Executive Summary

Growth will remain robust—but Kenya faces strong headwinds in 2014

Economic growth in Kenya remains robust. Strong economic performance continued in 2013 as the economy grew 4.7 percent, an uptick from 4.6 percent in 2012. Growth was driven by robust consumption spending and public investment in infrastructure, as well as higher industrial and services output. Growth was underpinned by macroeconomic stability, including single-digit inflation and a stable exchange rate. On the negative side, weak investor confidence resulted in anemic private investment and subdued GDP growth. And drought in the fourth quarter of 2013 depressed growth in agriculture and increased electricity prices, driving up production costs and reducing GDP by an estimated KSh 23.8 billion (0.7 percent).

Despite its robust performance, Kenya continues to underperform its regional peers. Kenya’s neighbors are catching up in terms of per capita GDP (Figure 1). Annual real GDP growth in the region averaged almost 6.1 percent between 2000 and 2012, accelerating the recovery that started in the late 1990s. This strong performance—driven partly by low fiscal deficits and low levels of government debt—has allowed Kenya’s peers to start closing the large income gap that once existed between them and Kenya. In order to retain its advantage, Kenya can accelerate its own agenda of structural reforms that are key to higher and sustainable growth. The priority should be on reforms aimed at increasing the flexibility of its economy to facilitate the transfer of resources toward the tradable sector, in order to increase exports and create jobs.

Macroeconomic stability underpinned growth in 2013, as lower inflation supported the demand for goods and services. Inflation expectations were anchored at a lower level as a result of lower international food and fuel prices and prudent monetary policy. Inflation averaged 5.7 percent (7.3 percent for food) in 2013 and 6.9 percent (9.6 percent for food) in the 12 months ending in May 2014. Industrial output growth rebounded strongly in 2013, partly thanks to stable exchange rates for most of the year. Economic activity softened in the last quarter of 2013, as inadequate rainfall in key bread basket zones reduced agricultural output, reducing GDP by KSh 23.8 billion (0.7 percent).

Figure 1: The gap in per capita GDP between Kenya and its peers narrowed between 1990 and 2012

![Figure 1: The gap in per capita GDP between Kenya and its peers narrowed between 1990 and 2012](source: World Development Indicators (World Bank))
The ongoing fiscal expansion is widening the fiscal deficit and raising the public debt-to-GDP ratio. The fiscal deficit remained high at 6.6 percent of GDP, as a result of ambitious public investment programs and increases in public sector wages. Fiscal policy remained expansionary, even though growth returned to its trend level. As a result, fiscal buffers were reduced, raising Kenya’s vulnerability to shocks. The debt-to-GDP ratio crossed the 50 percent threshold in 2014, raising concerns about the level of indebtedness and the availability of fiscal buffers to absorb volatility going forward (Figure 2).

Figure 2: The fiscal deficit increased in recent years, pushing up public debt

The World Bank projects that Kenya’s GDP will grow 4.7 percent a year in 2014 and 2015, supported by stronger global economic activity among its trading partners. The projections assume that the impact of inadequate rainfall and the insecurity caused by terrorist activity will be limited. The economy grew by just 2.7 percent in the first quarter of 2014, mainly as a result of delayed rain in the bread basket areas of the Rift Valley and increased insecurity. These shocks caused the Bank to reduce its growth projection for 2014 by 0.5 percentage points since the last Kenya Economic Update. The new projections reflect the effects of the drought, the deteriorating security situation, the low level of budget execution, and tighter global credit as the U.S. Federal Reserve winds down its expansive monetary policy.

Medium-term growth prospects remain favorable, despite emerging challenges. In the base case scenario, GDP growth is projected to increase 4.7 percent in both 2014 and 2015. In the optimistic scenario, GDP is projected to increase 5.0 percent in both 2015 and 2016. Robust domestic demand, underpinned by investment in infrastructure and household consumption, will continue to drive growth during the forecast period. Public consumption will remain high. A large public sector wage bill, transfers from the national government to the counties, and recurrent expenditures for social sector projects will continue to drive public expenditures in 2014 and probably thereafter. External demand for Kenyan exports and investment flows should revive as the global economy strengthens. Despite the increase in exports, however, net exports are expected to slow GDP growth over the forecast horizon, because demand for imported capital goods is projected to remain strong.

Inflationary pressures are building. Inadequate rainfall could create macroeconomic instability in 2014. The extent of the effect remains unclear, but higher food and electricity prices are expected to raise inflation above its target level, putting macroeconomic stability, private investment, and projected growth at risk.

Several risks threaten growth. Drought (or erratic rainfall) could reduce agricultural production, leading to higher food and electricity prices as well as inflationary pressures, the tightening of global monetary conditions could reverse capital flows, and the domestic security situation could deteriorate further. Strong inflationary pressures have been emerging since April, driven partly by unfavorable bad weather. Unreliable electricity supply (exacerbated by low rainfall) continues to impose high costs on enterprises. These effects could dampen household consumption and reduce domestic demand. Increased volatility in financial markets and capital flows could slow growth by
raising domestic interest rates and inflation. A worsening security situation would have a severe effect on the tourism sector and instill fear among current and potential investors across sectors.

**Addressing the fiscal pressures emerging from fiscal expansion is a priority for the authorities.** Given the reduction of fiscal buffers and the fiscal risks linked to the wage bill and devolution, a strong emphasis on achieving efficiency gains, is warranted particularly in order to address the access and equity challenges in the health sector. Additional expenditures should be pursued only if they are sustainable.

**Health care for many Kenyans is inadequate**

Despite economic growth over the past decade, health care outcomes in Kenya remain weak. Rates of maternal mortality and stunting among children have barely changed, and the incidence of non-communicable diseases is rising.

Catastrophic health-related spending continues to push Kenyan households into poverty. The proportion of households reporting catastrophic spending on health fell from 11.4 percent in 2007 to 9.4 percent in 2013, according to preliminary results of the 2013 household healthcare utilization and expenditure survey. But this figure still means that health-related expenditure pushed hundreds of thousands of Kenyan families into poverty last year alone. Improving access to primary care would contribute to achievement of the twin goals of the World Bank Group—to eliminate extreme poverty and promote shared prosperity—because the poor tend to benefit most from primary health care and out-of-pocket health care expenditures are an important cause of poverty.

Two years after its launch, the HSSF has already improved the quality and quantity of services, community participation, and governance.

Devolution of health care to the counties has the potential to improve health outcomes. Under Kenya’s new constitution, operational aspects of the delivery of health care services have been devolved to newly created county governments; the national government is now responsible only for policy making and regulation. The new constitution also guarantees equitable access to health services to all.

**Direct funding of lower-level hospitals—through the Health Sector Services Fund—has already improved services.** In 2010 the Ministry of Health introduced direct funding to dispensaries and health centers, through the Health Sector Services Fund (HSSF). This funding mechanism currently covers more than 3,000 facilities and will be expanded to about 6,000 by 2015. Two years after its launch, the HSSF has already improved the quality and quantity of services, community participation, and governance. Supporting increased utilization has been the shift from a kit-based “push” supply system to a demand-based “pull” system as well as the implementation of a human resources strategic plan that has deployed more than 3,000 nurses to the most underserved areas.

Kenya’s quest for universal access is achievable but expensive. Investing in comprehensive primary health care is a cost-effective way to achieve universal health coverage. The sector must be consolidated, and further strengthened, and the recently introduced systems need to be expanded at all levels, especially through the primary health care pyramid. Health care spending needs to be reallocated away from curative care toward preventive and promotive care. A multisectoral, multidisciplinary, and
holistic approach is necessary that increases the number of health staff in all disciplines, establishes an effective supply chain system for drugs and laboratory services, ensures improved transport services and infrastructure, and provides adequate water and sanitation.

The health care system needs to be more equitable. Seventy percent of health costs in Kenya go to hospital and specialist care, which benefit just 30 percent of the population (Logie and others 2010). Greater equitability could be achieved by allocating more funds to primary health care and by ensuring access to health insurance by the poor. The World Bank is supporting the Ministry of Health in implementing the phased introduction of subsidies for health insurance through the National Health Insurance Fund.

Creation of a comprehensive primary health care system depends on several factors, including:
- good policies and legislation at the national and county level that emphasize participation by communities and individuals
- participatory approaches to planning and management
- health literacy, especially among women, which has been found to reduce both maternal and child morbidity and mortality
- appreciation by the community of good-quality services, which increases utilization.