KENYA ECONOMIC UPDATE

December 2009 | Edition No. 1

Still Standing: Kenya's Slow Recovery From a Quadruple Shock

with a special focus on the food crisis

Poverty Reduction and Economic Management Unit Africa Region

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FOREWORD

With this Kenya Economic Update, the World Bank is launching a program of short, crisp and more frequent country economic reports, which have become a trademark of the World Bank's analytical presence in other countries. These Economic Updates will analyze the trends and constraints in Kenya's economic development. Each issue, produced bi-annually, will provide an update of recent economic developments as well as a special focus on a selected topical issue.

The Economic Updates aim to support all those who want to improve the economic management of Kenya. Specifically, the notes are intended to help inform and stimulate knowledge and debate on topical policy issues, and in doing so to make a contribution in unleashing Kenya's growth potential. In essence, the notes offer another voice on economic issues in Kenya, and another platform for engagement, learning and change.

This first edition of the Kenya Economic Update is titled "Still standing – Kenya's slow recovery from a quadruple shock, with a special focus on the food crisis". This title has two meanings, which are both true for Kenya today. First, the economy seems to stand still as economic growth barely matches population growth, indicating that Kenya continues to operate below its potential. Second, Kenya's economy has weathered four consecutive crises – post-election violence, global food crisis, global financial turmoil, and drought – well enough so that its economy is "still standing". This report looks at both of these dimensions and analyzes the weaknesses (and partial strengths) of the current growth momentum as well as Kenya's resilience, particularly with respect to the global financial crisis.

The Kenya Economic Updates are produced by the Poverty Reduction and Economic Management Unit of the World Bank Country Office in Kenya. It has been prepared by a team led by Wolfgang Fengler and Jane Kiringai, and including Christine Cornelius, Gabriel Demombynes, Catherine Gachukia, Millicent Gitau, Andrew Karanja, Hannah Messerli, Yira J. Mascaro, Thilakaratna Ranaweera, Dimitri Stoelinga, Fredrick Wamalwa and Carolyn Wangusi. Important contributions were also received from Aurélien Kruse, Tracey Lane, Lucas Ojiambo and Shane Streifel. Kathie Krumm (Sector Manager, East Africa and the Horn) and Johannes Zutt (Country Director Kenya) provided guidance and advice, and have been an invaluable source of encouragement to the team.

A panel of reviewers from outside and inside the World Bank provided excellent advice at major stages of the report. They included Aly Khan (www.rich.co.ke), Scott Rogers (IMF), Louis Kuijs, and Hassan Zaman (both World Bank).

The team benefited greatly from consultations with Kenya's key policy makers and analysts, which provided important insights, in particular the following institutions: the Office of the Prime Minister, the Central Bank of Kenya, the Treasury, the Ministry of Planning, the Kenya Institute of Public Policy and Research Analysis (KIPPRA) and the Kenya National Bureau of Statistics (KNBS).

CURRENCY AND EQUIVALENTS UNITS
(Fiscal Year: July 1 – June 30)
Currency = Kenyan Shillings
US $1.00 = KSh 75.50

ABBREVIATIONS AND ACRONYMS

CBK	Central Bank of Kenya
CBR	Central Bank Rate
COMESA	Common Market for Eastern and Southern Africa
CPI	Consumer Price Index
CRR	Cash Reserve Ratio
EAC	East Africa Community
EASSY	The East and Southern African Submarine System
ESF	External Shock Facility
FDI	Foreign Direct Investment
FY	Financial Year
GDP	Gross Domestic Product
HGSFP	Home Grown School Feeding Program
IMF	International Monetary Fund
KFSSG	Kenya Food Security Steering Group
KNBS	Kenya National Bureau of Statistics
KSHS	Kenya Shillings
ME	Middle East
MoF	Ministry of Finance
MT	Metric Tonnes
NCPB	National Cereals and Produce Board
NGOs	Non-Governmental Organizations
NPLs	Non-Performing Loans
NSE	Nairobi Stock Exchange
ODA	Official Development Assistance
PRRO	Protracted Relief and Recovery Operation
SSA	Sub-Saharan Africa
TEAMS	The East Africa Submarine Systems
UK	United Kingdom
US	United States
WB	World Bank
WFP	World Food Programme

OVERVIEW

Kenya is one of few countries in the world which will grow faster in 2009 compared to 2008. But this is where most of the good news ends. Kenya's projected growth of 2.5 percent in 2009 is not even matching its population growth, and it follows a year which realised even lower growth at 1.7 percent. These growth rates are below Kenya's potential, which was demonstrated in 2007, when the economy grew by 7.1 percent. At the same time, the country experienced four shocks in short sequence: the post-election violence in early 2008, the oil and food price increases, the global financial crisis and in 2009, the worst drought in a decade. Against the background of these multiple shocks, Kenya's recovery also demonstrates the resilience of its economy.

Agriculture will experience another year of contraction. In 2008, agriculture declined by 5 percent. In 2009, it is expected to contract by another 2.3 percent. The agriculture sector has not only been hit by domestic and external shocks but it is also the sector with some of the most difficult policy and structural challenges. At the end of 2009, the price of maize, Kenya's main staple, was double the international price and for most of the year it was also substantially higher than in Uganda and Tanzania. The 2008 political crisis disrupted food production, especially in the rift valley and the 2009 drought exacerbated the situation. Furthermore, the interventions of the National Cereals and Produce Board (NCPD) have led to additional price increases, which are detrimental to the large majority of Kenyans. In the domestic maize market, less than two percent of Kenyan farmers–mostly large and influential producers–are benefitting from the current extraordinary high food prices. The rest of the population, particularly the urban and rural poor, is paying a high price. These inequities point to an urgent need to review Kenya's agricultural trade policy and to re-examine the role of the NCPD (see also the special focus of this report).

The drivers of Kenya's modest recovery in 2009 are services and construction. Services which account for 55 percent of the economy are expected to grow by 4.4 percent, led by tourism (+28 percent) which recovered after experiencing a record decline in 2008 (-36 percent). Industry, which accounts for 19 percent of the economy, will grow by an estimated 3 percent, owing mostly to the booming construction sector (+13 percent). Manufacturing, which represents the largest share of Kenya's industry, will grow by 3 percent having been heavily affected by energy shortages. These shortages are also reflected in the contraction of utilities (-9 percent), the worst performing sub-sector in 2009 (see section 1).

Despite many challenges, the Kenyan economy has proven resilient to the quadruple shocks. Its fiscal position is strong, its financial sector is robust, the external sector remains in balance, and inflation has declined below 10 percent:

- ***Fiscal Position.*** Kenya entered the financial crisis from a strong fiscal position. Over the last decade, the country's public debt declined from 60 to 43 percent of GDP. This allowed the government to protect key expenditures and embark on an ambitious US$ 300 million (Ksh 22 billion) fiscal stimulus program, resulting in a projected budget deficit of 6.6 percent of GDP in FY 2009/10. Now it is important to implement the stimulus package speedily, coupled with a commitment to return to lower fiscal deficits by 2011.

- ***Financial Sector.*** Kenya's financial sector continued to grow in 2009, but at a slower pace compared to the period before the global crisis. The banking sector, measured by credit growth, grew by an estimated 20 percent in 2009, down from 25 percent in 2008. While the global crisis affected other countries' financial sectors, Kenya has been improving its performance in two important areas during the last few years, which increased its resilience to global trends. First, the banking sector became more stable. The share of non-performing loans (NPLs) fell from 19.3

percent in 2006 to 9 percent in 2009, despite a slight worsening since 2009. Second, the introduction of "mobile money" of which Kenya is a global pioneer coupled with the fact that major banks are expanding their customer base, increased access to finance from 26.4 percent in 2006 to 40.5 percent in 2009. Nonetheless, there is a risk that the financial sector will be affected by "second-round effects" through the four shocks absorbed by the real sector.

- ***External Balance.*** Like in other non-oil exporting developing countries, Kenya's current account deficit increased substantially since 2008. However, the overall balance remained broadly stable (and recovering from a deficit of 2 percent of GDP in early 2009) due to strong services exports (including tourism) and a strengthening of the capital account. This is also why the Kenyan Shilling has remained stable over the last two years, only supported by temporary drawing down of reserves in early 2009. However, there remains a risk if oil prices rise further in 2010.

- ***Inflation.*** Kenya's overall inflation declined substantially from 19.5 percent at the end of 2008 to below 5 percent at the end of 2009. Kenya is now a low inflation country; another indication of its strong macroeconomic policies. In the past, there has been some uncertainty about actual inflation levels due to the use of a methodology which had an upward bias, particularly during food price volatility. In October 2009, Kenya revised its inflation methodology, which corrected this upward bias and is in line with international good practice (see section 2.2).

For 2010, the World Bank projects a GDP growth rate of 3.5 percent, and a continuation of the country's modest recovery after the four shocks. This projection is in the range of Kenya's average growth rate since 2000 (3.7 percent) and similar to the expected growth rate for Sub-Saharan Africa (3.65 percent). However, at this rate, Kenya will continue to grow slower than its peers and neighbors. Ethiopia, Rwanda, Uganda, and Tanzania (all +5.5 percent) are expected to be the strongest performers in Eastern Africa.

However, Kenya has the potential to grow at 4 percent in 2010. But this would depend on recovery in the agriculture and manufacturing sectors, strong implementation of the government's fiscal stimulus as well as a favorable global environment spurring foreign direct investment. There is also a downside scenario. Slow growth may continue beyond 2009 if the domestic constraints to agricultural and industrial productivity continue and/or if the anticipated global recovery does not materialize, which would result in muted demand for Kenya's exports of goods and services, particularly tourism.

As Kenya enters a new decade, there are opportunities to accelerate growth and reduce poverty. Building on a strong macroeconomic foundation, the government responded appropriately to the financial crisis, by protecting key public expenditures and adopting a fiscal stimulus package. The downward revision of inflation further added credibility to the government's monetary policies. The main challenge for 2010 is the implementation of the fiscal stimulus package, while returning to lower fiscal deficits by 2011 to guard against pro-cyclicality. The main focus should be on protecting core social and infrastructure expenditures, while continuing a public investment program which Kenya would have programmed even in normal times.

Infrastructure bottlenecks and agricultural policy remain Kenya's main policy challenges. Infrastructure bottlenecks continue to negatively impact the economy, in particular the manufacturing and agro-export sectors. The government has embarked on an ambitious program to upgrade the road network and to expand energy generation, particularly geo-thermal. These improvements will also be critical to jump-start Kenya's merchandise exports which have been stagnant at around US$ 4 billion since 2006.

The agriculture sector remains the Achilles' heel of Kenya's economy, both in terms of production and wealth distribution. The sector's performance has been hit hard by external shocks and depressed by domestic policy challenges. The government, together with development partners, has responded relatively well to mitigate the impact of the 2009 drought. For 2010 and beyond, the key challenge is to address structural bottlenecks in agricultural policies which have been benefitting a very small group to the detriment of the general public, including the majority of Kenya's farmers.

A number of measures could help address the structural food deficit while supporting the poor. In the short term, the government could help the poor, including poor farmers by: (i) continuing the policy of low tariffs for maize and grain imports, while at the same time removing all import quotas; (ii) supporting food and livestock production through expanding access to inputs, credit and extension services; and (iii) implementing well-targeted social protection measures. These include support to orphans and other highly vulnerable individuals, cash transfers to vulnerable urban households, and school feeding programs. In the medium term, priorities include (i) reforming the NCPB; (ii) continuing the major push to upgrade infrastructure; and (iii) investing in agricultural technology generation and dissemination to reduce overdependence on maize (see special focus section).

Kenya aspires to become a middle-income country and it can build on a good foundation to progress towards this goal in the coming years. Kenya has a relatively well educated workforce, a strong private sector, a vibrant civil society, and an emerging urban middle-class. Several of Kenya's sub-sectors, particularly in services, are of international standard. At the same time, the country has been operating below its potential for a long time and only started demonstrating its economic potential from 2004 to 2007—before the quadruple shock. Building on a sound foundation of prudent macroeconomic policies and an innovative service sector, Kenya's challenge is now to implement micro-economic and sectoral reforms to unleash its growth potential in the next decade.

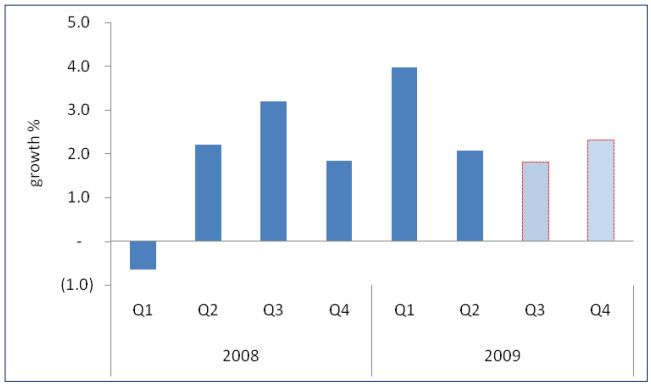
The State of Kenya's Economy

This first issue of the Kenya Economic Update examines the ways in which the Kenyan economy has been affected by four waves of crises. Section one describes the growth outlook for 2009, and how the phenomenon of slow recovery manifested itself across the different sectors of activity. Section two drills deeper into the successive waves of crisis, the transmission mechanisms through which they affected the economy, as well as the government's response to date. Finally, section three concludes the economic update with scenarios for growth in 2010 and an analysis of the assumptions behind them.

1. Growth in 2009

In 2009, Kenya's growth rate will reach approximately 2.5 percent. This signals a mild recovery compared to the 1.7 percent growth in 2008, but remains below the population growth rate and substantially short of Kenya's potential and aspirations. While low growth in 2008 was mostly a factor of the post-election violence and high food prices, a rebound in 2009 was hampered by the global financial crisis and the worst drought in a decade. In the first half of 2009, growth was relatively strong at 3 percent but this was partly a catching-up phenomenon after exceptionally low growth in the first half of 2008. For the second half of 2009, growth is projected to reach only 2 percent (see figure 1).

Figure 1 – A slow recovery in 2009, growth at 2.5%

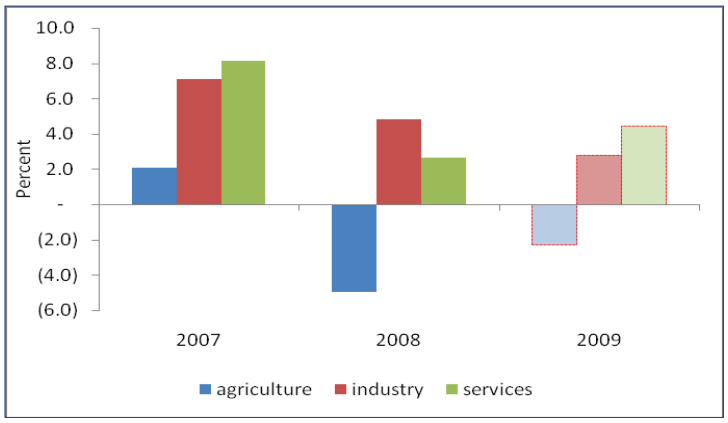


Source: KNBS / WB staff estimates

Kenya's modest recovery has been uneven across sectors, and is mainly driven by services and construction. Unlike in other Sub-Saharan

economies, services accounts for 55 percent of the economy and they continue to be Kenya's main source of growth in 2009 with an expected growth rate of 4.4 percent. Industry (19 percent of the economy) will grow by 2.8 percent, driven by a booming construction sector. However, the agriculture sector (27 percent of the economy), saw another year of contraction by 2.3 percent, following a 5.0 percent decline in 2008 (figure 2).

Figure 2 – 2009 growth: services perform strongly but agriculture contracts again

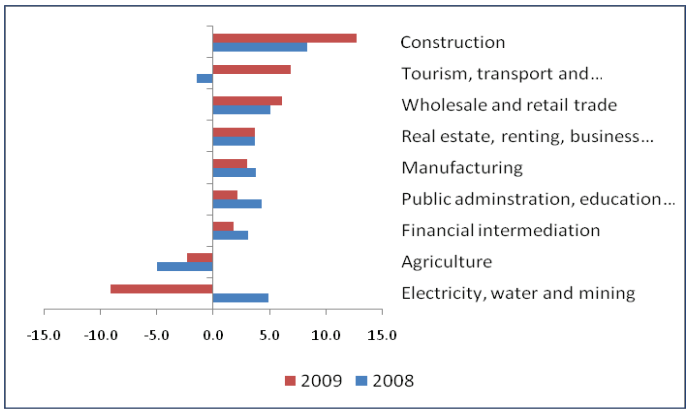


Source: KNBS and WB staff estimates (growth at factor costs)

Agriculture has been the sector most severely impacted by the multiple shocks. The political crisis disrupted production in the first half of 2008 and by the second half, inadequate rainfall and a tripling of input prices (fertilizer) dimmed hopes for a rebound. Recovery in 2009 was muted by the protracted drought. In the first half of the year, tea and horticulture production fell below 2008 levels (-17 and -7 percent respectively), while coffee production picked up (52 percent growth) from a very low base after years of difficulty. The horticultural industry–cut flowers, fruits, vegetables–which is one of the fastest growing agricultural sub-sectors, contributing more than 10 percent of total agricultural production, weathered the political but not the global crisis. Production contracted by 7 percent in the first half of 2009. The outlook for the end of the year is mixed: tea production will recover with the short rains and high global prices provide a boost for exports. For maize, the effects of the drought are expected to recede only in the first quarter of 2010 after the harvest. Kenya's food crop production and the country's overall food security are also suffering from inadequate structural policies, especially on trade and marketing (see special focus section of this report).

Industry has seen a very mixed performance in 2009. The sector's moderate growth of 3 percent is mostly driven by a booming construction sector, which is expected to grow by 9 percent. By contrast, utilities (water and electricity) and mining will see negative growth rates of -9 percent, mainly due to drought-related water and electricity shortages. Manufacturing will only expand at 3 percent, which is below 2008 levels (figure 3). The slowdown in the growth of exports for locally manufactured products, high input costs, power rationing and infrastructure deficit have been major hindrances for the manufacturing sector, which is losing almost 10 percent in sales due to power outages and transport bottlenecks (Investment Climate Assessment, World Bank 2007).

Figure 3 - Construction, tourism, transport and communication drove growth in 2009



Source: KNBS / WB staff estimates

Defying the odds, Kenya's service sector has been performing strongly despite the global crisis. Tourism (+28 percent) recovered after a 35 percent decline in 2008, the worst ever performance in Kenya's history (see box 1). Telecoms, transport, financial services, as well as retail and wholesale trade are also expected to perform better than in 2008. However, financial services will grow at only 2 percent, compared to 3.5 percent in 2008.

Box 1 – Kenya's Tourism: short term recovery but looming challenges

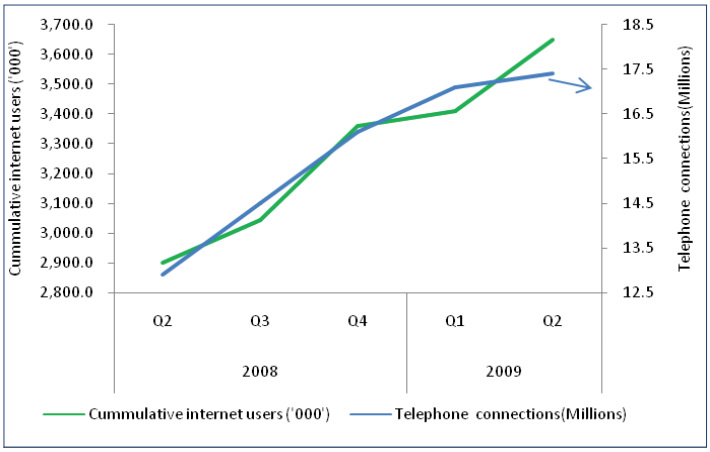
In 2009, tourism in Kenya recovered. The sector mirrors the overall economy which recovered despite the global crisis, mainly due to the weakness of 2008 rather than strength in 2009. Tourist arrivals (air and sea) to Kenya are expected to reach 930,000 by the end of 2009; a 40 percent increase compared to 2008. This recovery was supported by aggressive marketing, discounting of prices and a generally positive performance of the sector in Africa (+4 percent) which grew against global trends (-7 percent). However, Kenya's tourism revenues have thus only increased by 28 percent, after a 35 percent decline in 2008. While a substantial improvement over last year, sector revenues are still below the 2007 level.

Kenya's tourism sector is at a point of transition. Traditional source markets in the US and Europe have declined while travelers from new source markets are on the rise. New markets include Russia, China, the Middle East as well as Kenya's growing middle income group which has an expanding appetite for travel as do travelers from other African countries. These new markets offer the promise of increased arrivals. However, the spending propensity of these groups is less certain than that of traditional long haul travelers. This may explain why early estimates of 2009 tourism receipts are lower on a per traveler basis than in previous years. Alternatively, and a point of greater concern, is the possibility that lower average per person expenditures are a result of Kenya's tourism offering being dated and limited in an expanding regional and global marketplace of attractive travel destinations.

Source: World Bank staff

Telecommunication is one of Kenya's most dynamic sectors. Since 2008, connectivity to the internet (+28 percent) and phones (+35 percent) increased rapidly (see figure 4). By mid 2009, 17.3 million Kenyans owned a mobile phone, which translates into a penetration rate of 77 percent (for those 15 years and above). Telecommunication is becoming not only an important growth sector on its own but has started to create positive spillover effects for other sectors of the economy. Faster internet connectivity through fiber optic cables, the East Africa Submarine Systems (TEAMS) and the East and Southern African Submarine System (EASSY), which now connect East Africa to the rest of the world, will increase efficiency in the broader economy and has already boosted the service export industry (e.g. call centers). Perhaps the most significant multiplier is in the financial sector through the introduction of "mobile money" with an estimated customer base of 7 million subscribers (see also section on the financial sector).

Figure 4 – Rapid increase in internet and telephone connectivity since 2008



Source: Communication Commission of Kenya, 2009

2. Weathering the Storm – Kenya One Year after the Global Financial Crisis

2.1. Transmission Mechanisms and Response

One year after the crisis, Kenya's economy is still standing. The first round impacts of the global crisis have been relatively mild and were overshadowed by other shocks. Strong macroeconomic policies and additional reforms in recent years have also helped the country to weather the global crisis. A solid fiscal position and continued revenue efforts allowed the government to enact an ambitious fiscal stimulus program for 2009 and 2010. Kenyan banks have been shielded from the first round effects of the crisis, and were helped by complementary reforms, which have contributed to reduce NPLs since 2006. The other key transmission mechanisms of the global crisis – trade and financial flows – have been impacted but have not seen sharp reversals (see table 1).

2.2. The Financial Sector and Monetary Policy

The banking system has remained relatively insulated from the direct effects of the financial crisis, but there are emerging signs of vulnerability to feedback effects. Despite the relative openness of Kenya's financial sector compared

Table 1 – Kenya's weathering the global crisis: transmission mechanism and response
1a. The Transmission Mechanism

Transmission Mechanism	Status 2009	Outlook 2010
Banks	No contagion. NPLs stand at 9 percent (September 2009). Capital Adequacy: 19.8 percent against a statutory requirement of 12 percent.	Increased lending and other financial services to the real sector as the economy recovers.
Trade	Current account deficit at 6.7 percent of GDP. Recovery in tourism helped (partly) to stabilize services account.	Current account deficit projected to decline to below 6 percent of GDP.
Financial Flows (remittances, FDI, other flows)	Remittances projected to grow by 3 percent (higher than expected, but below pre-crisis growth rates). Net FDI expected to drop by US$ 500 million (but "other financial flows" have increased). Nairobi Stock exchange index mirrors Dow Jones and remains more than 50 percent below mid 2008 levels.	Remittances expected to recover in line with global trends. Reduced transaction costs with expansion of "mobile money" can trigger additional transfers. FDI remains subdued until the global economy recovers; dependent on IPOs, particularly in services.

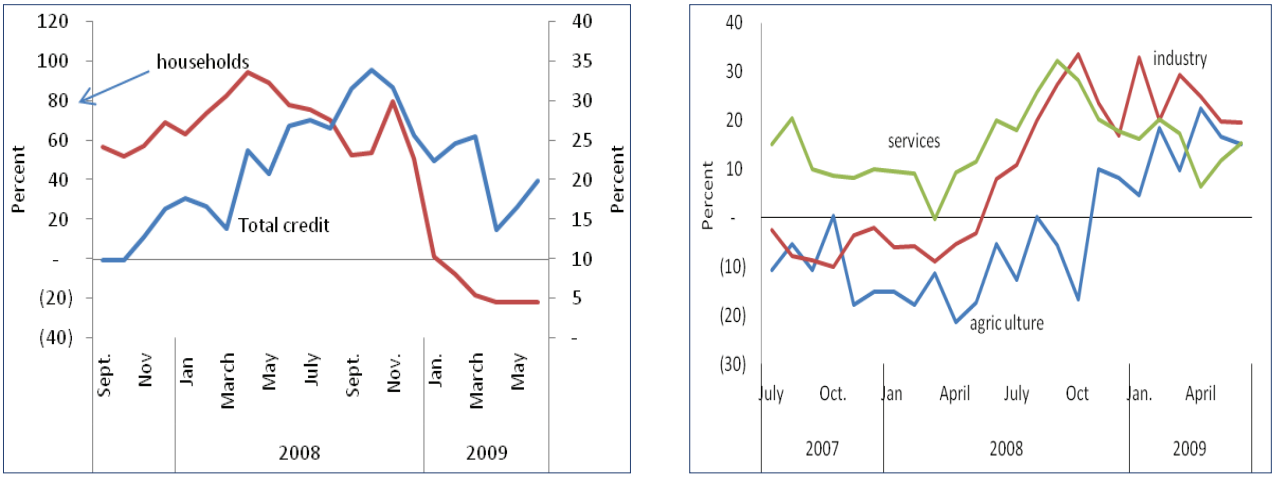
Table 1 contd.
1b. The Response

Response	Status 2009	Outlook 2010
Monetary easing and debt management	Reverse Repos to inject liquidity in the market and keep broad money aggregates on target. Central Bank Rate (CBR) reduced by 175 basis points to 7 percent. Sharp decline of inflation to 5 percent by end 2009; average inflation for 2009: 10.2 percent.	Ensure price stability and maintain inflation at 5 percent.
	Drawing down of external reserves by US$ 700 million, from 4 months to 2.7 months of import cover. Exogenous Shock Facility from the IMF injected US$ 200 million.	Reserves build up to 4 months of import cover. Expected improvements in debt management and increased liquidity in government bond markets.
Fiscal Stimulus	Supplemental budget for FY08/09 increased deficit to 5.9 percent of GDP, but realization at 3.7 percent due to difficulties in absorption. FY09/10 increased deficit to 6 percent of GDP; additional spending for rural infrastructure and social safety nets.	Debt to GDP ratio remains the fiscal anchor. Debt sustainability and interest rate impact of additional government borrowing will determine the size of stimulus if still required.

to other African countries, its exposure to the direct effects of the crisis was limited. This was largely thanks to limited inter-linkages with foreign banks and exposure to complex financial products. Overall, Kenyan banks remain well capitalized and the financial sector has made substantial progress towards increasing stability, improving access to finance and adopting key reforms. The share of NPLs has fallen from 19.3 percent in 2006 to 9 percent in 2009; capital adequacy in the banking sector was 19.8 percent at the end of August 2009, above the 12 percent minimum; the banking sector is profitable, with a return on equity above 30 percent over 2006-08; and average lending rates have been relatively low in real terms and stable.

However, the negative shocks reduced credit growth from 25 percent in 2008 to about 20 percent in 2009 with growth in credit to households declining sharply (see figure 5). Commercial bank lending rates have been sticky, reflecting an increased perception of risk in the market as a result of low growth in the real sector. Credit to the agriculture sector has been most deeply impacted and contracted until the last quarter of 2008.

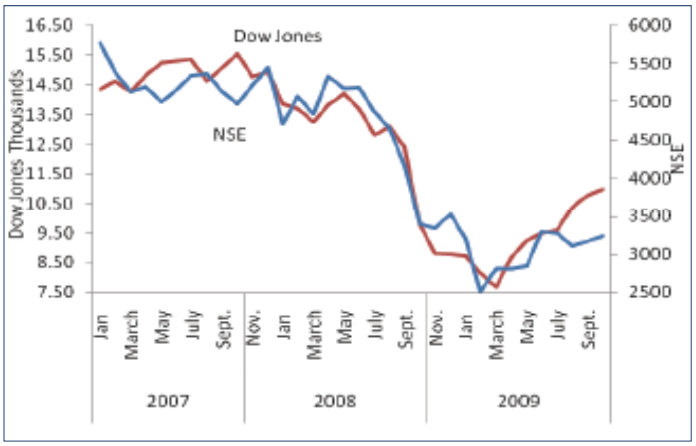
Figure 5 – In 2009, credit growth expected to be 12 percent – but credit to households declined



Source: Statistical Bulletin, CBK. Note: credit growth is year-on-year

The impact of the financial crisis can also be traced through the capital flows to Kenya, which reflect global trends and reduced FDI flows. The Nairobi Stock Exchange (NSE) index declined sharply since the beginning of the global financial crisis, and recovered only modestly in 2009. The poor performance of the NSE was also influenced by internal governance challenges which, however, have been addressed in recent months. Overall, the NSE index mirrors the performance of other indices around the world, including the South African stock market and the Dow Jones (see figure 6).

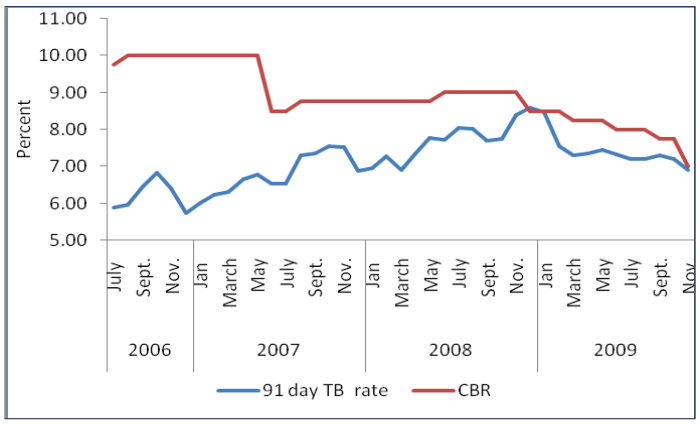
Figure 6 – Kenya's stock market performance follows global trends



Source: Nairobi Stock exchange & Dow Jones

To mitigate the impact of the global financial crisis, the Central Bank has been implementing countercyclical monetary policies to inject liquidity in the market. The Central Bank Rate (CBR) has been reduced by 175 basis points from 8.75 in the first quarter of 2008 to 7 in the last quarter of 2009 (see figure 7). The Cash Reserve Ratio (CRR) has also been reduced from 6 percent in 2008 to 4.5 percent in 2009. This was to ensure that government borrowing in the domestic market would not have a crowding out effect by putting pressure on lending rates. As a result, lending rates have been stable at single digits; the 91 day T bill rate has averaged about 7.5 in 2009.

Figure 7 - The CBR rate has been reduced by 175 basis points to inject liquidity in the market



Source: Central Bank of Kenya

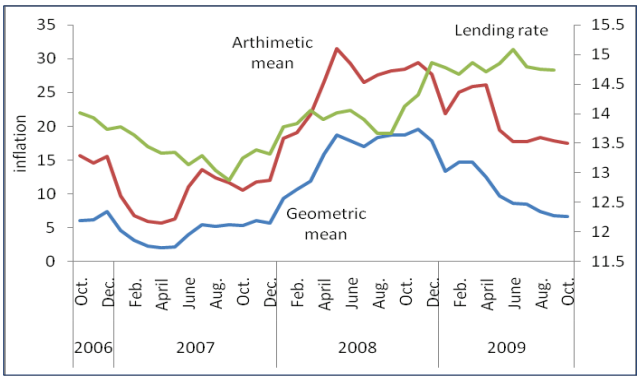
Overall inflation declined substantially from a high of 19.5 percent (November 2008) to 5 percent (November 2009). The sharp reduction in 2009 brings inflation back to the target of the Central Bank of Kenya (CBK) which it left since early 2008, when the global food crisis and the domestic political crisis resulted in a tripling of inflation. However, core inflation (which includes food and energy in Kenya) has remained at or below 10 percent, even during the height of the combined food and post-election crises in the first half of 2008.

During this period, Kenya's inflation estimates have been complicated by a computation method which caused an additional upward bias. However, in October 2009 the government adopted a new methodology [1] for measuring inflation in line with international good practice. The new methodology removes the upward bias which was particularly sensitive to volatile food prices. The new methodology provides a more accurate assessment of price changes creating more certainty for business and labor and adding credibility to the CBK's monetary policy (see figure 8). As a next step, the government has also announced an adjustment in the basket of consumer prices in February 2010, reducing the

[1] There are two broad types of methods to aggregate price data: arithmetic mean and geometric mean. Until October 2009, Kenya has been using the arithmetic mean (linked Carli index) which demonstrates a particularly strong upward bias during periods of high and volatile inflation. In October 2009, KNBS shifted to a weighted geometric mean (Jevons index). See also "Estimating Kenya's inflation level" (unpublished working paper, World Bank, October 2009).

weight of food in the consumer price index (CPI) from 50 to 40 percent. With this additional adjustment, overall inflation is expected to decline further.

Figure 8 – Inflation under the new and old methodologies

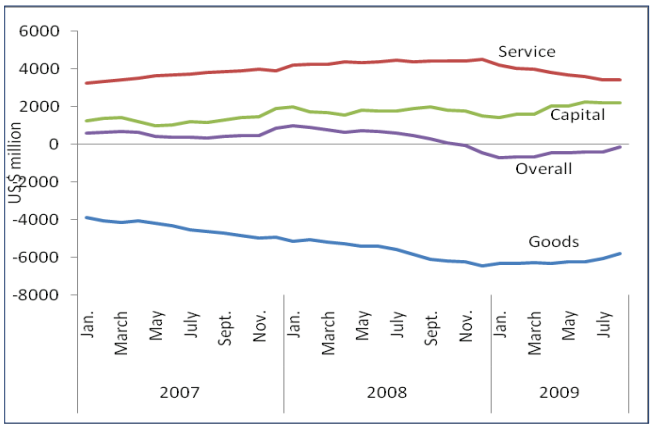


Source: KNBS - new is geometric mean, old is arithmetic mean

2.3. The External Sector

Since the onset of the global financial crisis Kenya's current account deficit increased from 4.5 percent in 2008 to 7.5 percent of GDP in 2009. Kenya has a structural current account deficit which is driven by a large trade deficit (US$ 6 billion), which is partly compensated by a strong service balance (US$ +3.5 billion). The overall balance remains stable due to strong capital inflows which have been increasing to above US$ 2 billion in 2009, mainly due to rising "other flows", stable transfers of remittances and increasing ODA disbursements. With the onset of the financial crisis, Kenya's overall balance turned negative as the trade imbalance widened further and service exports leveled off (figure 9).

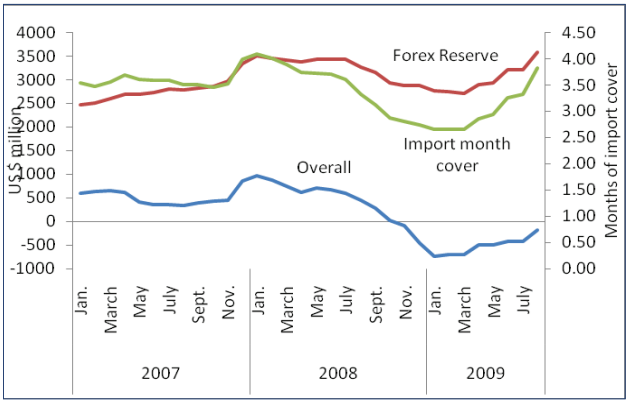
Figure 9 - Kenya's Balance of Payments: Services and capital flows balance a widening trade deficit



Source: World Bank computations based on CBK

The Central Bank's policy response was to draw down foreign exchange reserves while borrowing from the IMF's Exogenous Shock Facility (US $ 200 million) to stabilize the exchange rate. Before the crisis foreign exchange reserves stood at US$ 3.5 billion, about 4 months of import cover. By February 2009, the Central Bank drew down more than US $ 700 million and reserves stood at US $ 2.7billion, 2.7 months of import cover. The exchange rate depreciated at the beginning of the crisis but since March 2009, the shilling has been appreciating and the CBK has been accumulating a recovery of reserves (figure 10).

Figure 10 – Decline and recovery of Foreign exchange reserves and import cover

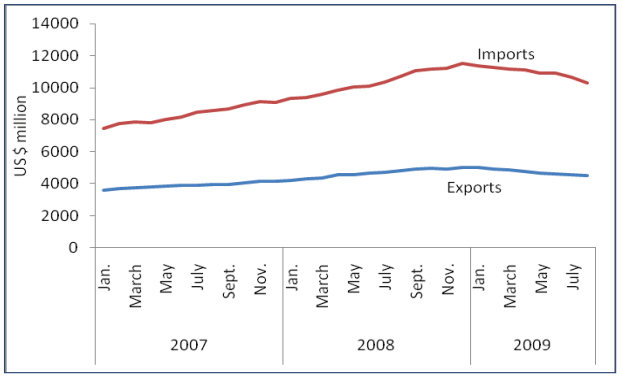


Source: World Bank computations based on CBK

After a sharp increase in Kenya's import bill in 2008, mainly due to rising oil and fertilizer prices, the trade balance improved slightly in 2009 when imports started to decline (figure 11). Exports never benefitted from the global commodity boom in 2008 due to the disruption in agriculture production after the post-election crisis. In 2009, the global crisis constrained the demand for exports and the drought limited the growth of agriculture exports while creating additional need for imports. Additional maize imports to close the food deficit exerted pressure on the current account and this is expected to continue until the first quarter of 2010 (see also Annex 3). Volume exports for tea and horticulture declined but coffee volumes increased though from a very low base. Tea production was particularly impacted by the drought and horticulture by the slowdown in global demand but high prices for coffee and tea compensated

for the volume shortfalls. Overall terms of trade will remain unfavorable to Kenya until there is a significant reduction in oil prices. The key challenge to export growth is limited diversification which is constrained by lack of competitiveness, especially in manufacturing—attributed to high cost of doing business.

Figure 11 – Since 2007, imports have been rising faster than exports



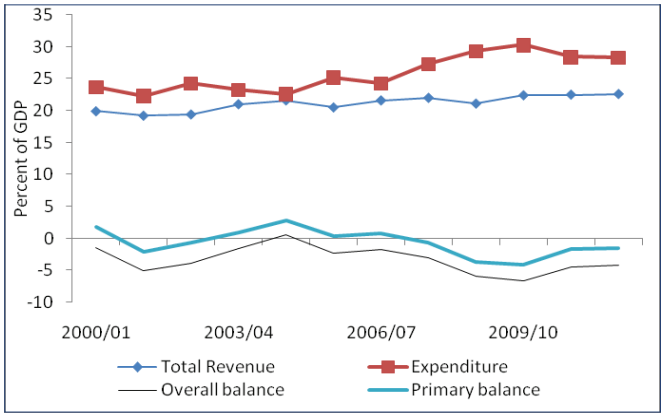
Source: World Bank computations based on CBK

2.4. Fiscal Position and Response

Kenya entered the financial crisis from a strong fiscal position. For most of this decade Kenya has been running a primary fiscal surplus which, coupled with strong growth, led to a reduction in overall debt levels from 60 percent of GDP (2000) to 40 percent (2008). This reduction and a strong revenue effort created the fiscal space to increase spending on infrastructure. In addition, the proceeds from privatization of state owned enterprises were also used to retire debt and Kenya now uses the debt to GDP ratio as fiscal policy anchor with a target ratio of 40 percent. Thus, when the multiple shocks hit the economy, the government had the ability to stimulate the economy without compromising macroeconomic stability (figure 12).

The Central Bank also used the opportunity of improving macro-fundamentals to shift government debt from 90 day Treasury bills to Treasury bonds with longer term maturity profiles (see figure 13). This shift in debt financing and management has helped to ease the debt service pressure and was supported by domestic re-

Figure 12 – Fiscal deficits remain manageable despite the 2009 stimulus

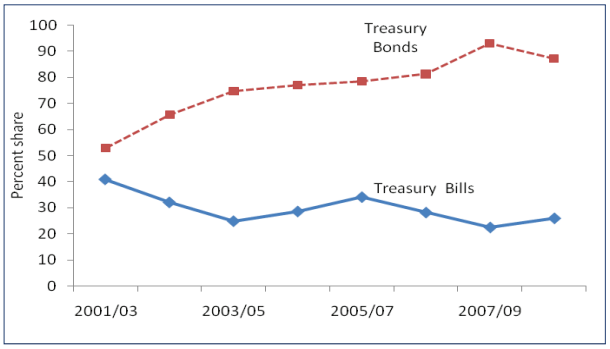


Source: Statistical Annex to the budget Speech, Budget Strategy Paper

forms in debt markets and structural measures to increase liquidity. Until the government will be in a position to issue international bonds, these reforms to the domestic debt market will help to finance the budget deficit at low costs. Kenya can now issue debt at single digit levels, and afford to finance a stimulus package from the domestic market within sustainable debt limits.

The government was able to adopt an expansionary fiscal policy starting in FY2008/09. Additional spending, if realized, would increase the deficit to 6.6 percent in 2009/10. The financing plan is composed of Kshs 50 billion (US$ 660 million) of net foreign financing and a balance of Kshs 118 billion (US$ 1.4 billion), equivalent to 4.3 percent of GDP, from the domestic market. Total public debt will increase from 40 to 43 percent of GDP, with a commitment to return to the 40 percent target in the medium term. The fiscal strategy is two-pronged: increased domestic borrowing through "infrastructure bonds", and rationalized expenditure on hospitality, office equipment and travel.

Figure 13: The restructuring of Kenya's domestic debt

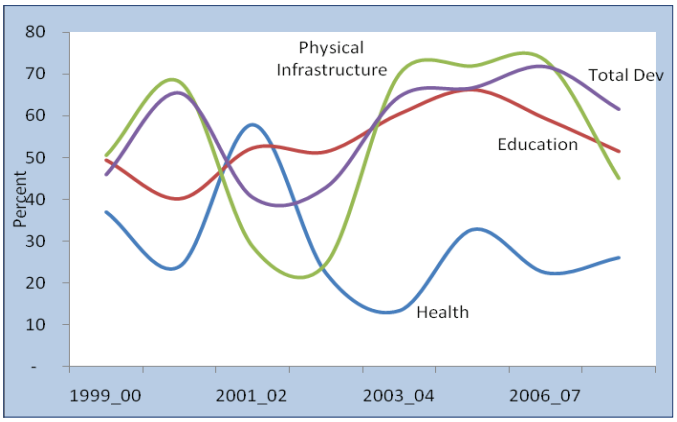


Source: Statistical Abstract, CBK

The fiscal stimulus created an opportunity for additional spending on infrastructure and social protection. Spending on infrastructure increased from 6.7 percent of GDP in FY 2007/08 to 7.1 percent in FY 2008/09, with a further projected increase to about 10 percent in FY 2009/10, and a strong focus on rural market development. Priorities in sector allocations remain broadly in line with previous trends: human resource development accounts for 35 percent of recurrent spending, and infrastructure for 38 percent of development spending. Jointly, the two sectors account for about 50 percent of total spending (47 percent in 2008/09 and 48 percent in 2009/10). The other significant component of the stimulus is a Kshs 7.6 billion (US$ 100 million) allocation for social safety nets. Most of it (Kshs 6.6. billion) was allocated for the second phase of a youth workfare program, the *Kazi Kwa Vijana*. Kshs 1 billion was allocated for a targeted food subsidy scheme.

However, delays in budget implementation could reduce the overall impact of the stimulus package. Investments in public services, particularly infrastructure, require lead time and are also often delayed due to cumbersome procurement procedures. During the last fiscal year, the full stimulus was not achieved and the budget deficit was -3.7 percent against a target of -5.9 percent. On average, only two thirds of the development budget is utilized each year but the ratio has been increasing (see figure 14).

Figure 14 - Development budget implementation is only 65 percent but has improved



Source: World Bank 2009. Fiscal Policies and Institutions for Shared Growth

Accelerating investment budget execution and implementation, and in particular projects with aid financing commitments, can complement the stimulus package and improve the balance of payments. For instance, increasing donor disbursements from 50 to 80 percent in FY 2009/10 would boost total spending by an additional US$ 400 million, which is more than the IMF provided through the External Shock Facility (ESF), without additional debt commitments.

Unlike in most developing countries, Kenya's fiscal policy had been a-cyclical and does not 'lean with the wind'. Most developing countries adopt a pro-cyclical fiscal policy, which contributes to macroeconomic volatility. This highlights the importance of Kenya exiting the fiscal stimulus program as recovery takes hold to guard against pro-cyclicality. In the context of a quadruple shock the attempt at a countercyclical fiscal policy seems appropriate. While the magnitude of the impact in the short-run may be limited, [2] it was important to protect core social and infrastructure expenditures while continuing a public investment program which Kenya would have programmed even in normal times to contribute to reaching its growth potential.

3. Entering a New Decade: Kenya's Growth Outlook for 2010

The World Bank projects Kenya's growth rate at 3.5 percent in 2010. This is a continuation of the timid recovery since 2008 and would result in a modest increase in income per-capita of about 1 percent. If realized, Kenya's growth rate would be close to the average for Sub Sahara Africa (4.1 percent), which is expected to rebound mainly due to South Africa. But Kenya will continue to lag behind its neighbors. Kenya's expected growth performance will be significantly lower than that projected for Uganda, Tanzania, Ethiopia and Rwanda (see figures 15, Annex 2 for key assumptions of growth forecast, and Annex 3 for the underlying data).

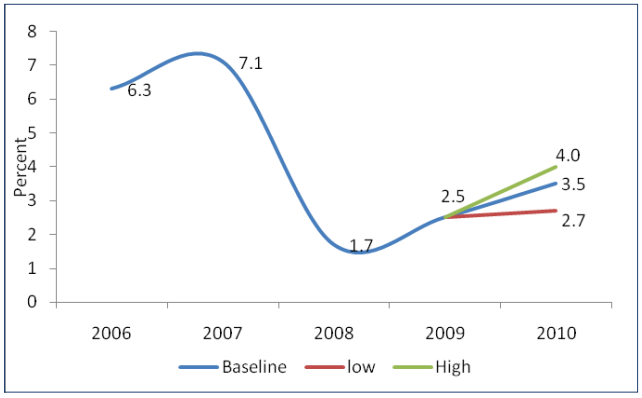
[2] A forthcomig world ak report also estimates that i the past a10 percet fiscal impulse led to ly 1 percet chage i gdp. Fiscal policies adistitutios for sharedgrowth:lessosfromthegloalcrisi,worldak2009.

Kenya's recovery will be driven by services and industry, while agriculture performance will remain sluggish until the second half of 2010. If this year's trends continue, transport, communications, tourism and trade will drive the recovery in the services sector, together with a strong recovery in the financial sector. Tourism arrivals show a positive trend, albeit still recovering from the sharp decline in 2008. A combination of aggressive source market diversification by the government and the 2010 FIFA World Cup in South Africa is expected to boost performance for the sector.

Kenya could grow at 4 percent in 2010, especially if agriculture performance improves due to favorable weather, and the supply of utilities (water and electricity) normalize to pre crisis situation. This scenario also assumes a faster than expected recovery in trading partner countries, pulling the tradable sectors and creating a second round growth impetus to the non-tradable sectors.

On the other hand, if both the domestic economy and the global environment remain sluggish, GDP growth in 2010 will be similar to 2009 at around 2.7 percent. This "low" growth scenario assumes weather conditions that do not enable a substantial pick up in agriculture (both domestic and export oriented), as well as a less rapid and robust global recovery, resulting in muted demand for Kenya's exports of goods and services (i.e tourism). These conditions in turn would slow down the overall economy, even if some fiscal stimulus could be sustained throughout 2010 (figure 16).

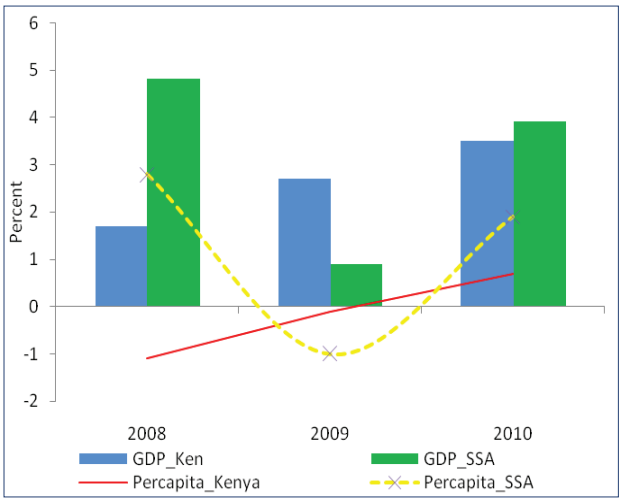
Figure 16 - 2010 growth scenarios

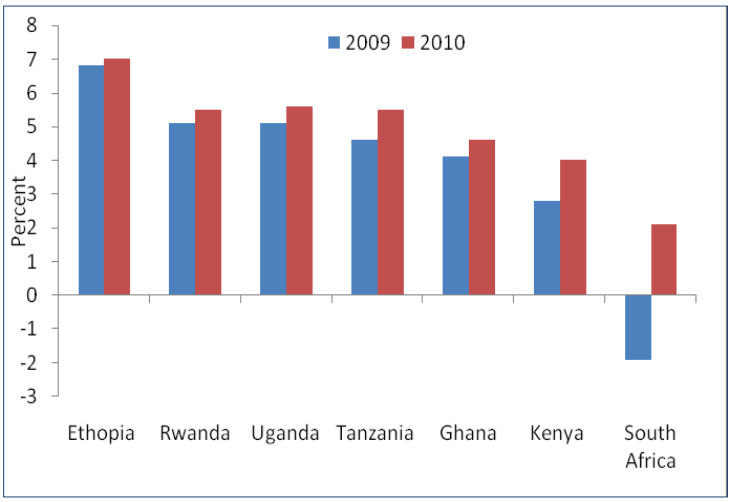


Source: World Bank 2009, Fiscal Policies and Institutions for Shared Growth

The continuation of Kenya's modest recovery in 2010 is reflected in a corresponding pick up in aggregate demand. Private consumption and investment as a share of GDP are expected to increase marginally. Supported by the stimulus package, public investment is expected to boost aggregate demand (see Annex 2 for 2010 growth assumptions). In the relatively more favorable external market conditions expected in 2010, exports are projected to increase. At the same time, with the higher growth expected in 2010 in the domestic economy and a higher oil bill, the share of imports is also bound to go up.

Figure 15 – Kenya's growth performance in a regional perspective





Source: World Bank staff estimates

Special Focus – Kenya and The Food Crisis

This special focus section provides a deeper analysis of Kenya's food crisis, which started in early 2008 with the rise in global food prices. Since then, Kenya's food prices doubled but, unlike global food prices, never declined. Kenya's food crisis was compounded by the 2008 post-election violence, which disrupted one planting season, and a severe drought in 2009 which left an additional four million rural poor in need of food aid. This note explains the effects of the 2008 and 2009 crises on Kenya's poor and analyzes the underlying causes of Kenya's food crisis, in particular of maize, which is Kenya's main staple.

1.Understanding the Effects of the 2008 and 2009 Crises

Like many countries in the world, Kenya was affected by the 2008 global food crisis. Kenya's food prices increased sharply alongside international prices as a result of global trends, including rising demand for bio-fuels and high oil prices. In Kenya's case, this also corresponded with the post-election crisis which disrupted the 2008 planting season and decreased the area planted with maize by 20 percent during the crucial long rains in early 2008. Tanzania's maize export ban further exacerbated food supply problems in Kenya.

In 2009, Kenya's food crisis became even more acute. A series of three failed rain seasons, including a widespread drought during the 2009 long rains planting season, further deteriorated the situation. A reduction of tariffs on maize (including the temporary elimination of import duty) by the Kenyan government in January 2009 came too late to address acute food shortages. A parallel intervention by the NCPB led prices to rise further in 2009. The Kenya Food Security Steering Group (KFSSG) [3] estimates that output of maize will be 28 percent below normal levels in 2009 as a result of insufficient rains.

The impacts of changes in food production and prices differ across socio-professional groups. The main groups affected by Kenya's maize policy are: (a) households that are pure food consumers (who buy but do not produce food), a category which includes most of the urban poor

and the landless, as well as urban non-poor; (b) farming households that are net buyers of maize, and; (c) farming households that are net sellers. In Kenya, approximately 60 percent of all farming households—and an even higher percentage of poor farming households—are net buyers, meaning that they buy more maize than they sell. In contrast, 2 percent of Kenya's farmers account for over 50 percent of maize sales.

The high food prices of 2008 had a negative impact on most of the poor in both rural and urban areas. Analysis in the World Bank's 2009 Poverty Assessment showed that the poor in Kenya devote 70 percent of their expenditure on food on average, and those in the poorest 20 percent of the population spend 77 percent. The high food prices of 2008 reduced the disposable income of the poor and near-poor, resulting in increased poverty. The urban poor were particularly hard hit as they typically do not derive any income from farming. In rural areas, the effects of high food prices were more nuanced. Net food sellers as a whole benefitted, as they saw their incomes rise. However, because most of the rural poor are net buyers of food, the typical poor rural Kenyan was negatively impacted by the food price spike.

The situation deteriorated in 2009, with rising prices driven by drought-induced low production. While government, together with development partners, invested heavily to boost production, unfavorable weather conditions reduced the expected impact. For the urban poor, the effects were similar to those of 2008: a steep drop in purchasing power. However, this time the effects were different for the rural poor. In 2009 the area of depressed production due to lack of rainfall was larger than the area affected by the post-election violence in 2008, resulting in a more widespread impact (see Table 2).

Table 2 - Impact of the 2008 and 2009 food crises on different target groups

		Urban Poor	Rural Poor	
	Primary Cause	All	Net sellers	Net buyers
2008 Food Price Spike	Rising international prices	Negative	Positive	Negative
2009 Food Crisis	Localized drought	Negative	Mixed, negative in drought areas	Negative

Source: World Bank staff

[3] The Kenya Food Security Steering group is a technical working group which monitors the food security situation and provides regular update. The group has broad stakeholder representation from Government departments, Donor agencies and NGOs.

2. Policy Response Options

General subsidy programs, like the one attempted in late 2008, tend to be expensive and to not efficiently target the intended populations. In an attempt to cushion the vulnerable against rising food prices, the government introduced a generalized maize subsidy scheme in November 2008. The scheme had two components. The first was a policy to sell maize to millers through the NCPB at below-market prices. The private sector was prevented from buying directly from farmers during this period. The millers were then expected to pass on the subsidy and sell the flour at a price below prevailing retail prices to everyone regardless of income status. However, rather than selling directly to the millers, the NCPB sold the maize to brokers, who then sold to the millers. The Kenyan public lost an estimated Kshs 23.4 billion (US$ 310 million) in subsidies and taxes foregone during the last fiscal year. The government withdrew the scheme in February 2009, with a commitment to develop an alternative, more efficient and targeted policy.

Existing government programs target three overlapping groups: i) pastoralists and agro-pastoralists in food insecure areas; ii) the urban poor; and iii) school-going children. A summary of the safetyness options being considered for them is provided below.

- **Pastoralist and agro-pastoralists in food insecure areas.** This group is a subset of the rural poor identified in Table 2. The World Bank's 2009 Poverty Assessment found that this group is the most disadvantaged in terms of levels of consumption and access to basic services. The most significant program directed at this group is the emergency Protracted Relief and Recovery Operation (PRRO), managed by the World Food Programme (WFP) on behalf of the government, and other development partners, covering about 2.6 million people.

- **Urban poor.** Food related support is limited in urban areas. Estimates indicate that, excluding school feeding programs, about 90,000 people are covered in Nairobi slums by relief programs provided by NGOs. The government is in the process of designing a targeted cash transfer program for this group.

- **School going children.** A regular school feeding program is managed by WFP on behalf of the government and caters to about 770,000 children. An evaluation completed in 2007 suggests that the program has positively contributed to increased enrollment, attendance, and completion rates. From July 2009 the government started funding the Home Grown School Feeding Program (HGSFP) which covers about 550,000 children. These two programs cover about 1.3 million children.

Other social safety net programs, notably the youth workfare program *(Kazi Kwa Vijana)*, supplement income and also improve food security, even if not explicitly focused on food (see section 2.4).

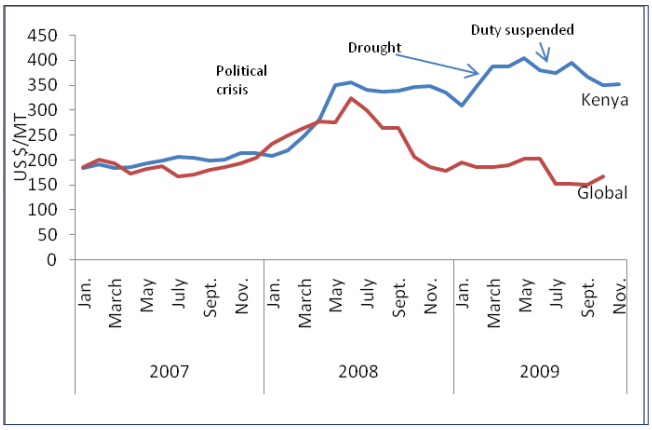
3. Food Prices and Food Production

Kenya has traditionally pursued a high food price policy, particularly with respect to maize. Wholesale maize prices averaged US$ 180 per ton between 1994 and 2005, making Kenya's maize prices amongst the highest in Africa. Import tariffs for cereals are in the range of 25–30 percent. Until recently, maize inflows from neighboring countries were restricted. In addition, the operations of the NCPB have raised the maize price in the country by offering producer prices for maize above market levels.

From mid-2008 onwards, the gap between Kenya's maize prices and world prices has grown markedly. Since the onset of the global food crisis, the price of maize doubled from US$ 185 per metric ton in April 2007 to US$ 356 in June 2008. While global maize prices declined to pre-crisis

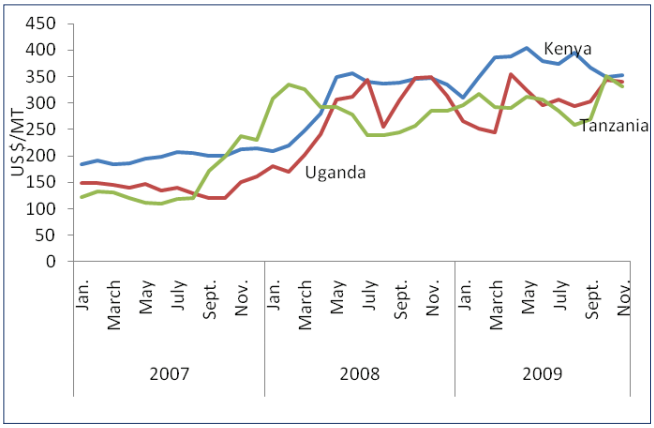
levels, maize prices in Kenya remained high and increased further, reaching US$ 404 in May 2009 (see Figure 17). Prices in neighboring countries also remained high, but less so than in Kenya (Figure 18). Although the tight supply situation prevailing in 2008/09 could partially account for the high prices, domestic marketing policies constitute the main reason. Research shows that the impact of NCPB market intervention has been to keep maize prices high, while the stated objective of stabilizing prices has not materialized. Grain prices continue to be volatile and unpredictable. Further, marketing margins are

Figure 17 – Kenya's maize prices increased while global prices declined



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

Figure 18 – Kenya's maize prices are also higher than its neighbors but the gap closed since mid 2009



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

high. See Annex 1 for an analysis of the needed reforms in Kenya's maize sector.

Maize policies which raise prices above market levels have distributional effects that contradict stated poverty reduction goals. The majority of the rural poor, who are the net purchasers of staples such as maize, wheat, and rice, are directly hurt by policies that raise prices of these commodities. Higher import prices risk jeopardizing the food security of millions of low-income consumers. The current maize production structure is skewed in favor of the 2 percent of maize farmers, who account for over 50 percent of the sales. This supports the view that expenditures on the development and dissemination of improved agricultural technology, provision of credit for small farms, and investments in rural infrastructure would more directly benefit smallholder farmers in the bottom half of the income distribution, and contribute more to rural poverty reduction than the current maize producer price support.

With rapid population growth and declining farm size, Kenya now has a structural maize deficit, which is likely to grow in the coming years. Kenya expects a long rains maize harvest (Oct-Dec 2009) of about 1.8 million Metric Tonnes (MT) and a short rains harvest of 0.3 million MT to be harvested in March 2010. With a national consumption rate of about 3.2 million MT, and the strategic stocks running low, it is expected that Kenya will continue to import maize to close the deficit. Taking into account new technology developments and past productivity growth trends, farm sizes in most parts of Kenya are too small for grain-based agriculture to lift most rural households out of poverty. Given existing landholdings, 38 percent of farmers in western Kenya and 67 percent in the eastern lowlands, for example, could not be self-sufficient in maize production even if they devoted all of their land to growing maize. Even under an optimistic scenario in which maize yields rise by 50 percent, the intensification of grain production for the market would be a relatively unattractive way to maximize crop revenue on very small farms. Diversification to higher value crops has proven to be a more effective strategy for poverty re-

duction. Therefore, given current consumption patterns, Kenya will continue to rely on imported maize, and policies should change to reflect this reality.

The profile of food insecurity of the Kenyan population has changed in the last ten years. Most farmers are net buyers of staple food. Wide disparities in landholding size has given rise to a highly concentrated pattern of marketed agricultural output from the small-farm sector. Less than 2 percent of producers account for 50 percent of the marketed maize production in Kenya, and their average maize sales income is over 20 times that of the bottom 70 percent of households. By contrast, more than 60 percent of farmers are net buyers of maize, living on relatively small farms with other farm and non-farm sources of income (see Table 3).

In the recent past, food policies have been mainly driven by the objective to safeguard the interests of large farmers, without due consideration of the impacts on consumers and the poor. The pressures from globalization and regional integration are intensely and continuously confronting policy makers in Kenya with the classic food price policy dilemma of how best to deal with producer incentives without hurting the welfare of consumers. In most cases these policies have turned out to be counter-productive and anti-poor, as they have increased food prices and thus made it more expensive for the poor to feed themselves.

A number of reforms could help alleviate Kenya's food crisis. Given that most Kenyans and particularly the poor are net food buyers, lowering food prices is good for the poor. The reduction of tariffs in 2009, if done earlier, would have avoided the worsening price trends. Box 2 outlines six measures which, if taken, would support Kenya's poor and middle-class, both urban and rural.

Table 3 – Two percent of maize farmers control 50 percent of the market

	Net maize sellers		Net maize consumers
	Farms accounting for 50% of maize sales	Rest of maize sellers	
Share of households	1.7%	36.7%	61.6%
Gross revenue, maize sales (US$, mean)	3,474	162	0
Total household income (US$, mean)	8,849	2,357	1,565
Land holding size (ha, mean)	11.09	2.77	1.56

Source: World Bank staff estimates
Note: this table is based on the forthcoming Kenya – Agricultural Policy Review: Current Trends and Future Options for Pro-Poor Agricultural Growth

Box 2 – Policy options for Kenya: six actions to solve the food crisis

Short-Term

1. **Lower Tariff for Maize and Grain Imports.** Allowing the maximum amount of food to enter Kenya will lower prices and help the poor to become food secure. It will also be important to remove other import restrictions (such as import quotas) and to work with the other members of the East African Community to eliminate the barriers to regional trade in food.

2. **Support Food and Livestock Production.** This includes improving access to inputs, improving access to credit and other services, and support to pastoralists and farmers in the marginal areas through restocking and supply of planting material for drought tolerant crops.

3. **Implement well-targeted social protection measures.** These include support to orphans and other highly vulnerable individuals, cash transfers to vulnerable urban households, and school feeding programs.

Medium-Term

4. **Reform the NCPB.** Most NCPB interventions have increased prices when only 2 percent of smallholders sell to the cereals board. As in other countries, such marketing boards are also prone to governance challenges, as the maize marketing scandal of 2008 has demonstrated (see also Annex 1)

5. **Continue to Improve Kenya's infrastructure**. Value chain analyses demonstrated that transport costs account for the largest share of the marketing margin. Continued investments in roads will make Kenya's farmers more competitive. Protecting Kenya's watersheds, and investing in water storage and irrigation, thereby reducing dependence on rainfall, would also help to improve Kenya's food security.

6. **Continue to Invest in Improved agricultural technology generation and dissemination to reduce its overdependence on maize.** Non-cereal components of agricultural GDP have performed significantly better than cereals, particularly maize, despite the fact that maize historically has received a great deal of policy and investment attention. Shifting production patterns toward non-cereals would not only help improve food security but also help to diversify farmers' incomes.

ANNEXES

Annex 1: The Reform of Maize Marketing in Kenya

Given that maize is Kenya's major food staple, efficient maize marketing is critical to food security, poverty reduction, and producer incentives. The operations of the NCPB have raised the price of maize by fixing a price floor well above market levels, with the result that Kenya's maize prices are among the highest in Africa, without generating the expected supply response. It is important to understand why.

The government has intervened in maize markets in ways that keep maize prices high and have little impact on price stability. Liberalization opened maize markets to the private sector and reduced marketing margins and prices. However, the NCPB remains a major player in the market among medium- and large-scale farmers in the high potential maize zone of the Rift Valley, where it raises prices and provides some degree of stabilization. Smallholders have little interaction with NCPB; presently only 2 percent of smallholders sell to the cereals board. NCPB's maize market interventions are generally anti-poor, in the sense that they raise prices paid to large-scale farmers at the expense of consumers—especially poor urban households and the majority of poor rural households who are net buyers of maize.

Marketing margins for maize are high owing to high transport costs, and prices continue to be volatile and unpredictable. High prices are commonly perceived to be the inevitable outcome of numerous links in the marketing chain and the unscrupulous behavior of traders. Value chain analyses show that although the value chain has many links, transport costs account for the largest share of the marketing margin, while traders' margins are usually very competitive.

At the heart of future food policy issues in Kenya is the question of how to maintain adequate maize production incentives for specific producers—the large-scale and small-scale farmers for whom maize is a viable crop for commercialization—without taxing consumers and producers of other farm products through high maize prices. Solving this conundrum will involve difficult political tradeoffs. In the short run, reducing NCPB operations will hurt large-scale maize farmers in the North Rift. Over the longer run, however, the confusion and uncertainty spread throughout the maize value chain by NCPB intervention have such a high cost that reform is most likely to reduce marketing (and production) costs enough to make maize farming more competitive, even with lower prices.

Relatively high world prices of maize due to structural change in the energy markets provides a unique political opportunity for NCPB to reduce its role in the market and move to a more transparent, coordinated system with minimal dislocation to surplus maize farmers in Western Kenya. As a first step, NCPB could set prices by using transparent rules for setting buying and selling prices for maize. This step would require NCPB to move away from pan-seasonal buying and selling prices (prices that are constant throughout the marketing year), which eliminate incentives for grain storage. As noted, price stability could also be enhanced through the intra-regional grain trade, which could be furthered by investing in market infrastructure, reducing trade restrictions and interventions, reducing nontariff barriers to trade, streamlining customs procedures, and harmonizing quality, safety and phyto-sanitary standards with neighboring countries.

Private storage could be encouraged by turning some NCPB grain silos and go downs into storage leasing operations. Additional storage facilities, coupled with better financing arrangements, could help the commercialized grain marketing system to weather downside price risk. These efforts could be combined with a warehouse receipt system to help farmers and traders get access to formal credit markets and would improve the efficiency of the food marketing system in general. To be successful, these systems must have: (i) an effective system of grades and

standards in place; (ii) sufficient trust, integrity, and quality control that there is essentially no default risk in using them; and (iii) regulatory procedures and oversight to ensure the integrity of the system.

Putting these reforms in place would open space for market-based risk management instruments through a commodity exchange with forward and futures markets. There are many barriers to participation in these markets, especially for small-scale producers, traders, and processors, and the public sector should play an important role in reducing these barriers and facilitating their use through long-run investments in grades and standards, credit market development, communication systems, market intelligence systems, regulations, and support for locally or regionally based commodity exchanges and insurance products. Most importantly, the government can provide a predictable policy environment that does not destroy the incentives for private individuals and firms to trade market-based risk management instruments.

Annex 2: Key Assumptions of the Growth Forecast

Projections for 2010 are informed by global and domestic trends for the first three quarters of 2009. The global downturn will continue to impact the demand for exports and tourism in Kenya's main source markets in Europe. The impacts of the protracted drought are expected to phase out in the first half of 2010, signaling recovery for agriculture and greater reliability in energy and water supply. The main destination for Kenya's manufactures is the EAC and the larger COMESA markets. Sub-Saharan Africa is projected to grow at 4.1 percent in 2010, thus manufacturing can be expected to expand in line with regional growth and domestic demand.

Agriculture. The rebound in agriculture is contingent on the extent of short rains in the 4th quarter of 2009 and favorable weather throughout 2010. The sector is expected to grow at around 2 percent in 2010 and onwards.

Industry. Within industry, construction has been a significant engine of growth in recent years. The stimulus package with substantial investment in infrastructure should further sustain the momentum in the sector in 2010 and beyond. With favorable weather, electricity and water supply sectors should also be expected to rebound, which will in turn help manufacturing to recover during 2010. Thus, industry is expected to grow by over 4 percent per annum in 2010 while manufacturing will grow by about 3 percent.

Services. The continued rebound in tourism as well as continued growth in wholesale and retail trade, transport and communications should lead to about 4 percent growth in the services sector in 2010.

The External Sector. The balance of payments projections show that oil and fertilizer prices will remain stable at 2009 levels, and likewise for primary commodities such that no significant gains in terms of trade should be expected, particularly if oil prices stabilize at, or increase beyond, end-2009 levels (US$ 75/barrel). The current account is expected to stay close to 2009 levels (-6.6 percent of GDP) assuming that higher imports from oil will be compensated by an improved export performance.

High Case Scenario. This assumes higher than average short rains in the last quarter of 2009 and normal weather in 2010, as well as a relatively fast global recovery.

Annex 3: Economic Indicators

Table 1: Kenya Macroeconomic Indicators

	2008	2009	2010
National income and prices[1]		**Annual Growth Rates**	
Real GDP (at constant prices)	1.7	2.5	3.5
Domestic Expenditures	1.8	4.2	4.2
Consumption	1.7	3.9	4.2
Investment	9.7	4.0	4.0
Exports of goods & services	3.6	3.3	5.8
Imports of goods & services	5.3	7.7	6.7
CPI change (period average)	26.2	10.2	5.0
GDP deflator change	13.1	12.5	5.0
Public (Fiscal) Sector[2]		**Percent of GDP**	
Fiscal balance incl. grants	-6.7	-5.0	-5.7
Total revenue and grants	21.6	23.5	24.2
Total expenditure and net lending	28.3	28.6	29.9
Current expenditure	21.8	20.3	20.4
Capital expenditure and net lending	6.5	8.3	9.5
External Sector[3]		**US$ Millions**	
Current Account Balance	-2159	-2164	-2243
Current ac. balance (% of GDP)	-7.1	-6.7	-6.7
Capital Account Balance	1680	2807	2702
ow. FDI (net)	153	454	450
Change in reserves (-=increase)	479	-643	-459
Foreign exchange reserves	3233	3862	4304
Other[4]		**Annual Growth Rates**	
Broad money (eop)	14.9	5.3	8.7

Sources: KNBS, Ministry of Finance, Central Bank, and WB estimates
1. Based on KNBS national accounts data for 2008, WB estimates for 2009 & 2010
2. Ministry of Finance data for 2008, and WB estimates for 2009 & 2010
3. Central Bank data for 2008 and WB estimates for 2009 & 2010
4. Central Bank data for 2008 and WB estimates for 2009 & 2011

Annex 3 contd.

Table 2: Aggregate Demand

	2005	2006	2007	2008	2009	2010
	Growth rates at Constant 2001 Prices					
Government final consumption expenditure	-0.8	1.5	7.6	3.7	4.0	4.1
Private final consumption expenditure	6.5	7.9	7.6	-0.4	3.8	4.2
Gross fixed capital formation	27.8	18.5	13.4	9.7	4.0	4.0
Gross domestic expenditure	6.4	9.3	9.1	1.8	4.2	4.2
Exports of goods and services	9.4	2.4	5.7	3.6	3.3	5.8
Imports of goods and services	14.9	17.8	11.1	5.3	7.7	6.7
Gross domestic product	5.9	6.3	7.1	1.7	2.5	3.5
	Percent of GDP at Constant 2001 Prices					
Government final consumption expenditure	14.9	14.2	14.3	14.6	14.8	14.9
Private final consumption expenditure	77.6	78.8	79.1	77.5	78.5	79.1
Gross fixed capital formation	18.7	20.8	22.0	23.8	24.1	24.3
Gross domestic expenditure	110.0	113.1	115.1	115.3	117.2	118.0
Exports of goods and services	27.1	26.1	25.8	26.3	26.5	27.1
Imports of goods and services	33.7	37.3	38.7	40.1	42.1	43.4
Discrepancy [1]	-3.4	-1.8	-2.2	-1.5	-1.6	-1.6
Gross domestic product at market prices	100.0	100.0	100.0	100.0	100.0	100.0
Net exports	-6.6	-11.2	-12.9	-13.8	-15.7	-16.4

Source: KNBS
1. Difference between GDP production approach and GDP expenditure approach

Annex 3 contd.

Table 3: Global Projections

		Year over Year Projections			Q4 over Q4 Estimates		
Annual growth	**2007**	**2008**	**2009**	**2010**	**2008**	**2009**	**2010**
World output	5.2	3.0	-1.1	3.1	-0.1	0.8	3.2
Advanced economies	2.7	0.6	-3.4	1.3	-2.2	-1.3	1.7
US	2.1	0.4	-2.7	1.5	-1.9	-1.1	1.9
Euro area	2.7	0.7	-4.2	0.3	-1.7	-2.5	0.9
UK	2.6	0.7	-4.4	0.9	-1.8	-2.5	1.3
Other developed countries	4.7	1.6	-2.1	2.6	-2.7	1.8	2.6
Emerging & developing countries	8.3	6.0	1.7	5.1	3.3	5.8	5.5
Africa	6.3	5.2	1.7	4.0	....	....	....
Sub-Saharan Africa	7.0	5.5	1.3	4.1	....	....	....
Developing Asia	10.6	7.6	6.2	7.3	5.5	7.7	7.8
China	13.0	9.0	8.5	9.0	6.9	10.1	9.2
India	9.4	7.3	5.4	6.4	4.8	5.1	7.0
ME	6.2	5.4	2.0	4.2	....	....	....
World trade volume (goods & services)	7.3	3.6	-11.9	2.5	....	....	....
Commodity prices	13.5	172.1	117.6	134.6	....	....	....
Oil	10.7	36.4	-36.6	24.3	....	....	....
Non-fuel	14.1	7.5	-20.3	2.4	....	....	....

Source: World Economic Outlook, IMF, October 2009
.... means data not available

Annex 3 contd.

Table 4: Sub-Saharan Africa Selected Indicators

	2005	2006	2007	2008	2009	2010
			Annual Growth			
Real GDP	6.2	6.4	6.9	5.5	1.1	4.1
Oil exporters	7.6	7.4	9.2	7.0	1.9	5.5
Oil importers	5.5	5.9	5.7	4.7	0.8	3.3
Real non-oil GDP	6.4	7.9	8.0	6.3	2.0	4.2
Consumer Price Averages	8.9	7.3	7.1	11.6	10.5	7.2
Oil exporters	14.8	8.1	5.6	10.5	10.6	8.9
Oil importers	6.2	6.9	7.8	12.1	10.4	6.4
Per Capita GDP	4.1	4.2	4.8	3.1	-0.9	1.9
			Percent of GDP			
Exports of Goods and Services	36.6	37.6	38.9	41.0	31.2	33.5
Imports of Goods and Services	33.6	33.1	36.2	38.2	34.2	34.6
Gross domestic saving	22.8	25.5	24.5	25.0	19.3	21.5
Gross domestic investment	19.9	21.1	22.0	22.2	22.4	22.7
Fiscal Balance (Including grants)	1.8	4.8	1.2	1.3	-4.8	-2.4
Oil exporters	8.8	11.3	3.6	6.3	-5.9	1.5
Oil importers	-1.3	1.5	-0.2	-2.0	-4.2	-4.7
Current Account (Including grants)	-0.4	4.1	1.1	1.0	-3.1	-2.1
Oil exporters	7.2	21.2	14.4	14.0	1.6	7.9
Oil importers	-3.9	-4.9	-6.2	-7.6	-5.6	-7.9
Reserves (months of imports)	4.7	5.9	6.0	5.3	5.8	5.5
Oil price (US$ a barrel)	53.4	64.3	71.1	97.0	61.5	76.5
GDP growth in SSA trade partners (in percent)	3.7	4.1	4.1	1.9	-1.8	2.2
GDP growth in SSA	6.2	6.6	7.0	5.5	1.3	4.1

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