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Kenya:
Economic Impact of the Political Crisis in Kenya: 2008 and Beyond

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INTRODUCTION AND SUMMARY

i. With the signing of the power-sharing arrangement in late February, economic recovery process has started. The initial reaction of markets has been positive as evidenced by gradual strengthening of the exchange rate and declines in key interest rates. While these are welcome developments, Kenya is facing enormous challenges. It is clear that economic growth rate in 2008 will at best be half of 2007 and inflation has almost doubled in January on a year on year basis. The crisis has already resulted in cuts in certain development expenditures as budgetary resources have been reallocated to fund activities arising from the effects of the violence. The combination of output and employment losses and sharply rising inflation had a direct impact on poverty. We estimate that, on a preliminary basis, poverty headcount has increased by 22 percent and a measure of severe poverty has gone up by 38 percent which means gains made over the past five years on this front has reversed.

ii. The violent disruption to the free flow of goods, labor and money has affected all sectors of the economy. While the situation is slowly returning to near-normality in most places, many problems will take time to resolve since the period has resulted in: (i) damage to physical assets, (ii) the displacement of about 300,000 people, about 1 percent of population; (iii) the loss of confidence among investors and tourists and (iv) damage to social capital. There are further risks to stability, for example if the main rains (March-June) are poor, which would further damage the agriculture sector (25 percent of GDP). Growth rate of private consumption is expected to slowdown following disruption of activities in agriculture, manufacturing and transport as well as the SME and services sectors. Higher food prices will also affect consumption though the on-going humanitarian efforts will have a moderating effect on the fall in consumption levels. In addition, but unrelated to the post election violence, the rising World prices of oil and foodstuffs are likely to increase inflation and the trade deficit. Looming global slowdown is another risk and Kenya's economic policies will need to factor these into the overall policy management framework.

iii. In order to consider short to medium term impacts of the crisis, on the economy this note reviews the performance of key sectors, as data on main components of aggregate demand are not yet available. The declines in the agricultural, manufacturing, and services sectors considered in this note are still guesstimates and collected data and information interpreted only to provide a picture of the broad orders of magnitude anticipated of the economic decline in valued-added. Assuming that the power-sharing arrangement holds and the country returns to normalcy a base case economic growth rate of about 3 percent could be expected for 2008. If a credible set of measures are steadily implemented and the fiscal constraint is managed well and donor funding increases these could add 1-1.5 percentage points to the base case rate of 3 percent. On the downside continued sporadic ethnic violence, inability of coalition government to reach key decisions, and lack of donor support could result in zero or negative growth rates in 2008.

iv. Over the next few years, our expectations are as follows. Given the sectoral prospects that are considered in the note, we are projecting a growth rate of about 5 percent in 2009 and about 6 percent in 2010. These are base case numbers and if the government is successful in putting together and implementing a well designed recovery program attaining higher economic growth rates would be possible. Inflation is likely to be at around 15 percent this year. With continued supply-side constraints and global high energy and food-stuffs prices we project that overall inflation rate would not go below 10 percent in 2009 although monetary policy would remain targeted on achieving a 5 percent underlying inflation rate (excluding food and energy process). We expect an overall inflation rate of about 8 percent in 2010. Price increases would have a major impact on the welfare of the poor and unless real incomes rise faster than inflation people who fell into poverty due to the effects of the crisis are likely to continue to remain poor.

v. While Kenya's external account situation seems to be manageable and investor sentiment expected to improve with the appointment of a national unity government, the fiscal situation needs to be monitored closely. The Social Economic Recovery Strategy, issued by the National Accord Implementation Committee is estimated to cost Kshs 31.47 billion and this is the amount the government seeks to raise from donors. However, it is not clear how this will affect the implementation of the budget. The Ministry of Finance has issued a budget circular on 20th of February and it announced cuts on certain public expenditures in anticipation of revenue losses. While it appears that revenue performance has so far been better than expected, there may be some revenue losses during the rest of the year as the effects of the crisis could manifest itself with lags. In turn, this may mean another round of cuts in development programs, particularly so if the estimated recovery cost is to be funded from domestic resources. However, at this point in time, and assuming continued good revenue performance, it seems that the attainment of FY 2007/2008 budget targets could be possible. This would mean a deficit of 5.3 percent for 2007/2008 (fiscal year starts in July 1st in Kenya). For the next two years, we are expecting a deficit of about 3 to 4 percent of GDP. These developments suggest that fiscal risks to the recovery and reconciliation process are high and that the mitigation of such risks would need to be on the agenda of policymakers and donors.

vi. This note is still a living document. We are planning to update it once more fiscal and balance of payments data are available sometime in May. The rest of this note is organized as follows. Sections I and II present the macro effects of the crisis and sectoral developments which are then used to calculate the real output expectations in 2008 and discuss factors that would determine the extent to which longer term prospects also are affected. Section III focuses on the poverty situation. Fiscal issues are taken up in section IV. External accounts are discussed in section V. Financial markets and issues related to investor confidence are in section VI.

I. INITIAL EFFECTS OF THE CRISIS: DECLINE IN ECONOMIC ACTIVITY AND RISING PRICES

(a) Output

1. In order to put the effects of the crisis into a perspective it is useful to start from the GDP growth projections before the crisis. Given the GDP growth rate of 6.3 percent in 2007 expectations was that real output would continue to increase and perhaps reach 7.5 to 8 percent in 2008. After the crisis, almost all analysts sharply reduced their GDP estimates. The Government has revised its GDP growth projection downward for 2008 by some 2-3 percentage points[1]. KIPRA and the Government's working group produced a 4.5 percent growth rate under its "optimistic scenario while its pessimistic scenario produced a slightly negative GDP growth rate. A few other estimates also indicated that the economy could actually contract in 2008. [2]. Our own projection, as explained after the sectoral performance of the Kenyan economy, is that a base case growth rate of about 3 percent could be expected for the current year.

(b) Inflation

2. The impact of the political crisis on inflation has been swift, as disruption to normal transportation, distribution and retailing, including of foodstuffs and petroleum, pushed prices sharply higher. As discussed later in Section III rising prices are likely to have had a major impact on poverty. Inflation soared to 18.2 percent year on year in January (the fastest rate since 2004)—and by nearly 9 percent compared with the previous month—largely because of a steep rise in food prices, which account for about half the consumer price index and an even larger weight for the poor (55%). In February, the overall month on month inflation was 19.1 percent. Inflation was far higher in some locations—especially North Rift Valley, Nyanza and Western provinces, where the violence was most intense. Very dry weather, coupled with high world oil prices, is exacerbating the problem. Although the ongoing return to more normal marketing patterns will ease price pressures, there is unlikely to be much price slippage from current levels, suggesting that year-on-year inflation will remain high throughout 2008. We are expecting that inflation will be around 15 percent for the current year, at least during the first six months, with a continued bias in relative prices against commodities more heavily consumed by the poor. Our projection at this point is that inflation rate will drop to about 10 percent in 2009 and then to around 7-8 percent in 2010. The Central Bank is expected to remain focused on the attainment of its underlying inflation target of 5 percent though given the supply constraints and high world energy and food process this may not be feasible in the next year or so.

[1] Estimates from the Kenya Government's Macro Working Group.

[2] A note prepared by the Kenya Association of Manufacturers (KAM) assumes that output worth about 40 workdays (about 28 percent of the total of 138 days until June 2008) would be lost during the first half of calendar 2008. This would result in a loss of about Ksh 260 billion of projected nominal output.[2] If this assumption were right, and assuming that the economy achieves its pre-crisis level in the second half, the economy would actually contract slightly (negative growth rate) during the year 2008 instead of growing at previously assumed rate higher than 6 percent.

Figure 1:

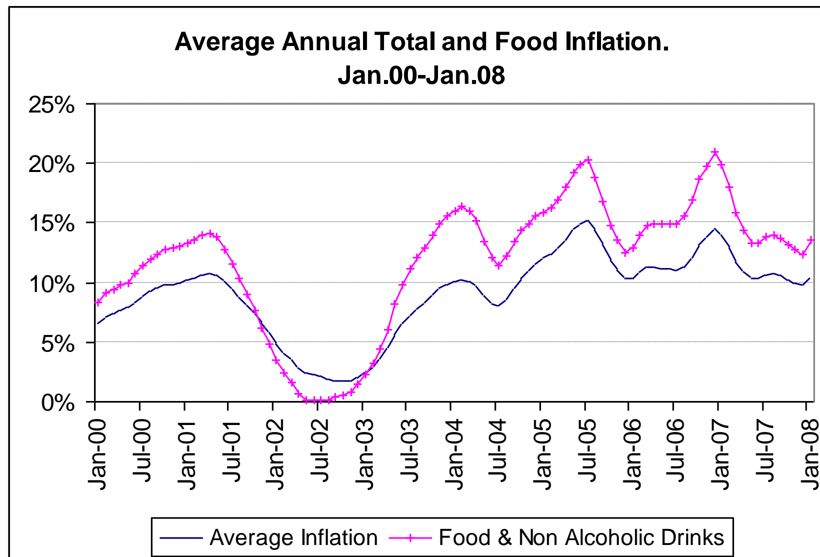
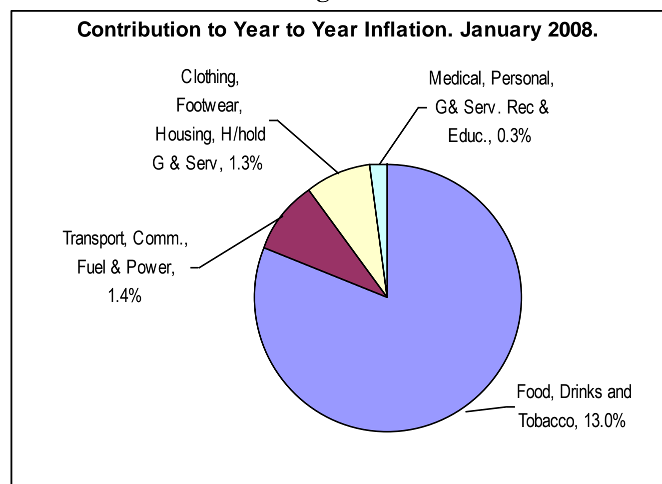


Figure 2:



II. SECTORAL PERFORMANCE AND PROSPECTS FOR 2008

(a) Tourism (5-10 percent of GDP directly and indirectly)

3. ***Short-term***. Post-election violence accompanied by travel warnings from European countries has had a significant impact on tourism. Given tourism is very sensitive to local instability, activity in this sector is likely to remain subdued in the next six months, even with the signing of the power sharing agreement. Coastal tourist resorts and game parks are recording very low levels of tourist arrivals. Kenya Tourism Board

(KTB) has recently lowered its projection of tourist arrivals to an average of 9,000 visitors per month for January to March 2008, which is a decline of about 92 percent over the previous projection. In January 2008, there were only nine charter flights to Mombasa, compared to 42 charters per week (some 34,000 tourists) in January 2007. Only 5000 tourists visited Mombasa in January compared to the 133,000 that had committed earlier. Twelve hotels have already closed in Malindi and Mombasa.[3] Occupancy rates are now at 10-30 percent range far below the 70-90 percent, which would normally be expected for this time of year. The occupancy rate in the Masai Mara is 25 percent compared to 94 percent in January 2007. Furthermore, forward bookings for 2008 have been cancelled.

4. As a result, KTB expects tourism revenues to be 60 percent below the pre-election projections for the first quarter of 2008 and 52 percent below first quarter 2007 receipts. The Kenya Association of Tour Operators estimate the tourism industry will lose Ksh20bn ($285m) in receipts between January and March.[4] These developments have already resulted in closures of some tourism businesses and substantial staff lay-offs. Industry associations estimate that 120,000 of the 500,000 jobs in tourism-related business will be lost by end March. The dramatic slowdown in tourism will clearly have a negative impact on overall GDP growth and on the current account. The industry is estimated to have earned were between US$800 million to US$1 billion, about 5% of the economy, in foreign exchange in 2007[5], but may not reach half this sum in 2008. A conservative estimate of losses assuming that there is political stability would be that the receipts shrink by about $300m in 2008. This would mean shrinkage in annual national output by about 1.5 percentage points over its 2007 level due to tourism losses alone.

5. ***Medium-term***. We expect that some of the damage to perceptions of Kenya as a safe destination will extend into the medium-term. There is an ongoing debate among the tour operators in Kenya as reported in the press and it seems that most observers do not expect that tourist arrivals would reach to previously expected levels by about 2010. While it is difficult to have a reliable estimate by making certain assumptions certain scenarios could be developed for illustration purposes. For example, if we assume that arrivals would sharply increase between July-December and there would be 10 percent decline in arrivals for 2008 and (ii) an assumed average earnings per tourist calculated on the basis of a 3-year average we could have the earnings profile for the sector. However, if the government puts in place a recovery plan for tourism sector that involves re-building international image of Kenya as a tourist destination, and building destination confidence of potential tourists through Kenya's tourist offices abroad, then a different picture would emerge of course.

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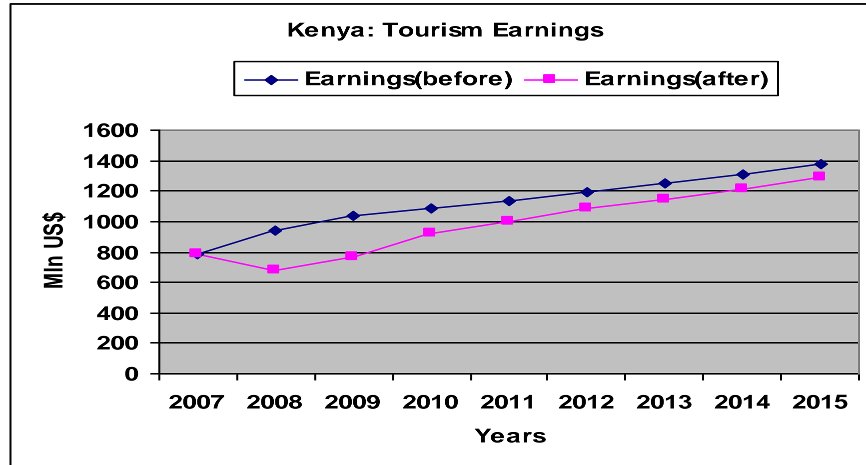
[3] Information from KTB and a memorandum prepared by the business community.
[4] Financial Times article February 2nd 2008
[5] Estimates from the Central Bank Of Kenya's Balance of Payments Report.

Figure 3:



(b) Transport, Communications, and Financial and Other Services (50 percent of GDP if Tourism is included)

6. ***Short-term***. The transport and communication sector was also adversely affected by the violence. Unrest in Nakuru, Narok, Kisii, Kakamega and Naivasha effectively paralyzed transport to the western regions of the country, with roadblocks erected at regular intervals on the roads; lorries, commuter buses and private vehicles were burned. Destruction of the Nairobi-Kampala railway at Kibera disrupted supplies to western parts of the country and Uganda, forcing re-routing to already insecure roads. It is more difficult to obtain information on other service sectors. However, the fact that shops, stores and banks have been closed during the crisis would mean that these sectors' contribution to GDP growth was negative in the first two months of the year. While the achievement of political solution is likely to lead a recovery in these sectors we do not expect this to be a rapid process due to lower incomes, lack of supplies and imported goods as well as higher oil prices. Small and micro credit associations report that they are facing defaults and they are estimating that they could lose between 15 to 40 percent of their repayments. Hence, it could be said with a reasonable degree of certainty that these sub-sectors would not expand as rapidly as in the past in 2008.

7. ***Medium-term.*** While the financial health of larger banks is thought to be better, there is no hard information. However, given the given the loss of output in the real sectors we would expect that financial sector's growth rate would decelerate to around 5-6 percent over the next two years or so from almost 8 in 2007. We expect rapid recovery in both transport and communications assuming that the political settlement agreement is adhered to. These two sectors have been growing at about 9 percent in 2005 and 2006 and preliminary growth rate for these two sectors in 2007 was about 8.5 percent. We could expect to see similar rates in the next few years mostly from capacity utilization in transport and from both investment and productivity gains in the communications sector. However, longer- term contribution of the transport sector would depend on dealing with the well-known structural problems. Assuming that Safaricom's privatization will go as

planned we could expect to see more investment and hence faster growth rates in this sub-sector. In summary, transport, communications, and financial sector and other services would probably lead economic growth in 2009 and 2010.

(c) Agriculture (25 percent of GDP)

8. The agricultural sector has suffered from a disruption in labor supply and destruction of farmland and capital assets. Estimates by Bank staff suggests that there has been an across the board decline in the production of all main commodities, with the exception of the cut-flower sub-sector, averaging 25-30 percent in volume terms. Although there were fears of major disruptions in the cut-flower industry, emerging statistics indicate that cut flowers exports were actually 15 percent higher (8,5 metric tons (MT)) than January 2007. This might indicate that flower exports are likely to be maintained at the 2007 levels of 95,000 metric tons valued at about US$ 613 million.

9. Post-election violence interrupted the peak season for the short-rains' beans and maize harvests and it is estimated that 30 percent of the crops was not harvested and was lost. Even for those farmers who had already harvested, there are fears that there was post-harvest losses of not less than 10 percent (30,000 MT) because of improper on-farm storage. Another important shortcoming was the poor short-rains harvest[6]. The short rains were inadequate in most of these areas and this could result in both reduced production and lower national supply. Crude estimates indicate that in total about 15-20 percent of the initially estimated 3 million MT of maize might be lost in 2008.

10. The situation in the coffee and tea sub-sectors is as follows. Estimates from Coffee Board indicate that 2007/2008 crop will be around 42,000MT, some 22 percent fall from 54,000MT last year. The decline is attributed to poor weather leading to high coffee berry disease incidence. As the November-December harvest constitutes around 70% of the total harvest, the reported disease incidence means that the Q1-Q2 of 2008 will be the most affected. The post-election disruption in the tea sub-sector was mainly in terms of reduced labor supply and burning of some tea trees. Some10-20 percent drop in production is expected from North Rift Valley in the first quarter mainly due to disruptions in tea picking. While it was initially thought that this effect would be temporary, more recent assessments, suggest that this may not be the case. It is now expected that export volumes are likely to decline by 25 million kilograms this year due to post-election disruptions, dry weather conditions in tea growing areas and the impact of frost in the West of Rift tea growing areas.[7] In 2007, a total of 369 million Kg of made tea was produced - 62% of this came from smallholders. About 58 percent total was produced in West Rift Valley, which includes farms and plantations that bore the blunt of the crises. With the situation returning to normal, tea production might be expected to increase, but it seems it is unlikely to return-to-return to 2007 levels of production.

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[6] Short-rains harvest normally contributes about 20 percent of the annual total production of maize and beans.

[7] Forecasts by industry regulator—the Tea Board of Kenya,

11. ***Medium-term***. Deep seated problems in agriculture ranging from land disputes to ethnic issues being among the key causes of the crisis recovery is expected to be slower and more difficult than other sectors. In addition to the crisis impacts noted above the crisis has resulted in large numbers of displaced farmers. KENFAP, an umbrella organization representing farmers in all sub-sectors of agriculture estimates that around 53,000 farmers and their families were displaced. Farm input prices have increased sharply on a month on month basis (28 percent) in February which is hitting the land preparation process and acreage under cultivation. Current preparation is reported to around 20 percent compared to 60-80 percent in normal times although it is expected that land preparation rates will increase in the second quarter and land under cultivation reductions will be limited to 30 percent. In the next few years sectoral growth rate is expected to be considerably lower than in 2007, which was around 8 percent, and it will be important to support the resolution of underlying causes of problems in the sector, especially land ownership issues. We are expecting a sectoral growth rate of 4 to 5 percent in 2009 and possibly 6-7 percent in 2010.

(d) Industrial Sector: Manufacturing, Construction, and the SMEs (15 percent of GDP)

12. ***Short-term***. The manufacturing sector has also suffered significant distribution setbacks as a result of limited supply of raw materials and heavy man-hour losses. The collective impact of these has been reduced capacity utilization, and hence productivity in January and February has been down to around 30 percent, which will be reflected in reduced GDP growth. Employment in the small and medium enterprises in the affected rural areas also suffered setbacks, since shops, machinery and plants were either damaged or demolished during the violence at rural marketing centers. In addition, to an estimated 120,000 job losses in tourism, KAM analysis estimates a temporary loss of about 400,000 jobs with casual informal labor likely to be the hardest hit. The impact of the crisis has been differential across geographical regions. KAM note that the hardest hit areas have been Kisumu, Eldoret, Kisii and environs, and estimate a 40 percent drop in output in the Western region of this sector. Construction activity has slowed down after expanding over 10 percent in 2007 and preliminary data suggests this sector is taking a wait and see approach. In 2007 the industrial sector, excluding agriculture, as a whole grew at the rate of about 7 percent. We are expecting a 3-4 percent growth in this sector in 2008.

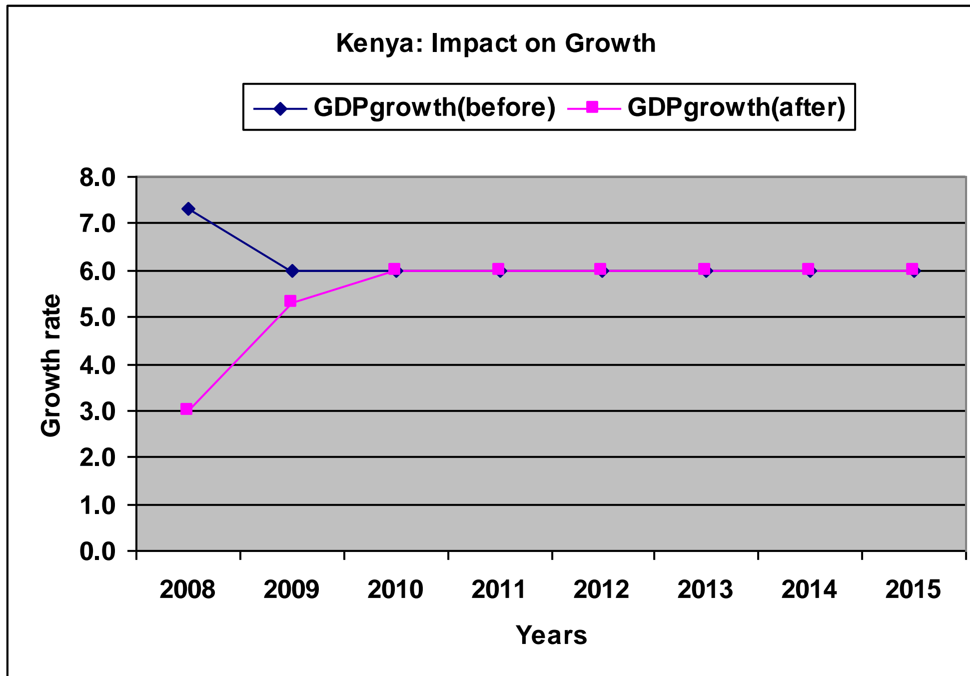
13. ***Medium-term***. With the expected formation of a national unity government soon we are expecting that uncertainties related to the business environment will be sharply reduced. This should give a boost to manufacturing and construction sub-sectors, as well as to others, in all industries, and we can expect to see relatively steep rises in productivity gains in 2009. If the new government can tackle some of the major problems hurting Kenya's investment climate we could see investment picking-up. If past trends are any guide, for example, we can expect that the construction sub-sector will grow rapidly in 2009 and 2010. Taken as a whole we project that the industrial sector will grow at around 5 percent in 2009 and 6 percent in 2010.

(e) Economic Growth Prospects

14. ***Short-term***. As the review of the key sectors above shows the sharp slowdown of economic activity in the first two months of 2008 has been mainly due to rapid decline in tourism arrivals, displacement of labor; disruption of input supply chains and trading routes; and a destruction of assets due to looting and arson. The hardest-hit was sector of the economy was tourism, the largest foreign exchange earner. Given the situation, it is almost certain that growth rates of key sectors in the first quarter will be negative. When the economy expanded at the rate of 6.1 percent in 2006, the agricultural, financial services, tourism, and transport and communications all grew between 5 to 15 percent. Preliminary data shows that similar sectoral output growth rates recorded in 2007 are likely to produce an overall growth rate of 6.3 percent. These data could be used to generate some projections for sectoral value added given sector shares.

15. Hence, assuming that first quarter sectoral growth rates will largely be negative and that recovery would start in the 2nd quarter of the current year it could be expected that the main sectors expand at half of their 2007 growth rates on an average basis. This would yield a GDP growth rate of about 3 percent in 2008. It is of course possible that the recovery in the sectors could be faster but the declines in the first quarter are large and growth rates in the remaining quarters may not be sufficient to deliver very rapid sectoral growth gains. What may add to this the growth rate in base case include: (i) adoption of credible measures by the government and to fully support the recovery; and (ii) by efficient use of fiscal resources, which will attract donor funding to complement the government's own development programs. This is possible but uncertain. Such measures and further donor funding would have the potential of stimulating aggregate demand and these could add 1 to 1.5 percent to GDP growth in 2008. On the downside, the inability of the government to move ahead with the recovery measures and sporadic violence would negatively impact the overall situation and expected capacity utilization rates and new investment may not materialize. In this case economic growth would be zero or negative.

Figure 4:



16. ***Medium-term***. The preceding analysis of sectors and our expectations related to the next few years, while tentative, would indicate that economic growth would be around 5 percent in 2009 and 6 percent in 2010. Much would depend on the government's ability to maintain and improve security and to implement measures to support the creation of a sound investment climate. While not analyzed in this note due to lack of data, supporting economic growth over the medium-term would need to rely on investments by both the public and private sectors. In this connection, it will be important for the government to demonstrate to the donor community that it has organized itself and can effectively absorb donor funds to augment its own funds for development projects. Dealing with deficiencies on the governance front would be a key factor to ensure the inflow of donor funds and it would be particularly desirable if the new government could signal its intensions to focus on these issues early on by developing a credible program that has a major governance focus.

III. POVERTY IMPACTS

(a) Causes and Estimates of Poverty

17. The crisis has had direct impacts on several dimensions that are relevant to poverty and well being. In the short term, public services in some areas have been disrupted and this may last a while. There have been job losses and prices rose sharply as noted earlier; and civil and social capital and networks have been adversely affected These have affected the poor, and also caused many families who were not previously

poor to fall below subsistence levels of consumption. There has been a clear regional dimension to the direct impacts. About 6.9 million or 40 percent of Kenya's poor reside in the current crisis hotspots, including Western 2.5 million, Nyanza 2 million, Nairobi 0.6 million, Mombasa 0.3 million, and around Eldoret, about 1.5 million.

18. It is possible to make rough estimates of the national level effects of the job losses and price increases that were associated with the crisis. If the cost of living has risen by 20 percent without a commensurate increase in incomes and wage levels, the poverty headcount would increase by about 22 percent, meaning that an additional 3.7 million Kenyans would fall into poverty, while hardship would worsen for those already poor, with the measure of severity of poverty worsening by some 38 percent. At the same time, the job losses associated with the conflict would increase poverty by some 9 percent, or about 1.4 million people. The total increases simply from these two effects, and abstracting entirely from the loss of life, assets and livelihoods, and worsening hardship among the already poor, could be of the order of five million Kenyans falling into poverty. Of course these effects will have been distributed unevenly across different districts and province, as well as across groups. The upcoming poverty and inequality assessment will attempt to provide a systematic review of crisis impacts based on the best available evidence and options for mitigating the impact going forward.

IV. BUDGETARY EFFECTS OF THE CRISIS

(a) Overview

19. The Fiscal year starts on July 1 in Kenya and until the crisis in early January the execution of the 2007/08 budget was halfway through. The most noticeable development was the higher than expected spending on development programs that were largely attributed to upcoming elections. However, the Treasury managed to keep spending within deficit targets prior to the crisis as revenue performance has been better than expected. The eruption of violence has changed this situation and the Ministry of Finance has issued a circular on 20th of February (attached) and has imposed cuts on certain recurrent expenditures in anticipation of revenue losses. It also noted that it received requests for additional funds amounting to Kshs 52 billion. While this amount is what is being requested, and does not necessarily mean that the Treasury would fund it, it nevertheless points to the fact there would be need for additional funds to deal with the affects of the crisis. Hence, it is unlikely that the current budget would be implemented as read in June last year.

20. The circular also indicated that development projects which are not likely to start during the current year should be deferred to next fiscal year. Given this situation it is the case it is highly likely that budgeted programs will be re-allocated to meet emergency needs across ministries which is what is happening at this point in time. In the past, the government has adjusted discretionary development expenditure to absorb shocks. The same should be expected this year. In fact, all expenditure adjustment is likely to fall on development expenditure, which would be a residual after meeting essential recurrent expenditure. For the projects funded by the Bank, counterpart funding may not be a

serious constraint to making progress on investment projects but rehabilitation of road network, funded by GOK's own resources, is likely to stop in tracks jeopardizing medium-term growth. From the recent growth work on Kenya, delays in road rehabilitation in particular are likely to have the most immediate negative impact on growth. It also would be important to avoid spreading resources too thinly instead of focusing on completing a few high-priority projects. Hence, fiscal risks to development projects are high.

(b) Revenue Performance

21. Revenue receipts until end-December were more than 4 percent higher than projected (about Ksh 8 billion ≡ USD 105 million more). Privatization proceeds from the sale of Telkom Kenya were also about five times the projected amount (about Ksh 22 billion ≡ USD 315 million, or about 1.3 percent of GDP. Both January and February figures have also beat expectations with revenues increasing by 18 percent on a year on year basis in February. However, it is possible that revenues or their growth rates may decline in the coming months as the effects of the crisis could hurt the economy with lags and the Government needs to monitor the revenue situation closely. As the fiscal picture is still evolving, and given the favorable revenue growth in February and the expected formation of the new government soon we are not at this point in time expecting major deviations from the FY2007/2008 revenue target which is about 21 percent of GDP.

(c) Expenditure Related Issues

22. The Social and Economic Recovery Strategy produced by the National Accord Implementation Committee estimates that recovery would cost Kshs 31.47 billion, around little over 1 percent of GDP, and expects to fund this donors. At the same time the Treasury circular referred to above has indicated that the Ministry has received requests for additional funds amounting to more than Ksh 52 billion, or 2.5 percent of GDP. However, these are needs and there is no guaranteed that all of these amounts would be funded. How much of the current budget is being reallocated to emerging needs due to the crisis and how much of the originally budgeted development spending is being cut is unknown. What is known is that the government has already allocated one billion Kshs to cater for immediate requirements of the crisis. Government's expenditure is likely to increase as it embarks on the difficult tasks of restoration of calm in the country, provision of security, resettlement of the displaced, and refurbishing damaged schools and other public buildings. It is also almost certain that government expenditures in this FY and the next will depend on donor funding of the cost of recovery strategy and unless external resources flow in the government is likely to reduce development programs further.

Budgetary Projections

23. While needs are there, the Treasury has repeatedly indicated that their objective is to adhere to the Kshs 34 billion domestic financing ceiling. Given the stronger than expected revenue performance and launching of the Safaricom share floatation, which

was oversubscribed, we are expecting that the budget target of 5.3 percent of GDP could be attained for the current year. However, it must be noted that this is already entailing cuts in development spending and the government will increase face tough trade-offs. For the next two years we are expecting fiscal deficits of 3-4 percent of GDP.

V. EXTERNAL ACCOUNT

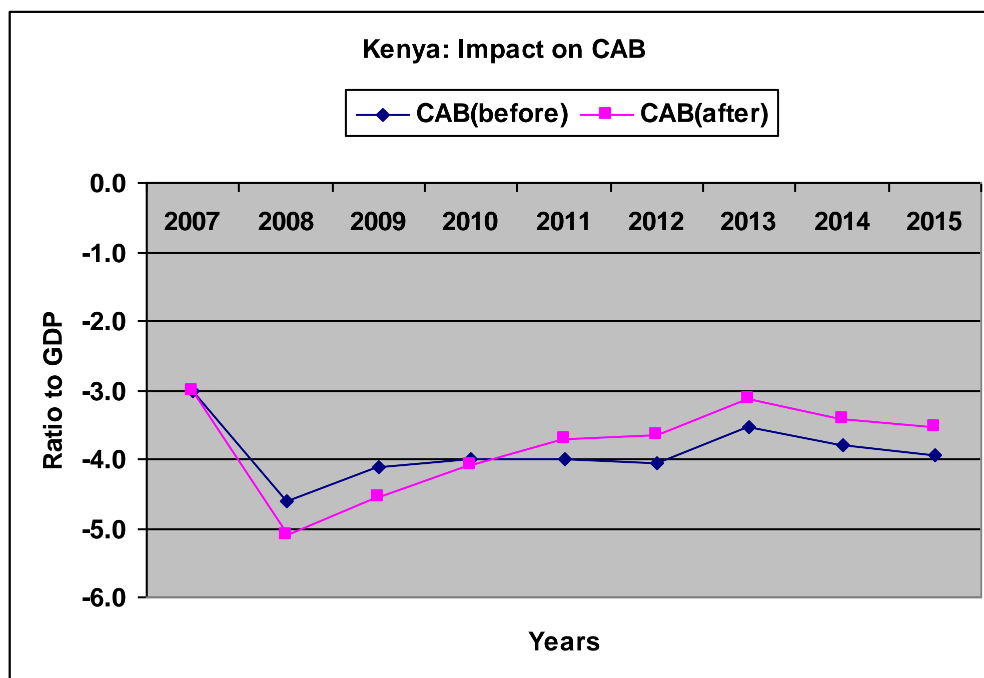
(a) Recent Trends

24. The latest Balance of payment data is of October 2007 and it showed a current account deficit of US$ 1,2 billion, or about 6.3 percent of GDP, in the year to October 2007 due to increase in the trade deficit. However, the expectation is that actual figure for the year would be around 3-4 percent. The current account deficit was attributed to merchandise imports that had been increasing significantly during the period due to strong economic growth. The growth in imports is dominated by the increase in the value of machinery and equipment whose imports rose by US$ 961 million in the year to September 2007. This implies that the growth in imports contributed to the expansion in productive capacity of the economy. A significant part of imports also came from chemicals, which are used as intermediate inputs.

(b) Current and Capital Account Expectations

25. The crisis is impacting both imports and exports. While it could be expected that the impact of decline in tourism receipts will be mitigated by the decline in imports, with the achievement of political settlement import demand is likely to grow faster in the second half of the year. Import volume growth was around 15 percent in 2007 and we are assuming that in 2008 imports could grow at around 10 percent. The volume of exports of goods and services are projected to increase at the rate of 7 percent in 2008 as opposed to 13 percent in 2007. Given these expectations we could see a current account deficit of about 4 to 5 percent of GDP in 2008. However, these are very preliminary estimates and will be revised once we obtain data on January and February balance of payment figures.

Figure 5:



(c) Foreign Exchange Reserves

26. As of end of February, 2008, the Central Bank's of Kenya holdings of official usable foreign exchange reserves amounted to US dollar 3.3 billion (equivalent to 4.84 months) compared with US dollar 2.4 million (equivalent to 4.4 months) a year earlier. This represents a build up of usable reserves by US dollars 943.2 million over the year. There was significant increase in official foreign exchange reserves towards the end of 2007 mainly because of receipts of balance of payments support from the IMF, the budgetary support from the European Union and privatization of Telkom Kenya

Table 1: Official Foreign exchange Reserves (US Million)

	31/7/07	31/8/07	28/9/07	31/10/07	29/11/07	24/12/07	31/01/08	28/02/08
Usable Reserves	2688.3	2667.6	2693.3	2726	2843	2789.6	3388.5	3330.7
Months of Imports**	4.21	4.11	4.15	4.2	4.32	4.32	4.93	4.84
Months of Imports**	3.41	3.4	3.43	3.47	5.58	3.58	4.07	4.00

Source: Central Bank of Kenya

VI. FINANCIAL MARKETS AND INVESTOR CONFIDENCE

(a) Interest rates

27. Interest rates have inched up prior to the elections. The 91-day and 182-day Treasury bill rose from 6.9% and 7.9% on December 24, 2007 to 7.1% and 8.1% on February 28, 2008 respectively (see figure attached). On the other hand, the Inter-bank rate and REPO rate declined from 7.2% and 7.4% to 6.5 and 6.5% respectively during the same period. This is because the election related expenditure led to a significant increase in money supply increase. As such, Banks found themselves with significant liquidity with little demand for credit during the political crisis. With the agreement on a political settlement it appears that calm has returned to markets and key interest rates have declined in the past few days. In fact, money markets were characterized by excess liquidity conditions and most investors chose to invest in government paper. Interest rates on Treasury Bills have been easing since the beginning of March. The average 91-day Treasury Bills rate falling by 11.3 basis points to 6.95 per cent while the average 182-day Treasury bill rate fell by 14.6 points from 8.137 percent to 7.99 percent during the auction by the end of first week of March 2008.

Figure 6:

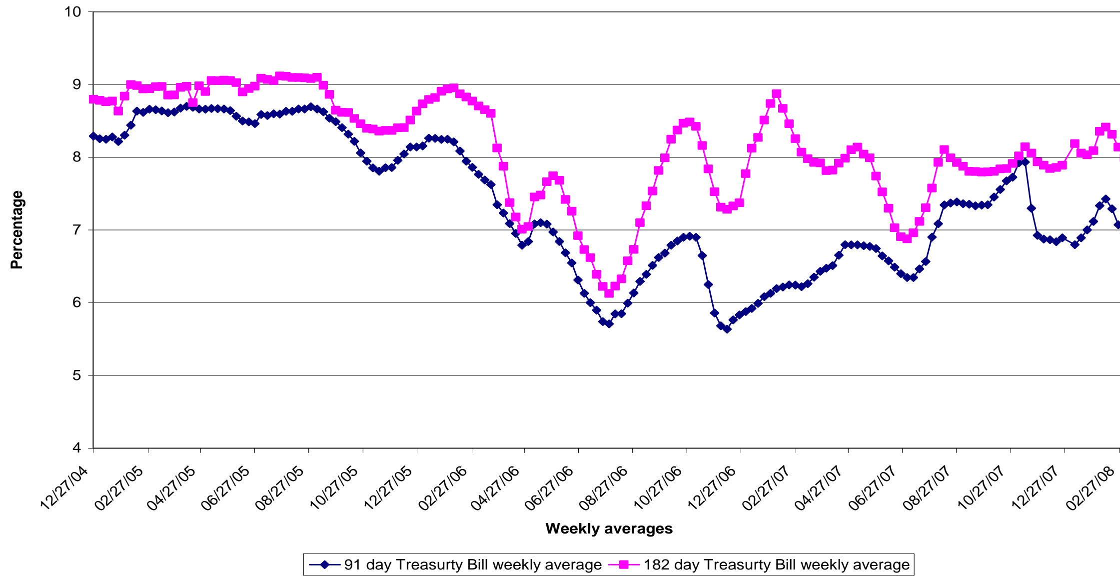
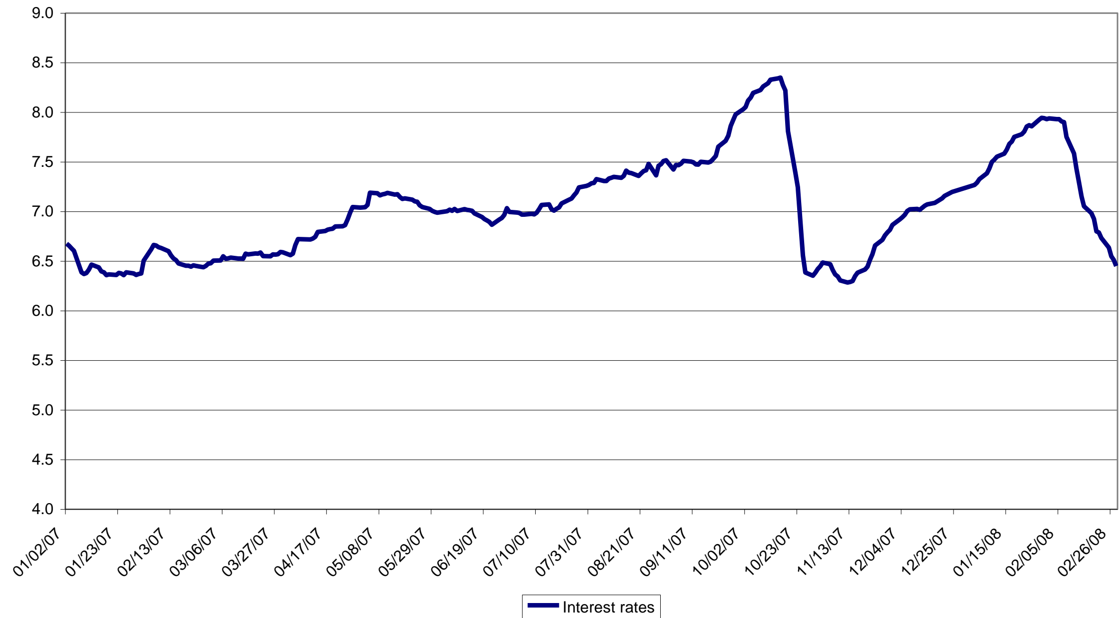


Figure 7:



(b) Exchange Rate

28. After the crisis the Shilling has depreciated against all major currencies. By February 28 the Kenya shilling had depreciated by about 13% against the US dollar and

the British sterling pound and 18% against the Euro compared to the exchange levels on December 24, 2007. Following the signing of the power sharing arrangement the Shilling started to strengthen. Starting in the Central Bank of Kenya sold over US$ 30 million in its monetary policy operation to mop out excess liquidity. As result the Kenya shilling strengthened against all major international currencies and on March 5th, the currency hit a 1.5 half month high on the back of more positive political sentiment and another round of selling by the central bank. On that day the local currency was trading at 66.90/67 to the US dollar. We are not expecting large swings and while it is possible to observe some more strengthening of the currency current levels are not necessarily undesirable. In fact one bit of good news is that this alleviates some of the pressure for exchange rate real appreciation which was beginning to raise competitiveness concerns.

Figure 8:

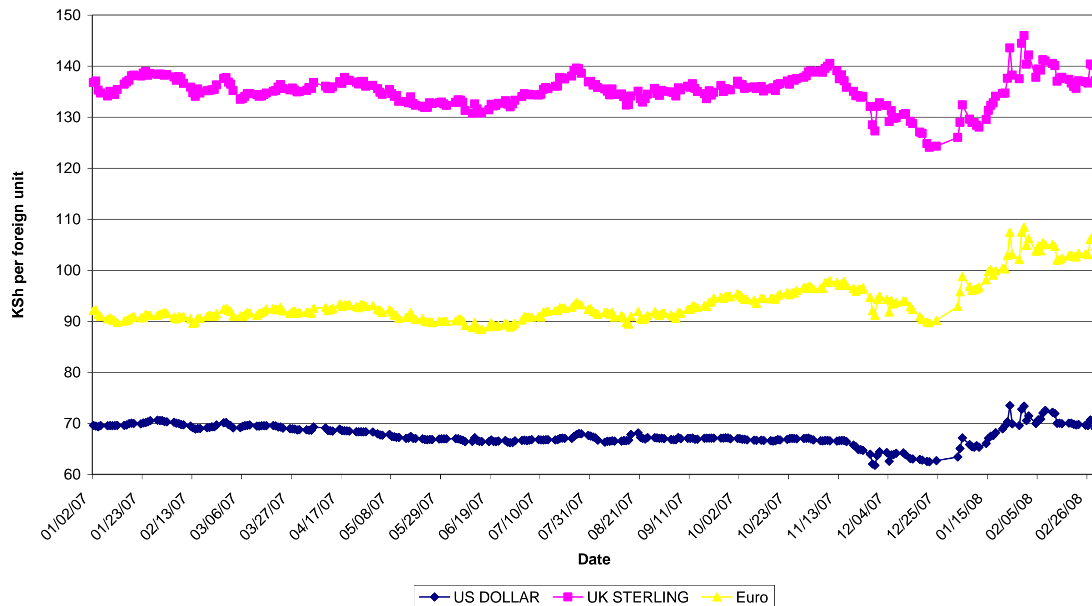


Figure 9:

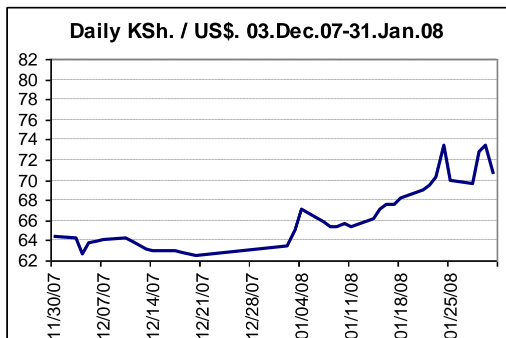
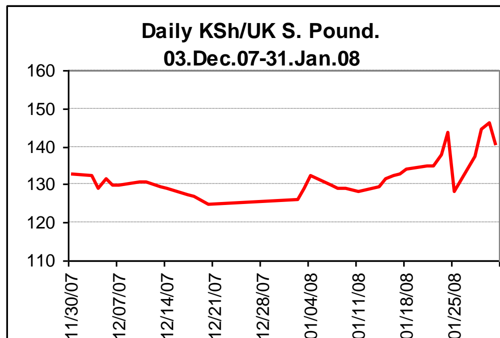


Figure 10:



(c) Investor Sentiment

29. The political crisis has increased Kenya's perceived riskiness which is not unexpected. S&P downgraded Kenya's long-term local currency rating to 'B+' from 'BB-'. At the same time, S&P placed both its long-term foreign and local currency 'B+' ratings on Credit Watch. Another international ratings agency, Fitch, revised the country's credit rating outlook from positive to negative. The latest survey of global executives by the Economist Intelligence Unit (EIU) put Kenya together with Ethiopia, Zimbabwe, and Algeria as political high risk zones in Africa for investors in 2008. However, these assessments were prior to the signing of the power sharing arrangement. In fact, the S&P has very recently upgraded Kenya's rating from "negative watch" to "stable outlook". Hence if the deal is adhered to many we would expect to see a reevaluation of other ratings as well..

30. With the formation of the new government Kenya's attractiveness for international investors is expected to improve. Safaricom has been a good test case and it will be interesting to see the results of the proposed transaction. There are a few other signals that is indicative of Kenya's continued potential as a major FDI destination. In mid-February, before the signing of the power-sharing agreement, Indian oil giant, Essar Energy Overseas Ltd, has won the bid to acquire 50 percent stake of the Mombasa based Kenya Petroleum Refinery. Another recent example is the recently announced plans of a Chinese company to open a tannery in Kenya ahead of a major shake-up in the global trade in animal hides. These developments are indications that with the normalization of the political life in Kenya and stable economic policies the country has the potential to be a desirable location for investors. However, it must be noted that now that ethnic and land conflict is in the open, certain segments of the economy may feel a more lasting impact, such as agro business in the western parts of Kenya and these parts of the country could attract less FDI than compared to pre-crisis expectations.