particularly as more open and transparent processes would diminish opportunities for corruption. A functioning PCBS would improve the port's efficiency and support Kenya's future obligations in providing supply chain security.

> "The use of modern customs practices, information systems and integrated IT systems in port operations should represent a major goal for Kenya

>> Box 1: What is a Port Community Based System?

A PCBS is an IT-based platform aimed at streamlining a port's administrative procedures. The system allows the stakeholders doing business around the port to exchange information and perform business transactions in a unified, secure and structured way. It ensures that all parties involved receive timely and accurate information on each transaction and, moreover, that the transaction is performed correctly. Having a PCBS in place drastically increases both the speed and transparency of the port. And it maximizes the physical infrastructure and helps manage the efficiency of the port operation as a whole.

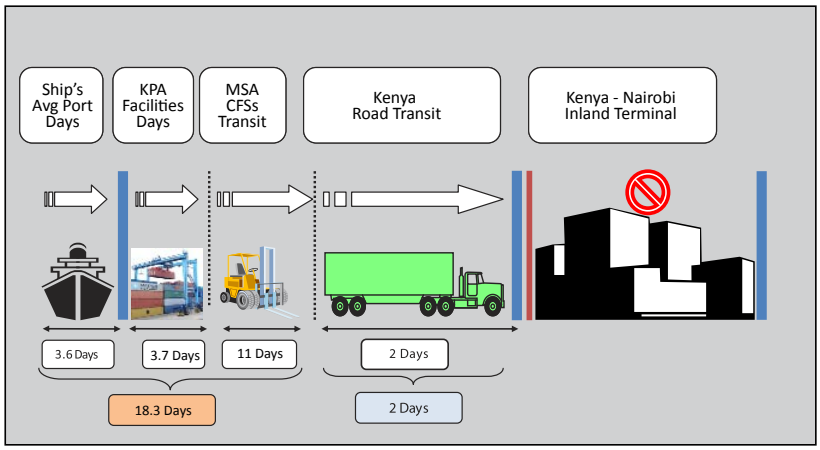
Source: World Bank staff staff

The Kenya Revenue Authority (KRA) faces two major challenges with clearance: introducing effective risk management, as currently nearly all import containers are subject to time consuming physical inspection, and improving efficiency and transparency in its operation. Clearance and transfer involves a complex mix of government processes, logistics and transport infrastructure. Since 2005 and the introduction of KRA's SIMBA IT system, on-line processing of vessel manifests by shipping agencies and customs declarations by clearing and forwarding (C&F) agencies, has improved the speed of revenue assessment. However, the SIMBA system does not provide automatic notification to other border control agencies, i.e. that cargoes have been declared and it does not communicate in real-time the status of cargo awaiting clearance. Thus, owners are not able to see where the weak/slow links are in the full clearance chain.

Improvements in regional trade would follow if customs clearances and inspections for all EAC goods were processed in Mombasa. Under the EAC customs union, the collection of revenue at the port of entry, i.e. Mombasa (possibly under joint supervision), would improve efficiency and transit times and help resolve the issue of transit goods being dumped in Kenya. If full clearance procedures were also introduced, e.g. inspections were undertaken, it would reduce transit times.

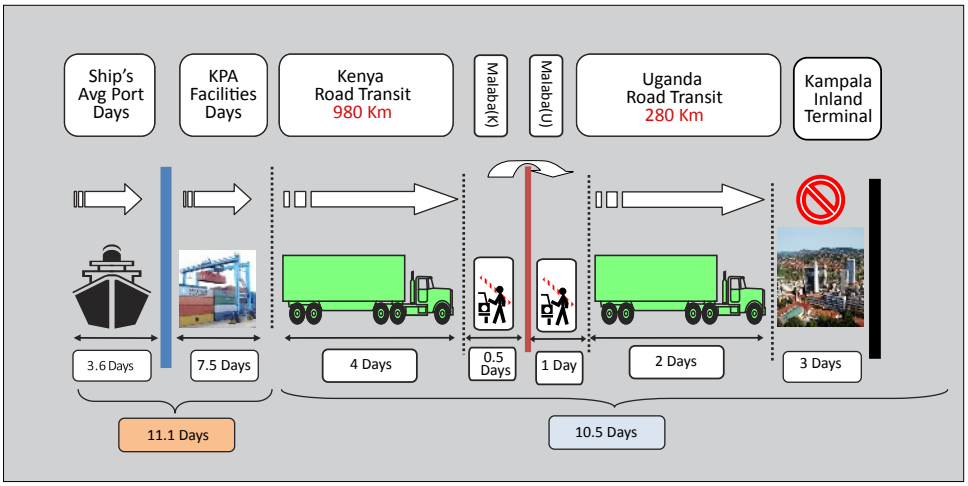
The costs of entering and transiting the Mombasa port have a significant impact on the cost of doing business in both Kenya and the EAC. The lack of effective integrated rail and road links means that Mombasa remains poorly equipped to handle containers and other goods. Linking quayside services to the Northern Corridor is fundamental to trade facilitation and regional integration. Increased imports volumes have placed increased stress on land transport, and have generated the need for faster and more efficient intermodal connections. Progress in this area has been poor. The failure of the railway system has resulted in a large number of new truck movements in and around the port contributing to the growing problem of truck congestion and parking and road deterioration. Rail transport carried around 80 percent of goods transiting Mombasa in the early 1970s. Today only 5 percent of Mombasa's freight moves on rails, a decline that has been due to the absence of sustained government investment in the railways and, most recently, the lack of invest-

Figure 18: It takes 20 days for a container to go through the port and by road to Nairobi, Kenya



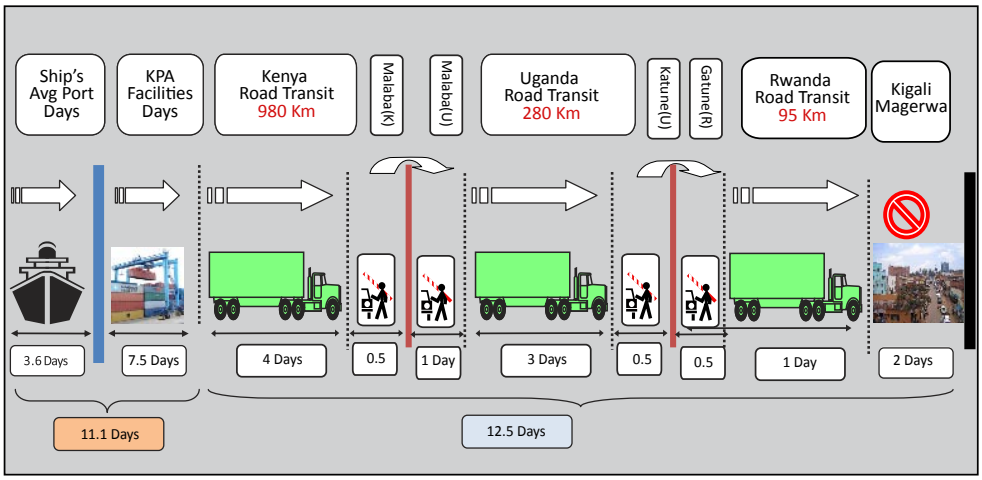
Source: Transit Transport Co-Ordination Authority of the Northern Corridor, 2009, KPA 2010 World Bank analysis 2010

Figure 19: It takes 22 days for a container to go through the port and by road to Kampala, Uganda



Source: Transit Transport Co-Ordination Authority of the Northern Corridor, 2009, KPA 2010 World Bank analysis 2010

Figure 20: It takes 24 days for a container to go through the port and by road to Kigali, Rwanda



Source: Transit Transport Co-Ordination Authority of the Northern Corridor, 2009, KPA 2010 World Bank analysis 2010

The failure of the railway system has resulted in a large number of new truck movements in and around the port

ment by Rift Valley Railways, the company that operates the Mombasa to Uganda rail line. For now there is no alternative to the movement of heavy trucks through an increasingly crowded town centre.

The inefficiency of Mombasa has a significant impact on transport times for imported cargo to Kenya and its EAC neighbors. Figures 18, 19 and 20 show the contribution Mombasa port makes to the total time it takes to transport goods to Nairobi, Kampala and Kigali respectively from the moment they arrive at the port. For goods destined to Kenya, the proportion of time spent at KPA facilities, including the CFS hold time, is estimated at 90 percent of the total time it takes for goods to move from ship arrival to Nairobi.

> “It’s much more expensive to transfer a container from Mombasa to Kampala than it is to move the same container from Japan to Mombasa by ocean freight

Port-related costs for low value bulk commodities such as raw industrial materials or grain, which make up the highest proportion of cargo entering the port, can be more than 15 percent of the delivered market value[6]. And this cost to businesses and consumers is compounded by the uncertainty of delivery times due to variable port performance.

Trucking rates in the region also remain disproportionately high. It much more expensive to transfer a container from Mombasa to Kampala than it is to move the same container from Japan to Mombasa by ocean freight. In addition, KRA imposes a double-licensing arrangement on trucks which requires that those authorized to carry only transit goods, cannot return to their country of origin with import cargo, i.e. they have to return empty. This adds further to the cost of doing business in countries beyond Kenya’s border.

Box 2: What is a Landlord Port?

The most popular port-management model employed worldwide is the landlord port, in which the public sector, in Mombasa’s case Kenya Ports Authority, withdraws from front-line cargo handling operations, allowing these to be concessioned to the private sector. The port authority focuses on broader aspects of port development such as estate management, navigation and planning. The system is in extensive use throughout Europe, the Americas and Asia. It is also a concept being taken up in Africa, but is it far from being the norm. Practically speaking, in the majority of cases the first step in this direction is the concessioning of container-terminal activities – that is, the port authority withdraws as the operator, allowing a private sector company to take over as the terminal operator and manager. These concessioning exercises have aimed at tapping the considerable body of expertise offered by international terminal operators. The Government of Kenya committed to transforming Mombasa to a landlord port in 2002, but there has been little progress on implementation except for the decision to now go ahead with the concessioning of berths 11-14. Table 2 details some of the exciting outcomes which have been achieved in Nigeria and Ghana which have adopted the landlord model.

[6] Port Reform Toolkit, World Bank, 2004

3. The Future for the Port of Mombasa — an Agenda for Implementation

The Government of Kenya should act now to implement much needed institutional reforms and deliver on its commitment to transform Mombasa to a landlord port. It is important that reforms take place before or in parallel with significant new infrastructure investments. The complex organizational structure of ports, where multiple government agencies are involved directly or indirectly, has always been a central issue in most aspects of port management. At Mombasa it constitutes a major obstacle to the development of a comprehensive conceptual framework for port expansion and reform.

In recent years, a number of African ports have embarked on port reform. Nigeria has been Africa's top reformer with a combined score of 80 (out of 100) reflecting improvements in legislation, restructuring, policy oversight, and private sector involvement. Kenya, by contrast has scored only 40 ranking at the bottom third in Africa[7].

The outcomes of reform in Africa and elsewhere should be more than ample evidence of the potential benefits. In 2006, Nigeria adopted the internationally favored port landlord model. Ghana adopted the same model in 2007, with port reform very

Table 2: Port reform is possible: examples from Africa and the Middle East

	Reform Actions	Outcomes
Nigeria	Adoption of the port landlord model in 2006	- A policy framework which is centered on Public-Private Partnerships - Scheduled private investment of US$ 500m (55 percent of total private sector investment in SSA ports) - Nigeria Ports Authority is now self financing - Private operators will pay in excess of US$ 5 billion to the government in rental/royalty fees - Reduction of congestion surcharges saved the Nigerian economy US$310 million within months of the concessioning - Improved turnaround time for ships and cargo - Improved cargo handling performance
Ghana	Adoption of the port landlord model in 2007	- Development undertaken with national and neighboring country needs in mind under the 'Ghana Gateway' program - Rising volumes of transit, national and transshipment cargo - Progressing toward delivering competitive service in line with international standards
Aqaba, Jordan	Container terminal concession and introduction in 2005 of an electronic Truck Control System to coordinate the movement of trucks to and from the port.	- System operational within 3 months - Inland transport costs have fallen by 25% - 25 percent more cargo moved with the same number of trucks

Source: World Bank staff estimates

[7] The 'port reform index' has been presented in the Africa Infrastructure Country Diagnostic, World Bank, 2009. Since this data was collected it is possible that Kenya lost additional ground because there have been important port reforms in Senegal, Angola and Benin, all countries which were ranked below Kenya.

high on the government's agenda as it aims to implement a barrier-free cargo gateway for countries beyond its borders. In 2004 Jordan's multi-billion dollar economic modernization strategy focused on revitalizing it sole seaport of Aqaba. The freight transport sector was underperforming due to the country's antiquated road freight management system which was heavily regulated, fragmented and lacking performance incentives. An electronic truck control system, which turned this situation around, was operational within 3 months. Simultaneously, bringing in a private operator, first through a 2-year management contract and then with a full concession arrangement, improved port performance without significant new hard infrastructure investments. The outcomes of these reforms are outlined in Table 2.

The government also needs to have a clear objective for Mombasa. Whilst the port is essential to more competitive Kenyan businesses, and more effective regional integration in Eastern Africa, there is scant mention of the port in the government's Vision 2030 document. Although objectives of port reform may be varied and range from the need to expand and modernize container handling capacity, generate revenue and reduce public expenditure, to stimulating growth of a distribution-based economy centered on a regional port hub, the government needs to be clear on what its objective is.

> "There can be no strategic port planning until the roles of the public and private sectors are clearly defined and failure to do this would put the concession of berths 11-14 under stress

Kenya is not keeping up with demand. In the time it has taken the government to update the Mombasa port master plan, Dubai World has built the brand new Doraleh Terminal on a greenfield site in Djibouti. The Djibouti terminal has a capacity of 1.2 million TEU per year and is now the largest and most modern in East Africa. And in the same time Nigeria has concessioned a large number of its ports.

A Port Master Plan prepared for KPA in 2004 was updated in 2009. The Master Plan did not look effectively at the complimentary hard and soft infrastructure needed to transform Mombasa into a world class port. And it did not address the many institutional, regulatory and legal changes which are also required. It did propose a number of short-term projects, to be completed by 2013, and longer term developments up to 2015 to 2030. Short term proposals included the concessioning of berths 11-14 to create more container handling capacity, the construction of a second container terminal with an annual capacity of 700,000 TEU (to be managed by the private sector) and dredging of the channel to enable handling of larger ships. Longer-term developments included the construction of a Mombasa by-pass linking the northern corridor to the south coast region and northern Tanzania.

A system of incentives combined with improvements in soft infrastructure should be implemented now to enable Mombasa to keep pace with demand before new container capacity comes on line. Kenya and the region cannot wait 3-4 years for new container capacity to come on-line without a serious impact on trade. Port capacity could be increased in the immediate term by a system of incentives to encourage port stakeholders e.g. banking services and all government agencies involved in cargo clearance, to move to full 24 hours operations. In addition, implementation of the PCBS should be speeded up. Similarly, a trucking control system, similar to that implemented in Jordan, would improve cargo handling and effectively increase capacity. Implementation of such IT software should be measured in months and not years as is the case in Mombasa.

The Government of Kenya faces a costly, time-consuming and potentially acrimonious process if structural and regulatory changes are not undertaken now in parallel with expansion and concession plans for berths 11-14. The past failed attempts at securing significant private sector participation in port operations and investments are testament to this. The reform of the KPA will be less successful unless there is simultaneous reform of the activities of customs and other agencies at the port to streamline their activities. Changes to the existing roles of some government agencies would likely require changes in the laws which cre-

ated them. There can be no strategic port planning until the roles of the public and private sectors are clearly defined and failure to do this would put the concession of berths 11-14 under stress. Moving the boundary between public and private operators requires strategic preparation, redefinition of powers and mandates, and legal adaptation before preparation for the tendering process. Failure of any concession would make the case for future private investment in the port difficult and compound existing problems.

Clarity on the future role of KPA is needed. The government's commitment to a landlord port would suggest that KPA would retreat from front-line operations and another round of concessioning would need to take place for the terminals currently operated by KPA. Controlled by the state, KPA currently owns most of the port infrastructure and undertakes the majority of port operations. The shift in the role of KPA from port service provider to landlord and regulator will be a difficult change management exercise. It will require new skills, institutional capabilities, and practices including regulating unfair and anti-competitive practices, designing and negotiating contracts with private providers of port services, performance monitoring and ensuring compliance with standards.

A decision on the route for the Mombasa by-pass is needed now. Mombasa town faces gridlock and the route to the Mombasa airport will be blocked unless work on a new by-pass and link road is started immediately. If construction of the by-pass is not speeded up and synchronized with new planned capacity increases at the port (though concessioning and expansion), congestion will become a worse problem than it is today, and new investments will not work efficiently. At the same time the government needs to focus on a new access road from the port linking to the by-pass or else all new port capacity will continue to be transported through an already congested town centre. Unfortunately, private sector developers currently looking to engage the government on these important issues find themselves having to deal with KPA, Ministry of Transport and the Ministry of Roads. It makes long term strategic planning currently impossible with no joint approach to how individual projects link to each other. Plans to modernize the port of Mombasa must look beyond immediate port infrastructure and foster coordinated efforts to improve road and rail systems that provide linkages to the Northern Corridor and neighboring markets.

KPA should be free of political interference and its managing directors appointed on 3 year performance management contracts following an open and competitive process. In the 18 years since KPA's inception it has had 14 managing directors. In the same period Tanzania Ports Authority has had 3. Instability at the top of KPA is not a recipe for good planning and reform. Ideally the government should undertake an international search and appoint the best qualified candidate.

> “Many of the challenges and the reforms needed, and outlined in this report, are well known and understood. What is new is the severity of the problem

Narrow vested interests have undermined investment and reform of Mombasa for a long time. Many of the challenges and the reforms needed, and outlined in this report, are well known and understood. What is new is the severity of the problem. Private investments which would lead to new local jobs, greater port efficiency and a positive impact on growth in the region, have been thwarted by narrow vested interests seeking to maintain the status quo. For example, plans to develop a new bulk fertilizer handling facility, which could lower fertilizer costs in the region, have not gone ahead due to interference and official intransigence. Most often developers and financiers walk away. And whilst unions and their workers might legitimately fear potential downsizing this should be viewed in the context of government plans for port expansion and the situation on the ground today. For example, despite concerns, the concessioning of ports in other parts of the world has typically resulted in net gains of jobs at the port and related industries.

Strong political will, and a clear mandate for reform is needed. Whilst the Ministry of Transport is the lead agency for Mombasa port is does not have strong operational capacity for port reform and management. Nor does it represent all the interests that are involved in the complex operations of the port. The operation, management, and expansion of the Mombasa port require a defragmented government approach and a strong coordinating body to enforce reforms and make the decisions which are necessary. A summary of the key reform measures government should consider to improve the operational effectiveness of the port is provided below.

>> Box 3: Summary of key suggested port reform measures

In the next 3 to 6 months

- Identify a coordinating body with a mandate for reform.
- Appoint the managing director of the KPA on a 3-year performance contract.
- Decide on the route for the Mombasa by-pass and start implementation together with the link road from the port.
- Set up a system of incentives to enable full 24 hour port operations by multiple stakeholders.
- Implement the IT Port Community-Based System.
- Approve the concessioning of berths 11-14 through a competitive and transparent process.

In the next 6 to 12 months

- Clarify the timetable for a full landlord port status as well as the role of KPA.
- Clarify the roles and responsibilities of public and private port stakeholders.
- Undertake reforms of customs collections, making them more efficient and transparent.
- Strengthen port operational capacity of the Ministry of Transport.

ANNEXES

Annex 1: Key Macroeconomic Indicators

	2007	2008	2009	2010	2011
	Annual Percentage change				
Macro aggregates					
Real GDP	7.0	1.6	2.6	4.0	4.9
GDP Per Capita	4.2	-1.0	-0.2	1.3	2.2
Private Consumption	7.3	-0.4	3.8	3.2	3.9
Government Consumption	7.2	3.7	5.5	4.1	3.4
Gross Fixed Investment	13.3	8.9	0.6	6.7	8.5
Exports, GNFS	6.0	7.5	-7.0	6.2	7.6
Imports, GNFS	12.7	6.6	-0.2	5.5	6.1
Prices					
Inflation	5.7	15.4	9.2	4.5	4.1
GDP Deflator	5.1	13.5	6.7	3.2	4.1
Exchange rate (Kshs/US$)	67.3	69.2	77.4	76.6	78.1
% of GDP					
Revenue and Grants	22.0	21.6	22.6	23.1	23.2
Expenditure	23.3	28.3	30.3	29.2	28.1
Budget Deficit	-5.9	-6.3	-6.6	-6.0	-5.2
Gross Domestic Investment	19.1	19.4	19.4	19.3	19.5
Government Consumption	14.5	14.6	15.7	14.9	14.6
Private Consumption	77.3	77.5	78.5	79.1	79.3
Exports	26.0	26.3	25.2	25.8	26.2
Imports	36.1	40.1	39.4	42.1	43.4
Current account balance	-3.8	-6.6	-6.9	-6.6	-6.0
General government balance	-3.0	-4.9	-5.6	-6.0	-5.6
Memo					
Nominal GDP (US$)	27,124.4	30,354.9	29,528.8	33,523.1	35,940.8

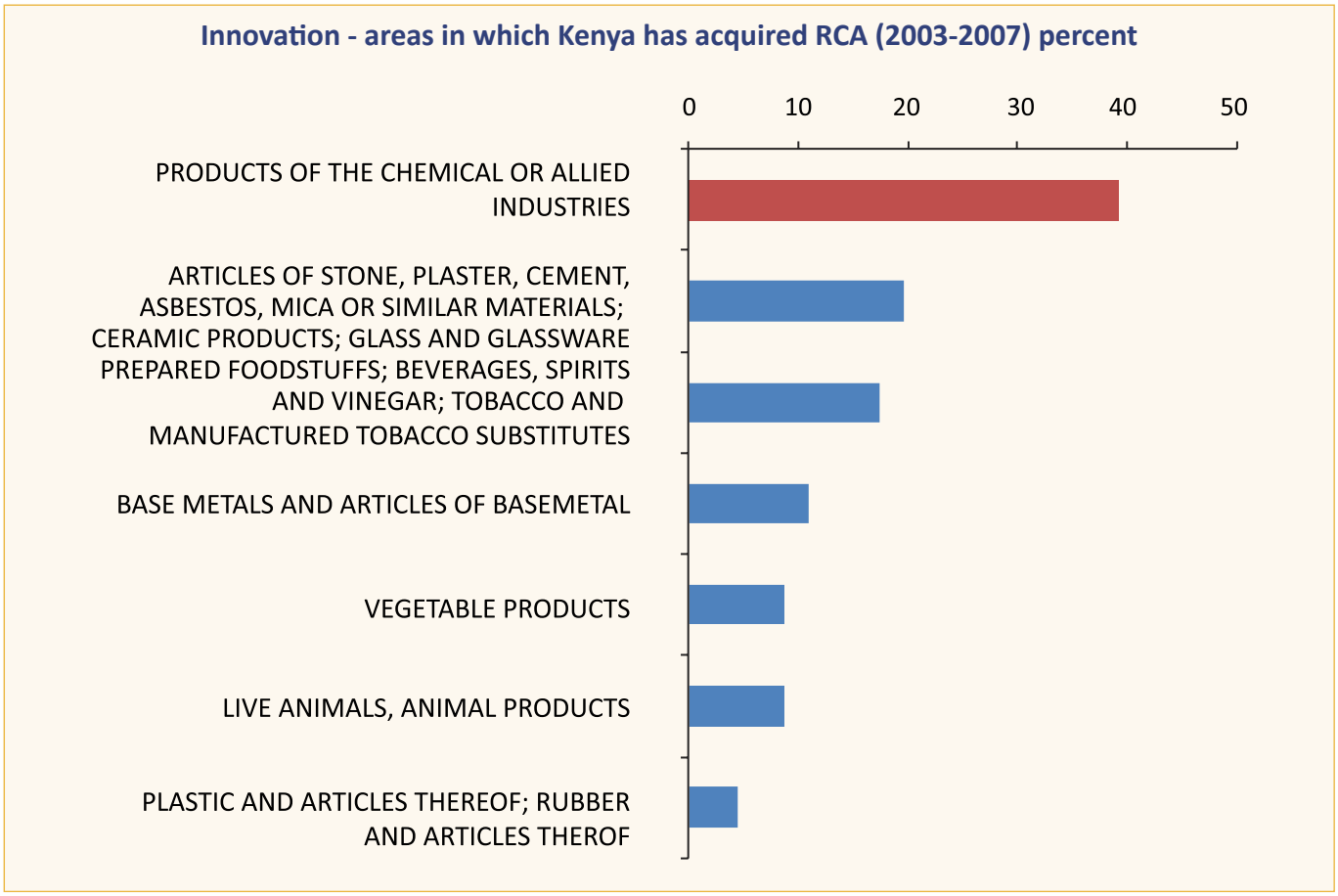
Source: KNBS, MoF and World Bank staff estimates

Annex 2: Sectoral shares in GDP, 2009

		Share of GDP %	Growth rate %
Agriculture, 25.5%	Agriculture and forestry	25.5	-2.4
Industry, 18.8%	Mining and quarrying	0.5	-4.2
	Manufacturing	11.5	2.0
	Utilities (Electricity and water)	2.6	-3.1
	Construction	4.2	14.1
Services, 55.7%	Wholesale and retail trade	11.7	1.5
	Hotels and restaurants	1.6	42.8
	Transport and communication	14.4	6.4
	Financial intermediation	4.5	4.6
	Real estate, renting, business services	6.3	3.0
	Public administration	3.8	1.6
	Education	6.9	2.7
	Other services	6.4	1.9

Source: KNBS and World Bank staff estimates
Note: GDP constant 2001 prices

Annex 3: Products where Kenya has Acquired Revealed Comparative Advantage (RCA)



Note: This bar chart shows that out of Kenya's increase in export diversification (measured by the number of products with RCA), 39% is due to innovations (new products with RCA) in the chemical or allied industries sector, 20% due to the stone, plaster and cement sector, and about 17.5% in the prepared foodstuffs and beverages sector. Note that Kenya has acquired a revealed comparative advantage in many new textile products, but has lost an equivalent amount - this suggests.

Annex 4: Kenya: Assumptions Underlying the 2010 Growth Forecast

Global Assumptions

1. World GDP growth will rebound to 3.3 percent in 2010, after contracting by 2.1 percent in 2009.
2. Global trade will recover in 2010, expanding 9.5 percent after contracting 11.2 percent in 2009. However trade volumes will remain below the pre-crisis period in 2010.
3. Euro area economies will see a weak recovery, expanding 0.9 percent in 2010 after a 4.1 percent contraction in 2009, while the UK economy will grow an estimated 1.4 percent, following a 5 percent contraction in 2009.
4. Non-oil commodity prices will recover partially in 2010, expected to gain 18.8 percent after plunging 21.6 percent in 2009.
5. Oil prices are expected to rise 32.8 percent, to average US$82 per barrel in 2010.
6. Tea prices (Kenya auction) are expected to average 245 US cents per kg in 2010, 215 US cents per kg in 2011 and 190 US cents per kg in 2012.
7. The crisis in Greece is contained with little spillover to other economies.

Kenya Specific Assumptions

1. The forecast assumes normal rainfall and above average output in agriculture which will keep food prices low and inflation within the policy target of 5 percent.
2. The government will continue implementing the stimulus program and only cut back spending starting the year 2011.
3. The constitution review process will be smooth and the growth in tourism will continue as projected during the high season.
4. Remittances are expected to recover slightly in 2010, after contracting marginally in 2009, as labor markets in major destination countries remain weak.
5. The impact from the disruption of air transport in Europe to the horticulture sector will be contained, as air transport resumes at full capacity.
6. The Euro Shilling exchange rate is likely to appreciate as a result of the crisis in Greece, reducing export earnings from the Euro area. This is factored in as the low growth scenario.

Source: World Bank staff estimates

Annex 5: Sub-Saharan Africa Forecast

(annual percent change unless indicated otherwise)	Estimate			Forecast		
	2007	2008	2009	2010	2011	2012
GDP at market prices (2005 USD)	6.5	5.0	1.6	4.4	5.0	5.3
GDP per capita (units in USD)	4.0	3.0	-0.4	2.4	3.0	3.6
PPP GDP	-4.4	-10.1	4.1	6.5	6.1	6.1
Private consumption	7.6	2.5	1.1	3.5	4.4	4.7
Public consumption	5.7	6.8	5.3	5.2	5.0	4.8
Fixed investment	16.7	11.8	4.9	6.7	7.4	8.0
Exports, GNFS	3.7	3.9	-6.8	9.3	6.5	6.7
Imports, GNFS	11.1	5.7	-4.1	9.8	7.3	7.4
Net exports, contribution to growth	-2.6	-0.8	-0.8	-0.6	-0.6	-0.6
Current account bal/GDP (%)	-0.3	0.6	-2.2	-1.2	-1.5	-1.6
GDP deflator (median, LCU)	7.0	9.3	6.8	4.8	5.1	5.0
Fiscal balance/GDP (%)	-27.2	0.7	-5.8	-4.8	-3.3	-2.2
Memo items: GDP						
SSA excluding South Africa	7.1	5.9	3.6	5.3	5.9	6.1
Oil exporters	8.0	6.3	4.0	5.7	5.7	6.1
CFA countries	4.5	4.2	2.4	3.8	4.0	4.5
South Africa	5.5	3.7	-1.8	2.8	3.4	3.8
Nigeria	6.4	5.3	5.6	6.1	5.7	6.4
Kenya	7.0	1.7	2.6	4.0	4.9	5.4

Source: World Bank, GEP January 2010

Annex 6: Exports of goods and services (% of GDP)

	1960-70	1970-80	1980-90	1990-2000	2001-2008
Kenya	31.1	29.8	25.3	27.2	25.9
Ireland	32.8	40.7	53.0	76.1	86.1
Vietnam			15.3	39.5	66.8
Thailand	16.2	19.9	26.9	46.3	70.4
Korea, Rep.	8.3	26.4	33.5	31.9	39.9
China	2.6	5.5	13.7	22.0	33.1
Uganda	25.4	15.2	10.3	10.2	13.6
Rwanda	10.3	13.1	9.5	6.4	10.0
Ethiopia			6.5	8.7	13.3
Ghana	20.9	15.0	12.0	28.3	40.9
South Africa	27.2	28.9	27.7	23.9	30.2

Source: World Development Indicators

Annex 7: Share of imports by countries of origin

	U.K	U.S.A	Germany	Italy	United Arabs	Saudi Arabia	France	India	South Africa	Japan	other	Africa
2002	8.3	5.7	5.1	1.6	10.6	5.2	3.8	5.4	5.7	6.7	41.8	10.3
2003	7.0	5.1	3.9	2.1	11.3	8.6	3.2	5.3	8.3	6.6	38.7	13.2
2004	7.5	4.0	3.6	2.0	11.6	8.7	3.4	6.3	9.6	6.7	36.6	14.4
2005	12.1	9.2	3.4	1.7	13.4	5.9	3.0	5.2	9.1	5.0	32.1	13.2
2006	6.5	4.7	3.6	2.3	14.7	5.0	2.0	7.1	6.4	5.6	42.0	12.0
2007	4.9	7.4	3.7	2.2	14.8	2.9	2.7	9.4	5.8	6.8	39.5	11.9
2008	3.6	3.6	3.5	1.5	14.8	3.4	2.1	11.8	6.1	5.8	43.6	11.3
2009	4.9	6.3	2.8	1.8	10.7	3.2	2.1	10.6	9.2	6.2	42.2	13.5

Source: CBK Statistical Bulletin

Annex 8: Composition of VAT, Corporate Tax and PAYE by Economic Sector

Economic sector (% of total collection)	2008			2009		
	VAT	CT	PAYE	VAT	CT	PAYE
Activities not adequately defined	0.0	4.5	8.3	0.0	6.9	11.1
Agricultural and livestock production	0.1	1.6	2.0	0.2	2.2	1.5
Industry	32.2	26.7	15.8	32.4	21.5	14.7
of which Electricity and water	7.5	0.2	2.4	5.0	0.6	1.8
of which Construction	2.2	3.9	1.1	2.5	1.0	1.1
Services	33.0	64.7	38.6	34.5	65.5	40.5
of which hotels and restaurants	3.9	2.0	1.4	4.1	0.6	1.6
of which transport and communication	4.1	13.4	7.9	5.1	10.4	8.0
Public administration	34.8	2.5	35.3	32.9	3.9	32.3
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: KRA and World Bank staff estimates

Annex 9: Composition of GDP in Selected Sub-Saharan Countries

	Share of GDP, 2008					
	Private final consumption	Central Govt. consumption	Investment	Exports	Imports	Gross national savings
Ethiopia	84.9	11.3	20.8	11.6	28.6	16.5
Ghana	80.8	13.6	32.0	36.8	63.2	19.6
Kenya	78.6	10.8	24.7	24.9	39.0	17.6
Rwanda	89.6	9.1	20.8	8.1	27.5	13.0
South Africa	61.5	20.2	22.2	36.3	40.4	14.0
Tanzania[1]	79.2	10.6	17.4	16.8	24.2	10.1
Uganda	82.4	11.8	23.3	15.6	33.4	12.0

Source: World Bank, Africa Development Indicators 2010

Annex 10: Share of total exports by Countries of destination

	U.K	Germany	USA	Netherlands	Uganda	Tanzania	Pakistan	France	Egypt	Belgium	Other	Africa[1]
2002	11.6	2.6	2.0	6.5	18.5	8.4	4.9	1.4	4.0	1.4	38.8	48.3
2003	11.6	2.9	1.5	7.7	16.7	8.0	5.0	1.7	3.0	1.3	40.5	46.2
2004	10.4	2.1	2.0	8.0	16.9	7.7	5.2	1.7	3.2	1.2	41.6	46.4
2005	9.6	2.1	1.8	7.5	17.4	8.2	5.8	2.1	3.6	1.2	40.7	49.3
2006	11.0	1.9	7.2	7.9	11.2	7.4	5.9	1.5	4.0	0.9	41.3	43.5
2007	10.5	2.2	7.0	8.0	12.2	8.1	4.9	1.4	3.2	0.9	41.5	44.9
2008	11.1	1.8	6.0	7.6	12.3	8.5	4.1	1.4	4.5	0.8	41.9	47.3
2009	10.9	2.1	5.2	7.5	13.3	8.9	4.4	1.2	3.4	1.0	42.1	47.4

Source: CBK Statistical Bulletin

Annex 11: Principal Import Commodities in 2009

Commodity	('000'DWT)
Petroleum, Oil, Lubricants	5,671
Maize	1,561
Clinker	1,135
Wheat	1,074
Iron and Steel	780
Other liquid bulk	760
Plastic	402
Rice	387
Sugar	281
Chemicals and Insecticides	218
M/Vehicles & Lorries	296
Paper and Paper Products	296

Source: Kenya Ports Authority, Annual Review and Bulletin of Statistics, 2009

[1] includes re-exports

Annex 12: Kenya's Poor Connectivity with Global Trade Routes

Kenya is poorly connected to global shipping and Mombasa port has a low number of connections with other African countries. Greater efficiency at Mombasa, better regional integration along the Northern Corridor, and increased capacity for transshipment business are important factors which will attract more ships and increase port traffic. Given the relatively modest amount of goods passing through the port annually, Mombasa is not well positioned to respond to the dramatic changes in trade and shipping patterns which are occurring around the world. These changes mean that for Kenya, and by association her neighbors, to benefit from the reductions in costs related to global shipping, the port will need to be modernized and to operate more efficiently. An overarching requirement to justify the larger and more efficient vessels, discussed below, will be an increase in port volume, which will come over time as Kenya's economy, and those of its neighbors, expands.

Access to global markets depends to a large extent on maritime transport connectivity as most of the world's largest ports are situated on the main global shipping routes between East and West. UNCTAD's Liner Shipping Connectivity Index (LSCI), Table 1[18], aims to capture a country's level of integration into global shipping networks. The five components of the index are: a) the number of ships visiting a port; b) the container carrying capacity of those ships; c) the maximum vessel size; d) the number of services; and e) the number of companies visiting a country.

China leads the LSCI ranking (1st out of 132 in 2009), followed by Europe and then Asia. Kenya ranks 13th within Africa, behind such countries as Ghana, Nigeria, Senegal, Djibouti, Benin and Togo. Most African countries are far below the world average which is not surprising given Africa's share of world trade is less than 3 percent. And with East Africa currently having the smallest trading volumes in Sub-Saharan African[19], the region lags behind many countries in West Africa that are closer to the European market and who in recent years have enacted important port reforms and expansion. On intra-regional trade, i.e. the percentage of direct connections with other African countries, West Africa tends to score higher. The decline in Mombasa as a transshipment port due to capacity constraints is reflected in the low percentage of direct connections to other African countries.

Volumes of shipping container and cargo traffic are both important measures of economic health. In 2009 the port of Mombasa imported 301,460 containers,[20] which translates to a crude average of 5800 per week. Demonstrating the relatively low volumes of trade this represents, this number equates to the capacity of one modern vessel plying international trade routes which routinely carry between 7000 - 12000 containers each. To divert these vessels from existing East-West networks is not financially viable for shipping lines, meaning that Mombasa is increasingly served by relatively small feeder vessels (mostly under 2,000 TEUs) from transshipment ports in the Middle East, mainly Salalah (Oman) and Dubai (UAE), adding to time and cost. Europe's main port, Rotterdam (Netherlands), has no direct container flows to either Mombasa or Dar es Salam. The direction of trade may also be changing as some lines consider services from Asia to the Caribbean and Latin America via southern Africa. Maritime transport costs have an important share in the landed price of bulk commodities, such as clinker and crude oil. An increase of the size of ships entering Mombasa would enable realization of economies of ship size.

The Government of Kenya is in the early stages of considering building a major new port at Lamu, several hundred kilometers north of Mombasa. The government's argument for the port is that it needs to expand capacity for Kenya and the EAC away from the busy and congested Mombasa-Nairobi corridor and develop markets in southern Sudan and Ethiopia. According to government, this could be accom-

[18] UNCTAD Secretariat, using data provided by Containerization International Online, 2009
[19] Review of Maritime Transport, United Nations Conference on Trade and Development, 2009
[20] Kenya Ports Authority, Annual Review and Bulletin of Statistics, 2009

plished more rapidly through building a port on a new site, rather than concentrating all future port development in Mombasa. Lamu might also become the transshipment point for oil exports from Uganda and, if deposits are proven up, the Eastern DRC. Its construction would require massive investment in port, road and possibly rail infrastructure as no corridor currently exists.

However, there is currently no trade passing through Lamu and no road or rail links to the EAC. It is not clear that a new port is the most efficient way to handle Kenya's and the EAC's growing trade requirements. It could also add to further fragmentation in East African shipping, making it more difficult for efficient sized vessels to begin using Mombasa, further delaying Kenya's connectivity to major shipping routes. Furthermore, the Lamu port would do little to support enhanced regional integration in the EAC given its remoteness from the EAC market. Further study of the feasibility of Lamu port and its positive and negative benefits for Kenya and neighboring countries should be undertaken before any investment decision is undertaken. A study by the government is on-going.

Table 1: Indicators of African countries' connectivity in liner shipping

	LSCI World Ranking	% of direct connections with other African countries
Egypt	17	15
Morocco	23	35
South Africa	29	40
Nigeria	50	43
Cote dívoire	53	45
Ghana	54	43
Djibouti	58	24
Senegal	63	59
Mauritius	64	41
Togo	68	52
Namibia	69	58
Benin	70	52
Kenya	72	32
Cameroon	73	50
Congo	74	43
Angola	75	43
Tanzania	83	30
Libya	84	13
Mozambique	85	48
Sudan	86	33
Gabon	88	48
Madagascar	91	63
Algeria	96	14
Guinea	97	54
Gambia	103	44
Mauritania	104	50
Tunisia	107	19
Sierra Leone	111	43
Liberia	112	67
Cape Verde	115	44
Comoros	117	64
Seychelles	118	75
Democratic Republic of Congo	137	100
Equatorial Guinea	141	55
Guinea-Bissau	143	50
Eritrea	145	33
Somalia	149	33
Sao Tome & Principe	153	45

Source: Review of Maritime Transport, United Nations Conference on Trade and Development, 2009

Kenya Economic Update – Running on One Engine

Kenya has entered a new decade with renewed momentum for strong and sustained growth. Being part of Africa's strong recovery after the global crisis and a regional leader in services, Kenya has high hopes for a strong economic performance during this new decade. After two years of low growth, the World Bank projects 4.0 percent growth in 2010 which means that most Kenyans will again experience an improvement in their living conditions. To achieve and sustain high growth over the next decade, Kenya will need to address its economic imbalances, avoid domestic shocks, and manage the impacts of future external crises. The theme of this ***second Kenya Economic Update****, "Running on One Engine", reflects the structural nature of Kenya's current economy - Kenya's strong engine is domestic consumption; its weak engine is exports. In order to restart the export engine, Kenya will need to address a number of issues, especially the infrastructure deficit. The port of Mombasa, for example, is Kenya's most important and concentrated infrastructure asset. As the special focus section of this report concludes, the port needs substantial reform and upgrading to reach international standards and to meet the demands of a growing and increasingly integrated East African Community.*

Photos on the cover are from the private collections of Kenya Ports Authority (left, right) and the German Development Cooperation - GTZ Health Programme, Kenya, with the photography by Ursula Meissner (middle). All the photos inside the report are from Kenya Ports Authority.

Design by Robert Waiharo

Hill Park, Upper Hill Road
P. O. Box 30577-00100 Nairobi, Kenya
Telephone: 260300/400, 2714141
Fax: 260380/1