KENYA ECONOMIC UPDATE

June 2012 | Edition No. 6

Walking on a Tightrope

Rebalancing Kenya's economy with a special focus on regional integration

THE WORLD BANK

Walking on a Tightrope

Rebalancing Kenya's economy
with a special focus on regional integration

TABLE OF CONTENTS

ANNEXES

LIST OF TABLES

LIST OF FIGURES

LIST OF BOXES

ABBREVIATIONS AND ACRONYMS

APR	Annual Percentage Rate
ASEAN	Association of Southeast Asian Nations
ATM	Automated Teller Machine
BPO	Business Process Outsourcing
BPS	Budget Policy Statement
BRIC	Brazil, Russia, India, China
CAGR	Compound Annual Growth Rates
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CES	Common Economic Space
CET	Common External Tariff
CFS	Container Freight Station
CRA	Commission on Revenue Allocation
EAC	East African Community
EAPP	East Africa Power Pool
EEA	European Economic Area
EITI	Extractive Industries Transparency Initiative
EMU	Economic and Monetary Union
EPC	Export Promotion Council
ERS	Economic Recovery Strategy
EUCU	European Union Customs Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
ICT	Information and Communication Technology
IDF	Import Declaration Form
KCB	Kenya Commercial Bank
KES	Kenya Shillings
KEPHIS	Kenya Plant Health Inspectorate Service
KEU	Kenya Economic Update
KNBS	Kenya National Bureau of Statistics
KRA	Kenya Revenue Authority
LIBOR	London Interbank Offered Rate
MRA	Mutual Recognition Agreement
NCPB	National Cereals and Produce Board
NEER	Nominal Effective Exchange Rate
NMC	National Monitoring Committee
NTBs	Non-Tariff Barriers
PIP	Plant Import Permit
REER	Real Effective Exchange Rate
SACU	Southern African Customs Union
SPS	Sanitary and Phytosanitary
SSA	Sub-Saharan Africa
TBT	Technical Barriers to Trade
WDI	World Development Indicators
WITS	World Integrated Trade Solution

FOREWORD

It is my pleasure to present to you here the sixth edition of the World Bank's Kenya Economic Update. Following economic turbulence at the end of 2011, the Government of Kenya raised interest rates, and reduced public spending, to help stabilize the economy in 2012. Inflation is now declining, and the exchange rate is more stable. Even so, the outlook for 2012 remains mixed, as macroeconomic instability tends to increase around elections, and the crisis in the Euro zone is clouding the international economic outlook. This is why we chose as the title of this report "Walking on a Tightrope".

This report has three main messages. First, Kenya's economy is stabilizing, although it remains vulnerable to domestic and external shocks. After sailing through rough waters in 2011, the World Bank projects growth of 5.0 percent for 2012 and 2013, providing shocks are avoided. Second, Kenya's high and widening current account deficit can be interpreted to mean that the country is living beyond its means. To address this issue, it is time to rebalance the economy by increasing savings for investment—and also increasing exports. Third, the East African Community (EAC) presents many opportunities for Kenya, but non-tariff barriers to trade remain considerable. Kenya can lead the way to deeper EAC integration, by helping to lift non-tariff barriers, and so unlocking regional trade. This would help to reduce Kenya's trade deficit, as well as its domestic food prices.

The World Bank remains committed to helping Kenya to walk the tightrope successfully, and to rebalance the economy through regional integration. The Bank's series of Economic Updates, which we publish in a new edition every six months, have become our leading vehicle to analyze development trends in Kenya, and to contribute to the implementation of the Bank's strategy for Sub-Saharan Africa—a strategy that puts a special emphasis on knowledge and partnerships. With these reports, we aim to support all those who want to improve the economic management of Kenya. As in the past, we are proud to have worked with many key Kenyan stakeholders during the preparation of this report. We hope that you too will join us in debating policy issues that are topical in Kenya today, and in making your contribution to helping Kenya to grow, and to achieve a permanent reduction in poverty.

Johannes Zutt
Country Director for Kenya
World Bank

ACKNOWLEDGEMENTS

This sixth edition of the Kenya Economic Update was prepared by a team led by Jane Kiringai together with John Randa, Nora Carina Dihel, Ian Mills and Peter Warutere with supervision from Wolfgang Fengler. The core team consisted of Betty Maina, Allen Dennis, Catherine Ngumbau, Caroline Wambugu, and Lucy Wariara.

The team acknowledges contributions from Andrew Roberts, Geoff Handley, Aurelien Kruse, Miriam Omolo, Olivier Cadot, Julien Gourdon, Laban Maiyo, Fred Wamalwa, and Roger Sullivan.

The report benefitted from insights of several peer reviewers including Nehemiah Ng'eno, Mombert Hoppe and Paul Brenton. Humberto Lopez and Johannes Zutt provided overall guidance to the team.

Partnership with key Kenyan policy makers was instrumental in the production of this report. On May 30, 2012, a draft of the report was presented at the Quarterly Economic Roundtable. The meeting was attended by senior officials from the Ministry of Finance, the Kenya National Bureau of Statistics, the Kenya Institute of Public Policy and Research Analysis, the Kenya Revenue Authority, the International Monetary Fund, the National Economic and Social Council, and Office of the Prime Minister.

Special appreciation goes to Mart Logistics, for conducting a truck drivers' survey along the northern corridor.

MAIN MESSAGES AND KEY RECOMMENDATIONS

Main Messages

- **Kenya's economy is stabilizing but still vulnerable.** At the end of 2011, the government increased interest rates and lowered the fiscal deficit by curbing expenditures, temporarily stabilizing the economy. Inflation declined, the exchange rate stabilized, and economic growth slowed in 2011 to 4.4 percent. The outlook for 2012 is mixed. With economic stability and good rains, growth could reach 5 percent in 2012 and 2013. However, another series of shocks (increased oil prices, a poor harvest, the euro zone crisis, or domestic instability) could easily create renewed economic turbulence, and slow down economic growth to 4.1 percent.
- **The current account deficit has increased and Kenya remains vulnerable to external shocks.** High oil prices and weak exports have widened Kenya's trade deficit, and this has contributed to a current account deficit of 13.1 percent of GDP, a record high for Kenya and amongst the highest external deficits in the world. Kenya's exports remain few (tea, tourism, horticulture) and its import bill remains vulnerable to high oil price increases.
- **Kenya can improve its trade balance, lower prices and improve food security by reducing non-tariff barriers to trade.** The EAC now trades more with itself than with any other region of the World. However, Kenya imposes numerous rules and regulations across a wide variety of sectors on imports, particularly from EAC partner states. Where these rules and regulations are poorly designed or implemented, they become non-tariff barriers. In the food sector, if Kenya were to reduce non-tariff barriers it would ease domestic food prices, help the poor and enable the EAC market to boost production in food surplus countries – which is win-win for both EAC producers and Kenyan consumers.
- **Kenya is in an excellent position to benefit from EAC integration and expand its trade in services.** Kenya is a net importer of goods but a net exporter of services. Kenya's services have experienced dynamic growth and the sector has further potential for expansion. However, regulatory barriers restrict services, particularly in the banking, professional and business sectors. Services trade liberalization and regulatory reform are needed to enable Kenya to benefit fully from EAC integration.

Key Recommendations for Economic Management

- **Keeping inflation low remains vital for Kenya's economic recovery.** Tight monetary and fiscal policies in 2012 have helped Kenya to regain macroeconomic credibility. Any reduction in interest rates should be gradual to maintain macroeconomic stability and not endanger external financial inflows currently supporting the shilling. Similarly, fiscal consolidation should continue but now needs to strike the right balance between budget cuts and priority investments for growth especially in transport, electricity and water.
- **As the economy stabilizes, it is time to change gear from short-term stabilization to structural reforms for sustained growth.** Kenya's competitiveness in some sectors has declined (as domestic prices, including food, energy and transport, remain elevated) and this is putting pressure on exporters' margins as well as on overall competitiveness. As a result, non-tradable sectors, especially services and construction, are driving growth while the share of tradable sectors, especially manufacturing, is declining. It is time to address these imbalances and to promote exports.
- **Kenya needs to increase public and private savings.** Kenya's growth is mainly driven by consumption. Domestic savings have been declining and the excess of investments over savings is increasing the current account deficit. In short, Kenya is living beyond its means. Tax and expenditure policies can be used to cut back consumption and create incentives to increase savings and investments.

Key Recommendations for Regional Integration

- **Establish a trade regulatory committee and consult stakeholders.** The trade regulatory committee should review existing rules and regulations - removing those that cannot be justified - and inform the design and implementation of new rules in the least trade-restrictive manner, without compromising legitimate public policy objectives. It has been shown in the past that an inclusive and transparent process with stakeholders is crucial for successful regional integration.
- **Develop an effective monitoring mechanism with possible sanctions for non-compliance.** The COMESA-EAC-SADC Tripartite online reporting and resolution system is showing signs of encouraging progress and good practice. The binding dispute settlement processes of the WTO, and the experience of the EU in establishing a legally binding mechanism with sanctions for non-compliance, provide additional relevant models for the EAC to consider.
- **Eliminate regulatory barriers, and disseminate market opportunities, in trade in services.** Reforms should focus on aligning regulatory frameworks in financial services and mutually recognizing professional qualifications. Collaboration should be encouraged between universities and professional associations to address skills-shortages and support given to the Export Promotion Council to expand dissemination of market information on services to Kenyan firms.

EXECUTIVE SUMMARY

In 2012, Kenya's economy has been on a tightrope. Policy makers have had to walk a fine line between stabilizing the economy and maintaining the growth momentum. While inflation has declined, the exchange rate stabilized, and the fiscal position improved, fundamental economic imbalances continue to make Kenya vulnerable to shocks. In the absence of economic and social turbulence, Kenya should grow at 5 percent in 2012 and 2013, which would still be substantially below its neighbors. Kenya has been benefitting from the integration and growth momentum in the East African Community (EAC), which has become one of the most vibrant economic regions in the world. However, despite impressive increases in trade between the five EAC partners in recent years, there is still a large untapped potential. EAC trade could increase several-fold if unnecessary restrictions in the trade of goods and services –particularly non-tariff barriers- were removed.

Kenya's Economy: Stable But Vulnerable

Kenya's economy is stabilizing gradually. After sailing through rough waters in 2011, the economy is back on track to achieve 5 percent growth in 2012. Three main factors underpinned stabilization. First, the Government's determined action to increase interest rates during the third quarter of 2011 and prudent fiscal policies sent important signals to the markets and this also helped to stabilize the exchange rate. Second, inflation has started to decline sharply, thanks to lower international food and energy prices. Third, Kenya's service sector continued to expand strongly, with very good results in tourism.

The return of macroeconomic stability gives hope for 2012 and 2013. While inflation was close to 20 percent at the beginning of 2012, it is expected to remain below 10 percent during the second half of 2012 — a mirror image of 2011. With lower inflation, interest rates may fall, which will allow the exchange rate to return to more competitive levels and overall spur economic activity.

However, Kenya's growth remains below the African average and substantially below that of its EAC partners. Sub-Saharan Africa is expected to grow at 5.3 percent in 2012 and 5.6 percent in 2013, and the EAC continues to outperform the region, with average growth likely exceeding 6 percent in both years, making it one of the best performing regions in the world. Such strong performance is to the benefit of all countries in the region. Even with growth at 5 percent, Kenya's per-capita income is now exceeding US$800 for the first time, and the country is firmly on the path to Middle Income status.

Debt levels have returned to below 45 percent of GDP: if Kenya were part of the European Union, it would be one of its least-indebted members. With relatively low levels of debt, a stable exchange rate and declining inflation, Kenya again has the space to run slightly higher fiscal deficits to maintain public investment programs, especially in infrastructure. In the medium-term, Kenya will also need additional fiscal resources to manage the transition to a system of devolved government.

Kenya has avoided a severe economic downturn, but structural weaknesses remain and they make the country vulnerable to renewed instability. Kenya's economy is out of balance and the external position has become even more vulnerable as the country's current account deficit has skyrocketed and could reach 15 percent of GDP in 2012 (see figure 1). This is among the worst external balances in the world and poses a significant risk to Kenya's economic stability. An additional external shock, especially a sharp rise in oil prices, would trigger severe economic stress, especially if accompanied by capital outflows.

Over the last decade, Kenya's imports have grown faster than its exports. Since mid-2011, Kenya's earnings from its top four exports have not been sufficient topay for its oil imports. While earnings from traditional exports have grown (especially tea and coffee) thanks to higher global prices, the import bill has in recent years has grown even faster, on account of high oil prices. In 2011 alone, the import bill rose by 23 percent. This has widened the current account deficit, threatening macroeconomic stability.

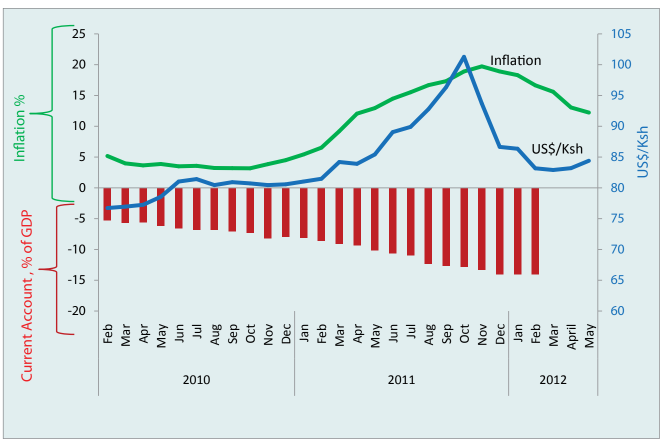
Kenya has great potential to increase its exports, both in goods and services. For goods, there is potential is in new markets —notably the BRICs— and new products, especially light manufacturing. Kenya's services exports are already doing well: Kenya's net trade in services generated a surplus of US$ 2.35 billion in 2011 and there is potential for further expansion. Kenya's wide current account deficit is driven by the deficit in goods, which reached US$ 9 billion in 2011 (see figure 2). Therefore the challenge for Kenya is to strengthen its services sector further, while acting to develop its embryonic manufacturing base.

Kenya continues to face enormous challenges in food and energy. Both sectors are critical for Kenya's economic prospects and for the country's agricultural and industrial transformation. In the short-to medium-term, policies in both sectors will have an important impact on the macro-economy:

- **Food.** Over the last year, Kenyans paid almost double the global price for maize and triple the global price for sugar. This is hurting the poor disproportionately as they spend a large share of their income on food. It is also increasing Kenya's macro-economy vulnerability by increasing inflation.
- **Energy.** Kenya remains heavily-dependent on hydropower, and electricity shortages are frequent when rains are uneven. As a result, Kenya has had to make increasing use of fuel-powered thermal plants, and therefore to import more oil at the very time when oil prices were rising sharply. The ballooning oil import bill has in turn caused Kenya's current account deficit to widen. Kenya has embarked upon a major investment program and expansion in geo-thermal energy, which will bring multiple benefits to the country, not just for industry and the environment, but also for the macro-economy in reducing the oil import bill.

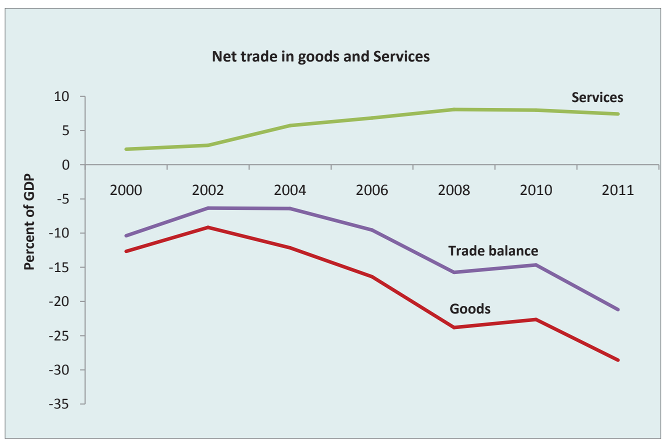
Food and energy are two sectors where Kenya and its partners can benefit greatly from regional integration. While Kenya is facing a structural food deficit, Tanzania and Uganda produce a surplus, especially in maize. Expanding the food trade within the EAC would enable Kenyan consumers to pay less for food while also allowing Tanzanian and Ugandan

Figure 1: Kenya's economy in 2012: stabilizing but still vulnerable



Source: World Bank computations based on KNBS and CBK data.

Figure 2: Kenya's trade Balance has deteriorated despite strong service exports



Source: World Bank computations based CBK data.

farmers to earn moreby selling their produce to the Kenyan market. In energy, a "regional power pool" would enable Ethiopia to earn revenues from selling power to energy-deficit countries such as Kenya, Tanzania, Uganda and Rwanda.

The Promise of Regional Integration

The East African Community is one of the fastest growing regions in the world. Over the last decade, the region has experienced average growth of 5.8 percent, the second-highest of any economic block in the world, just below ASEAN (which grew at 6.1 percent). The EAC's growth has been fueled by rapidly growing trade between the EAC countries, which tripled in value over the last decade and could increase further. The EAC has also experienced unprecedented demographic growth, as the population has grown more than 30 percent over the last decade, from 110 million people in 2002 to 145 million people in 2012. By 2030, the five EAC countries will be home to an important market with a population of about 200 million.

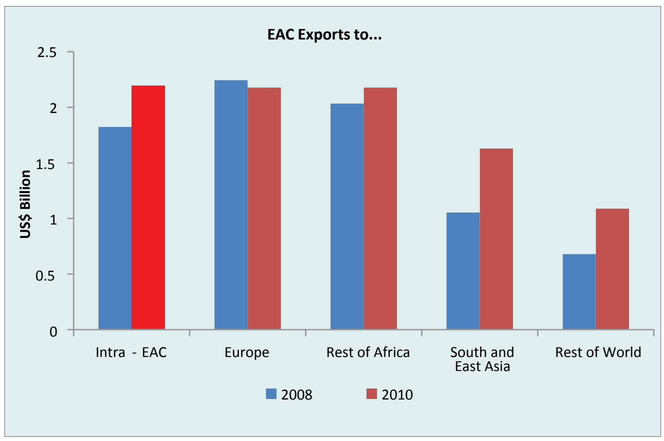
Global and regional integration are complements, not alternatives. Many European, American and Asian countries benefitted simultaneously from global and regional integration (into the EU, ASEAN and NAFTA). The EAC countries can also use regional integration as a stepping stone for competing globally.

Regional integration is a win-win strategy for growth and poverty reduction in East Africa. Tanzania and Uganda have relatively robust agriculture sectors and their mining sectors have been benefitting from rising commodity prices. Kenya has a vibrant service industry and Nairobi is increasingly serving as a hub for global companies seeking to expand into Africa. So far, Kenya has been riding the wave of Africa's growth momentum. Now is the time for Kenya to become East Africa's growth engine again: it is best placed to kick-start manufacturing, which remains East Africa's Achilles heel.

Kenya can also leverage regional integration to rebalance its economy. Strong regional growth presents opportunities for Kenya to mitigate its own external vulnerability. Deepening Kenya's intra-EAC trade would help reduce its widening current account deficit, cushion it against global turbulence and open the economy to more FDI, which has already increased threefold in the EAC this decade. Increasing intra-EAC trade would contribute to better food security in Kenya, develop regional production chains in food and manufacturing that would create employment, and open up new markets in services and increase efficiency in existing ones.

The EAC is now trading more with itself than with other regions of the world. Over the last decade, trade with other African countries has been expanding rapidly and it now accounts for about half of Kenya's total trade. Trade within the EAC has also risen importantly, including in manufactured goods such as food products, beverages, tobacco, and cement. Kenya's trade with its EAC partners has now overtaken trade with Europe (see figure 3).

Figure 3: EAC trading more with itself than other regions – which was not the case in 2008



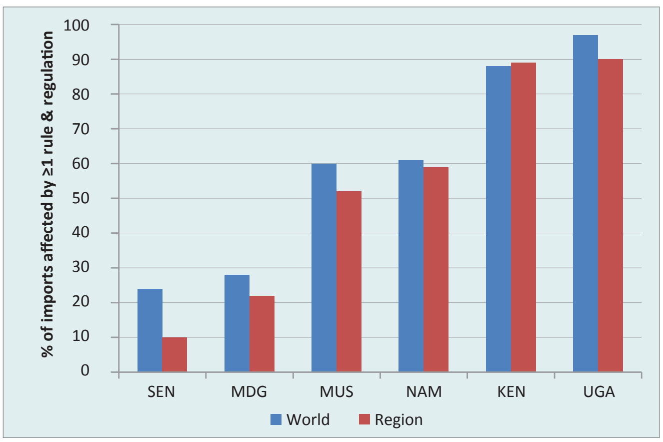
Source: World Bank compulations based on WITS data.

Tariffs have declined markedly, but the business climate is still poor in most EAC countries. In the last two decades, EAC countries have reduced their tariffs sharply, from an average of 26 percent in 1994 to 10 percent in 2011. However, most EAC countries are still struggling to implement critical business reforms. So, while there have been many positive developments over recent years, the full potential of the EAC remains untapped.

Non-tariff barriers continue to hamper trade and hit the poor. A reduction in non-tariff barriers would give all EAC countries a major boost. EAC countries have made progress on reducing quotas and restrictive import licensing requirements, but still need to make headway on other of rules and regulations - namely health and safety regulations, technical barriers to trade (which arise when standards, regulations and assessments systems are not applied uniformly), inspections, and quantity controls. Non-tariff barriers raise prices in domestic markets and, when they affect food products, hurt the poor most.

Despite Kenya's good intentions in fostering regional integration, it remains a major hindrance for growing trade within the EAC. Kenya is currently imposing more rules and regulations on imports than do many other African countries – it is close to the bottom amongst countries compared (see figure 4). Kenya is also the only country (in this comparison) which imposes more measuresrules and regulations on imports from its regional partners than from the rest of the world (while other SSA countries impose less measuresrules and regulations on imports from their regional partners than from the rest of the world).

Figure 4: Kenya and Uganda's trade barriers are among the highest in Africa



Source: Cadot and Gourdon, World Bank 2012.

"Kenya is currently imposing more rules and regulations on imports than do many other African countries.

Kenya imposes non-tariff restrictions across a variety of sectors, including food. These measures restrict the free flow of trade across many sectors, particularly metals, machinery and food. Even in food, where Kenya has a major deficit, the country is imposing too many restrictions, which end up raising domestic prices and hurting consumers. As a result, Kenya now has a maize deficit of 1.13 million metric tons, which explains why the EAC as a whole also entered into a food deficit in 2010.

The potential for trade in services remains large. Kenya is competitive in transportation, communication and financial services, and Kenya-based banks are now leading regional integration in the EAC banking sector. Kenyan companies have started to position themselves in neighboring countries (for instance in retail) and the country is exporting more and more services to EAC countries (especially Uganda), which are benefitting from better and more affordable services. If Kenya's non-tariff barriers were reduced, the service exports sector could expand further and contribute to strengthening the current account.

The State of Kenya's Economy

1. Stabilizing but vulnerable

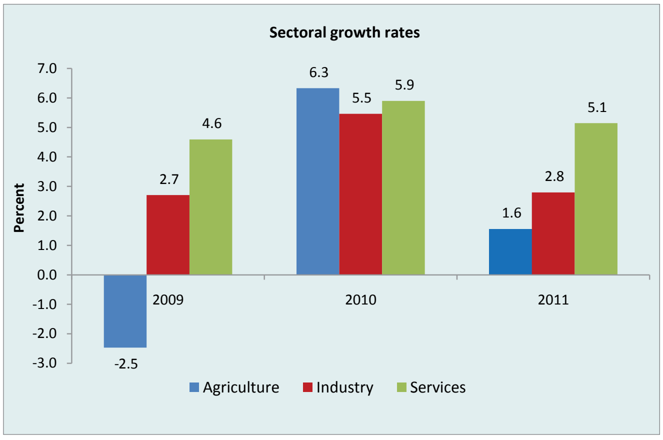
In 2012, Kenya's economy returned to a more stable path. Inflation is declining and is below 10 percent; the exchange rate has stabilized and low fiscal deficits have brought debt levels to below 45 percent. While Kenya's economic growth slowed in 2011 to 4.4 percent, it is now back on track, with economic stability and good rains, and is projected to reach 5 percent in 2012 and 2013. At the same time, Kenya's economy is more vulnerable than ever to shocks, due to a large and widening current account deficit, which could reach 15 percent of GDP in 2012. Another oil price shock, poor harvest, or an episode of domestic instability, could easily create renewed economic turbulence. Kenya's exports continue to be driven by traditional products, and are sold to traditional markets. At a global level, Kenya's exports remain few (tea, tourism, and horticulture) and are recording modest growth. However, in Africa, especially East Africa, trade has been expanding rapidly, which demonstrates the potential of regional integration for Kenya.

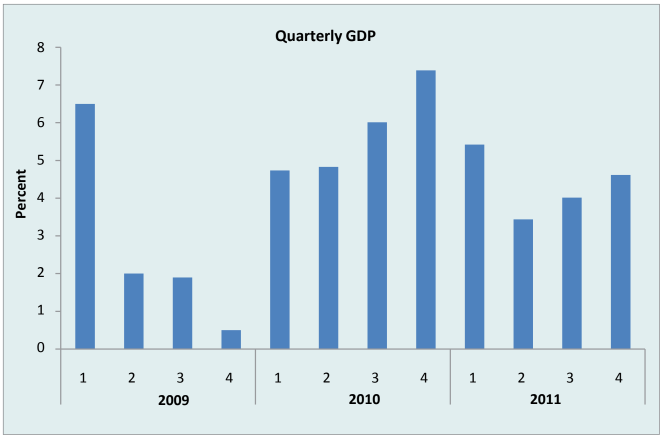
1.1 Economic performance in 2011

In an environment of global turbulence and domestic shocks, Kenya recorded moderate growth of 4.4 percent in 2011. For the second consecutive year, the economy experienced positive growth across all quarters and sectors, even though agriculture performed poorly. The agriculture sector growth declined from 6.4 percent in 2010, to 1.6 percent in 2011. This is attributed to dry weather conditions in 2011. However, in terms of total value, Kenya's export crops benefited from favorable global prices, which compensated for reduced output and explained the increased export earnings. Growth in the services sector remained robust, at 5.1 percent, though this was at a slower pace than in previous years. Industry experienced tepid growth in 2011 at 2.8 percent, a significant decline from 5.3 percent in 2010 (see figure 1.1 for details).

Kenya's growth for the last four years has been relatively modest. Since the 2008 crisis, Kenya has been growing at an average of 3.5 percent per year, well below the average for Sub-Saharan Africa (5.5 percent, excluding South Africa) and significantly slower than the East African Community (EAC) countries, some of which are among the fastest growing developing countries in the world. For example, Rwanda grew at 7.9 percent, Uganda 7.2 percent, and Tanzania 6.7 percent during the 2008-2011 period (see figure 1.2).

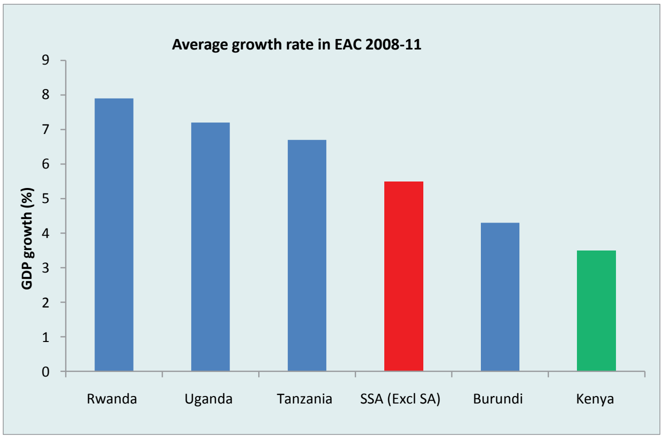
Figure 1.1: Growth remained resilient in all sectors and all quarters

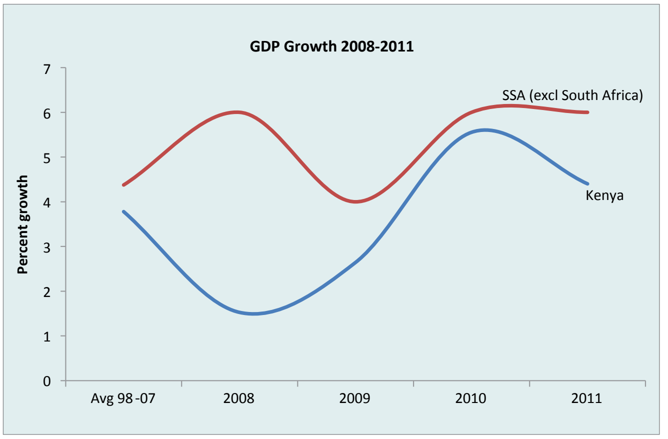




Source: World Bank Computations based on KNBS data.

Figure 1.2: Kenya's growth tails in the EAC region ……and lags behind the average for SSA





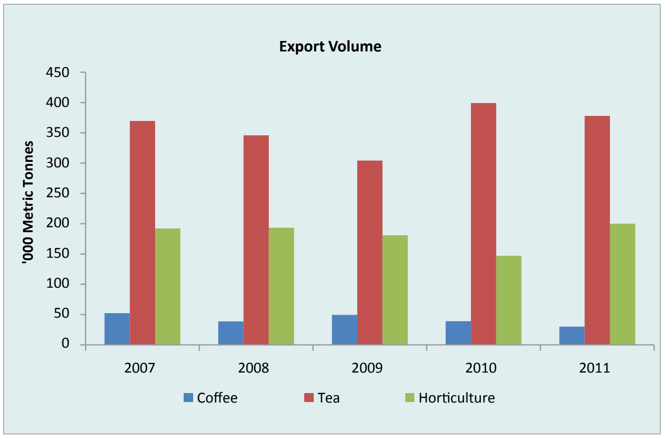
Source: World Development Indictors.

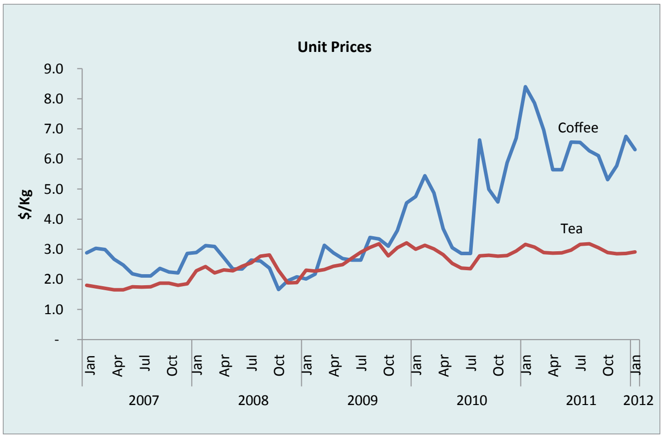
Revenue from tea and coffee increased substantially – but only due to high prices, not volumes (which declined). Tea, coffee and horticulture—Kenya's main export crops—all saw a decline in production in 2011 compared to 2010 levels (see figure 1.3); but the global commodity price rally was strong enough, which enabled the value of Kenya's export commodities to actually increased in 2011 compared to 2010. However, potential gains for Kenya from higher export prices, were eroded by the higher oil prices which Kenya had to pay.

Some of the highlights of the economy in 2011 include:

- Tea production contracted by about 5 percent in 2011, but domestic currency earnings from the subsector benefitted from high global prices and a weak shilling for part of the year, as earnings increased by 17 percent;
- Coffee production also declined in 2011 compared with 2010, but coffee farmers emerged the real winners in 2011, as global prices increased by 50 percent; and
- Agricultural growth remained modest, due to the dry weather conditions. The 2011 drought was concentrated in Kenya's arid and semi-arid regions, which affected pastoralist's livelihoods, especially livestock, but impacted agricultural production only mildly. The food sub-sector cereal production increased by 5 percent and horticulture production declined, but prices increased thus earnings remained stable in 2011.

Figure 1.3: Tea and coffee earnings increased but production contracted





Source: World Bank Computations based on KNBS.

A decline in hydropower generation negatively affected industry. Low water levels, resulting from the drought in 2011, led to a decline in hydropower generation and a shift towards emergency diesel generated power. As global oil prices peaked, the cost of diesel generated power increased, raising the costs of production for industry. Furthermore, interruptions in electricity supply have costed businesses in Kenya some 7 percent of their annual sales revenue, which also explains the decline in manufacturing growth to 3.3 in 2011 (from 4.5 percent in 2010). Since other sectors grew faster than manufacturing, the sector's share in GDP declined from 9.9 percent in 2010 to 9.4 in 2011.

The services sector sustained robust performance in 2011. Tourism continued to experience a boost, recording higher tourist arrivals than 2007, which had been a record year. Kenya has been attracting significant numbers of tourists from new markets, with substantial growth from the Middle East (42 percent) as well as Asia (25 percent), compared to 2010. This could be as a result of new flight routes which Kenya Airways has inaugurated to the Far East. The tourism market from Europe recorded relatively lower growth of 11 percent, when compared to previous years and to other markets.

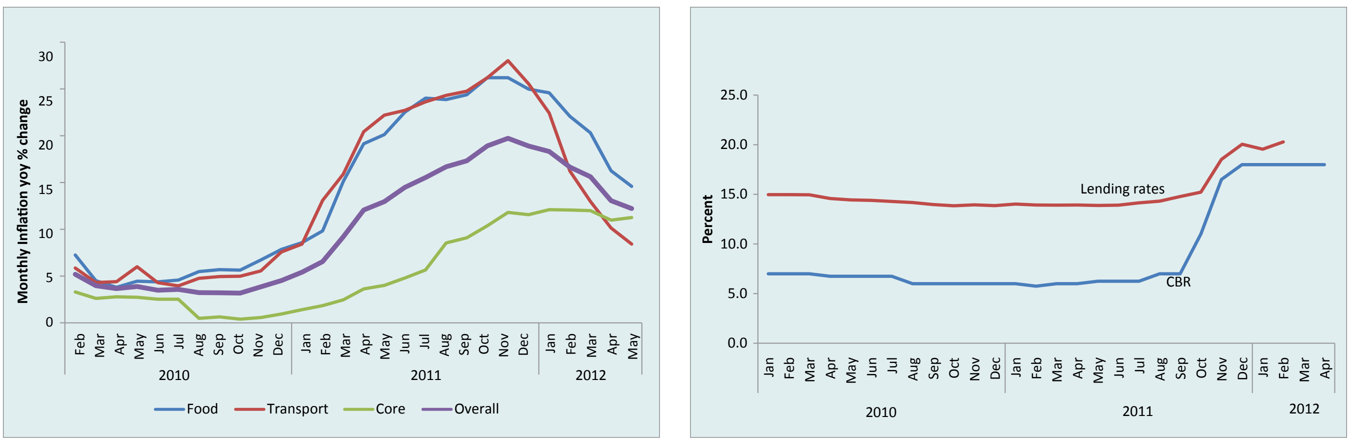
1.2 The Monetary sector: At the center of the stabilization effort

The strong intervention of the Central Bank during the third quarter of 2011, has helped to ease inflation and to stabilize the exchange rate. High interest rates are attracting foreign exchange inflows, which have strengthened the financial account, and financed a widening current account deficit, which remains vulnerable to high oil prices (see discussion on the external account). By raising the Central Bank Rate (CBR), all interest rates in the money market increased and private sector credit growth slowed. As a result, the shilling stabilized against the major currencies, overall, inflation declined, and core inflation leveled off.

The Central Bank increased interest rates to stabilize the economy. Specifically, it tightened monetary policy in October 2011, by increasing its policy rate to 18 percent from 7 percent, previously. As a result, money market interest rates increased, with the repo and the interbank market rates also increasing sharply by 13 and 7 percentage points, respectively, in the same month.

The Central Bank measures resulted in an increase in both deposit and lending rates. In response to tighter monetary policy, commercial banks increased both their lending and deposit rates. Average lending rates of commercial banks increased by 525 basis points, from 14.8 percent in October, to 20 percent in December; deposit rates increased by 278 basis points, from 4.2 to 7.0 in the same period. The interest rate spread widened from 11 to 13 percentage points, as lending rates remained high (see figure 1.4). In response to public outrage against

Figure 1.4: Inflationary pressure easing …as high interest rates rose



Source: World Bank Computations based on KNBS and CBK data.

commercial bank lending rates, there have been attempts to curb interest rates on loans, through legislative amendments to the Finance Bill tabled in parliament, but these have been successfully resisted by the executive. Had the amended Finance Bill passed, it would have threatened all the gains made during the last decade, in deepening both Kenya's financial markets and financial inclusion (see Box 1.1).

> "The slowdown in lending growth has mainly impacted private households."

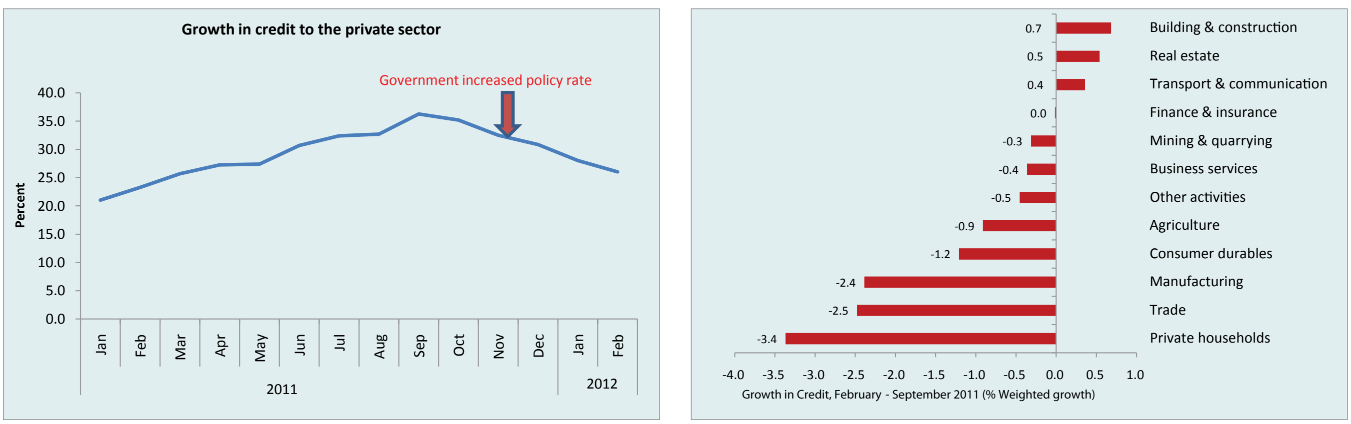
Lending to the private sector has contracted in response to high interest rates. Growth in lending to the private sector has declined from a peak growth rate of 36.3 percent in September 2011, to 26.0 percent in February 2012. The contraction affected all sectors, except building and construction, transport and communication, and real estate (see figure 1.5). The slowdown in lending growth has mainly impacted private households (-3.4 percent contraction), trade (-2.5 percent), and manufacturing (-2.4 percent). While the significant drop in credit to households is desirable to contain inflation, a decline in credit growth to trade, and manufacturing harms growth. However, credit growth continued in building and construction, transport and communication, real estate. Building, construction and real estate are non-tradable sectors with high import content, which remain profitable even when the real exchange rate is overvalued.

Financial markets have welcomed the government's decision not to cap lending rates. Recent sharp increases in interest rates have been painful for many Kenyans. However, these interest rate hikes were necessary to stabilize the economy, and cool off aggregate demand; which would have hurt the economy even more, and for a longer period. In addition, there is a perception that banks are charging an undue high "mark-up" for loans, also called the "spread" between deposits and lending rates. These perceptions drove some legislators to propose a legislative interest-rate cap.

1.3 Responsive fiscal Consolidation

The government adopted a prudent fiscal response to the 2011 shocks, demonstrating its commitment to fiscal discipline. As revenue and domestic borrowing underperformed, the government rationalized its expenditures. Government expenditures were cut from the budgeted 33.6 percent of GDP, to 30.3 percent in 2011/12. This fiscal consolidation resulted in a reduction of domestic borrowing by about 2 percentage points from 3.8, to 1.9 percent of GDP. As a result, public debt as a share of GDP declined from 48.8 percent in 2010/11, to 43.1[1] percent in 2011/12 (see figures 1.6 and 1.8). Revenue performance remained strong at 24.0 percent of GDP and government contained

Figure 1.5: Lending to private sector contracted by 10.3 percent... except for non tradable sector



Source: World Bank computations based on CBK data.

[1] *This ratio excludes the recent syndicate loan of US$ 600m.*

>> Box 1.1: The case of interest rate controls in Kenya: why it was a bad idea, and alternative options

Evidence around the world demonstrates that attempts to control prices, especially interest rates, almost always backfire, often leading to higher interest rates and usually hurting the poor most. There are three main reasons for these unintended outcomes. First, any interest rate ceiling means that credit has to be rationed, in which case there is no guarantee that the most productive investment receives the credit. Often credit is rationed on political grounds and the banks that give out these loans often don't get repaid, putting their balance sheets in jeopardy. Kenya already has a number of painful experiences: in the mid 1980s 11 banks collapsed and in the 1990s 23 banks became insolvent, some of which were put under receivership and merged under consolidated institutions. Second, with interest rate caps, there emerges a "curb market" in credit, with lenders charging exorbitant interest rates to (typically poor) people who have no other option than to borrow in these parallel markets. Third, in the longer run, interest rate ceilings make people reluctant to put their money in banks, leading to slower financial development, which in turn hampers growth. Alternative ways to bring interest rates down include:

(i) Promote competition and transparency. The CBK could direct commercial banks to adopt the Annual Percentage Rate (APR) framework, which would facilitate full disclosure on the cost of borrowing to customers. The APR is the effective interest rate that a borrower pays on a loan. Currently, there are too many hidden charges. In addition, the CBK could ensure that the weighted average lending and deposit rates for every commercial bank and deposit taking micro-finance Institution are posted on the CBK website each month by type of loan. This would allow consumers to effectively evaluate their lending and borrowing options.

(ii) Improve efficiency in the banking industry. Even though Kenya has adopted IT systems which will have brought down operating costs for commercial banks (e.g. ATMs, fewer back-office operations and front office operations), these lower costs have not been passed on to customers: banking charges are still very high in Kenya when compared to other countries. The CBK and Kenya Bankers Association need to further review the interconnectivity of bank platforms, as a way of bringing down operations costs of banks.

(iii) Sharing both positive and negative customer information via a credit bureau would reduce non-performing loans. Parliament should pass laws to force banks to share both positive and negative customer information. When banks reward good borrowers with lower rates and punish those with negative ratings by charging higher rates, both the share of non-performing loans and the cost of borrowing will decline.

(iv) Improving efficiency of commercial banks by encouraging them to lend to each other in the horizontal repurchase market. Banks are hesitant to provide such lending since the master-repurchase agreement does not guarantee them collateralized assets in the event of default. The CBK should amend the master-repurchase agreement to enable banks holding government securities as collateral to realize it upon debtor default.

(v) Addressing the need for a comprehensive consumer protection policy for financial services is a cornerstone for a vibrant financial market as consumers are encouraged to take greater responsibility in their financial decision-making. This will include tightening consumer laws to protect bank customers.

(vi) Reduce overall costs for customers. The authorities need to cap legal fees on discharging/charging securities, eliminate stamp duty on debentures/charges, and allow sharing of securities.

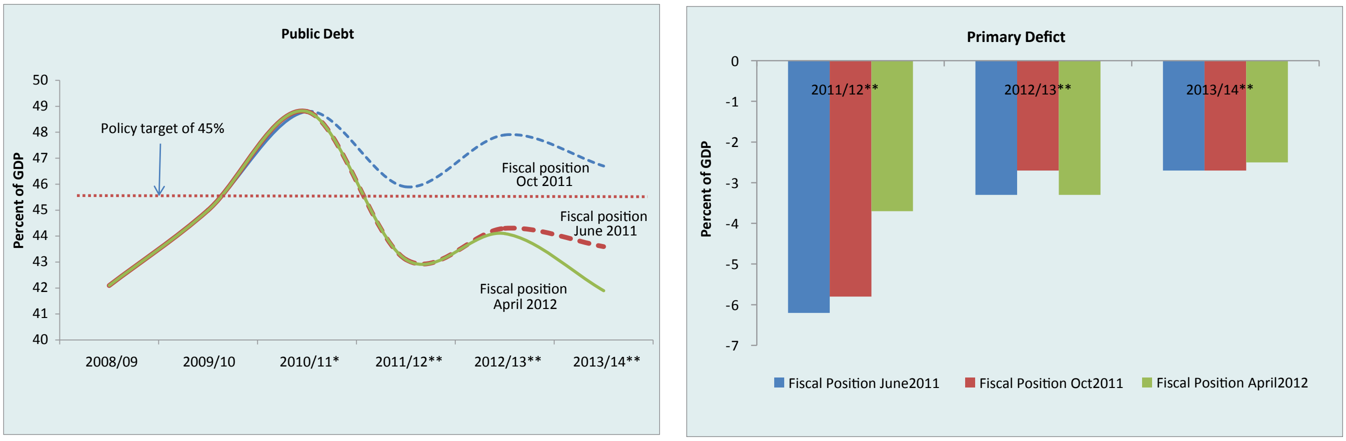
Source: World Bank staff.

expenditures. By the end of 2011/12 the overall fiscal balance including grants is projected to decline to -4.9 percent of GDP, 2.5 percent below the initial budget figure of -7.4 percent.

A larger share of total spending is allocated to the development budget. The government has devoted a larger share of its budget towards development spending on a significant number of infrastructure projects both at national and constituency level (through the Constituencies Development Fund or CDF). The development budget has grown considerably, from 4.7 percent of GDP in 2006/07, to 7.9 percent of GDP in 2010/11 (see figure 1.7). The medium-term outlook will see a further increase to about 10 percent of GDP, a third of total spending. Meanwhile, recurrent spending was constrained at or below 21 percent of GDP over 2009/10 to 2011/12.

Fiscal consolidation was achieved at a cost, but it was necessary to contain inflation. Although the budgetary allocation for development expenditure

Figure 1.6: Fiscal consolidation in 2011 demonstrates commitment to fiscal discipline



Source: Ministry of Finance, Budget Policy Statement 2012.

has increased, the cut back in domestic borrowing ultimately translated into reduced development spending in 2011/12. The pre-crisis budget allocations called for development spending to increase to 12.5 percent of GDP, but this had to be scaled back to 9.6 percent. The Kenyan budget is structured so that domestic revenues finance the recurrent budget, while domestic borrowing and foreign financing support the development budget. Short falls in revenues also resulted in reductions in recurrent spending, for operations and maintenance. Revenue collection was under budget by about 1 percentage point of GDP, which was reflected in a similar cutback in recurrent spending.

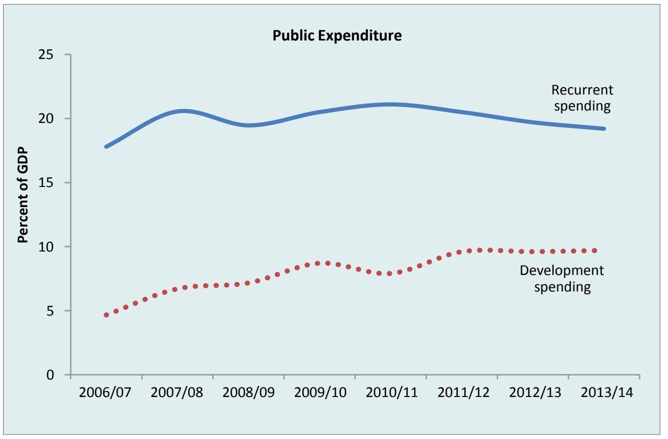
The government has resorted to external borrowing, to ease pressure in domestic money markets and complement monetary policy. Monetary tightening affected government borrowing through higher costs of borrowing (interest rates on government paper), and created a liquidity crunch, as borrowing from the CBK discount window was restricted. For the first time since 2003, the government found it difficult to fund the budget, by borrowing in the domestic market. Monetary tightening forced commercial banks (the main holders of government security), to hold onto their funds, as the Central Bank increased the reserve requirements, and limited activities at the discount window. The lack of liquidity in the market pushed interest rates from 6.4 percent in mid-2011, to 21.8 percent at year end. The government borrowed US$ 600 million in foreign denominated debt from a syndicate of foreign commercial banks, to plug the fiscal gap in the 2011/12 budget. This loan eased the pressure on domestic money and exchange rate markets, and yields on government debt have declined.

Table 1.1: Fiscal consolidation as a result of shocks in 2011 (percent of GDP)

	2009/10	2010/11	2011/12 Budget	2011/12 BPS	2011/12 Consolidation
Revenue	22.3	24.1	24.9	24.0	-0.9
Expenditure and net lending	29.5	29.3	33.6	30.3	-3.3
Recurrent	20.5	21.1	20.9	20.5	-0.4
Development	8.7	7.9	12.5	9.6	-2.9
Fiscal Deficit	-6.4	-4.5	-7.4	-4.9	2.5
Public debt	36.2	48.8	45.9	43.1	-2.8

Source: MoF Budget Policy Statement 2012.

Figure 1.7: Recurrent and Development Spending

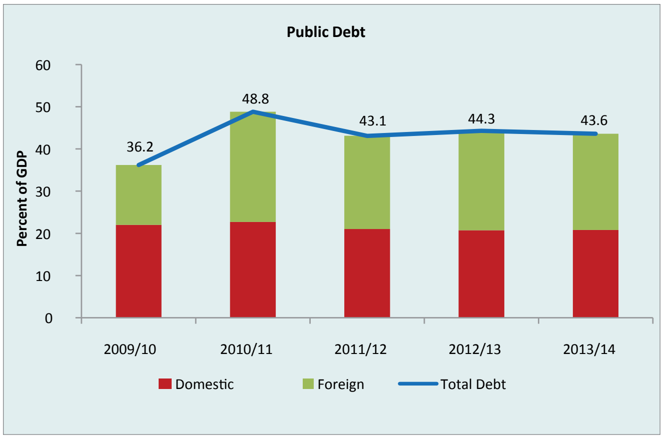


Source: MoF Quarterly Economic and Budgetary Review, various and Budget Review and Outlook Paper, December 2011.

There is potential to expand the primary deficit over the medium-term, if growth increases in line with expectations. If Kenya continues to grow at 4.3 percent in the next three years, it can run an average primary deficit of 3.0 percent of GDP. However, if Kenya grows at 5 to 6 percent in the next three years, it would have room to increase its fiscal deficit to an average of 5.5 percent of GDP, to sustain a debt-to-GDP ratio at 45 percent. In our view, Kenya still needs significant investment in infrastructure, in order to increase potential output, and minimize underlying structural supply constraints, like the high cost of energy. Our projections show that Kenya could sustain a slightly higher deficit than planned, to enable both a reasonable level of infrastructure investment, and a debt-to-GDP ratio of 45 percent (see figure 1.9).

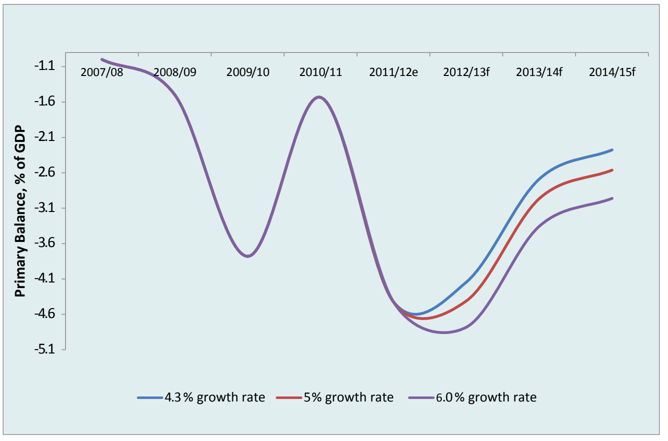
The first budget under the new constitution will allocate 26 percent of 'shareable' revenue to devolved government units – including any funds spent through the CDF – according to the Budget Policy Statement (BPS). The Constitution (Article 187) provides that finance follows functions. Using this provision, the central government has earmarked KES. 139 billion for devolved functions , plus KES. 21 billion for the CDF, which is 26 percent of audited Revenues (2010/11), and 16 percent of total estimated revenue and grants in the 2012/13 BPS. The largest share of the revenue is allocated for infrastructure, followed by health, public administration and social protection (see figure 1.10). The Commission on Revenue Allocation (CRA) has proposed a formula for consultation to allocate the county equitable share among the 47 counties: which assigns a 60 percent weight to population; 20 percent for a basic equal share; 12 percent to poverty levels, 6 percent to land area; and, 2 percent to county fiscal responsibility (see figure 1.10).[2]

Figure 1.8: Trends in Public Debt



Source: MoF Budget Review and Outlook Paper, December 2011.

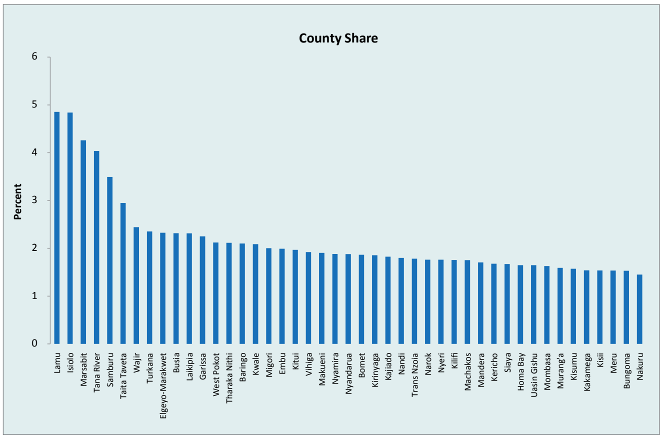
Figure 1.9: Kenya can sustain a debt to GDP ratio at 45 percent



Source: World Bank simulations.

[2] *For more insights into Kenya's devolution process, especially fiscal decentralization, see the forthcoming World Bank report "Devolution without Disruption - Pathways to a successful new Kenya" [title TBC].*

Figure 1.10: On per capita basis the CRA consultation formula is skewed in favour of countys with low population density



Source: World Bank

1.4 External Account remains out of balance

In 2011, the current account deficit nearly doubled to 13.1 percent of GDP.[3] Imports grew by almost 20 percent, while exports only increased by 10 percent. Import growth was mainly driven by oil imports, which accounted for 27.6 percent of the total import bill in 2011, jumping from US$ 2.7 billion (8.9 percent of GDP) in 2010, to US$ 4.1 billion (11.6 percent of GDP) in 2011. The growth in oil imports reflects a 33 percent increase in oil prices (from US$ 79.5/bbl to 106) during 2011, coupled with a 12 percent increase in volume (from 3.2 to 3.6 million metric tons), which was due to the need to expand thermal power, as hydropower operated below potential. With factor income and transfers roughly constant, the deterioration in the trade balance was also apparent in the current account balance.

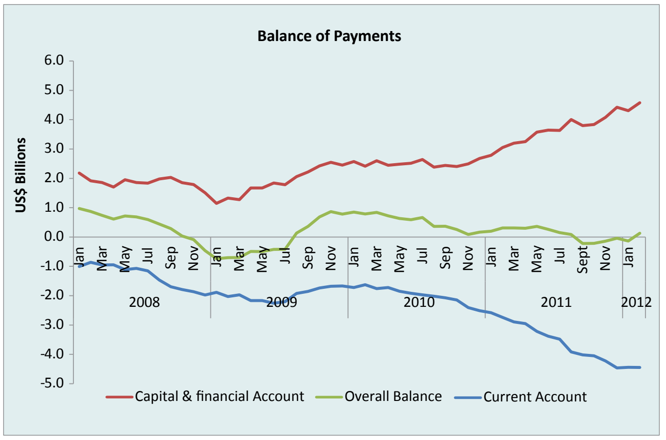
The widening current account deficit also pulled the overall balance into negative territory. The current account deficit was mainly financed by short term flows, which were attracted by high interest rates. The interest rate differential between domestic rates and those in the international markets (LIBOR), after controlling for inflation, increased from 26 basis points in August 2011, to a peak of 700 basis points in October 2011, before falling to 473 basis points in March 2012. As a result, net inflows into the financial account increased by 68 percent in 2011 to US$ 4.2 billion (mainly short-term inflows). Net short-term flows increased by 45 percent from US$ 1.1 billion in 2010, to US$ 1.7 billion in 2011. Net Errors and Omissions increased by US$ 1.5 billion from US$ 0.85 billion in 2010, to US$ 2.4 billion in 2011, which also helped finance the current account deficit.

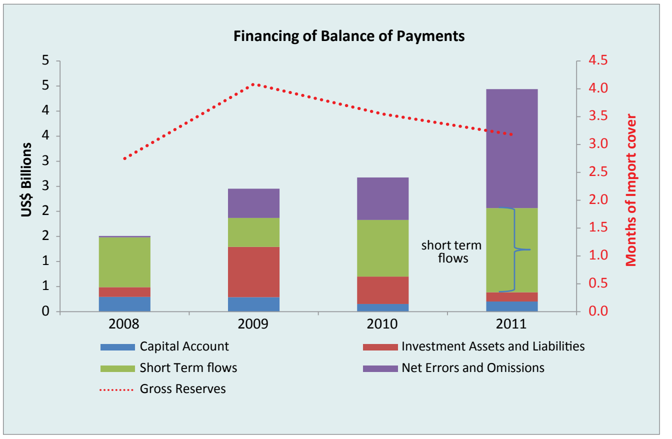
Short term inflows have increased the supply of foreign currency and stabilized the exchange rate. Significant increases in net short term foreign currency flows (mainly portfolio flows) increased the supply of dollars in the market, which stabilized the exchange rate – at least for the moment. By early 2012, the shilling had recovered the nominal losses experienced in 2011. During the first four months of 2012, the shilling appreciated against the US dollar (to 82.9 from 101.3), the UK pound (to 131.2 from 159.4) and the Euro (to 109.6 from 138.9). This represents a nominal appreciation of about 18 percent against these major currencies, since October 2011. Going forward, any reduction in interest rates should be gradual, so as to maintain macroeconomic stability, and not endanger external financial inflows, which are stabilizing the exchange rate.

A strong shilling and high domestic prices have resulted in a real exchange rate appreciation, negatively affecting exports. The recent appreciation of the shilling, coupled with high inflation, wiped off any competitive advantage Kenyan exporters might have gained through a weaker exchange rate in 2011. The trade weighted real exchange rate appreciated by 17.2 percent, between October and December 2011, and the trade weighted nominal exchange rate appreciated by 15.5 percent during the same period. The appreciation in the real effective exchange rate reflects the impact of high domestic prices, and reduction of earnings of Kenyan exporters.

[3] *KNBS numbers report a current account of Kshs 296 billion and Nominal GDP of Kshs 2.5 trillion.*

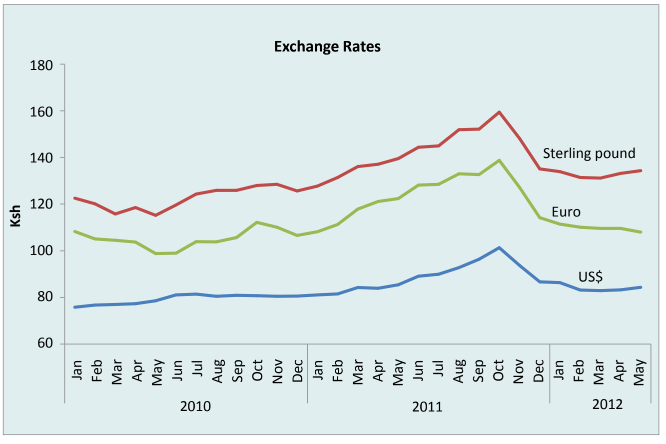
Figure 1.11: FDI and short term inflows financed the current account deficit

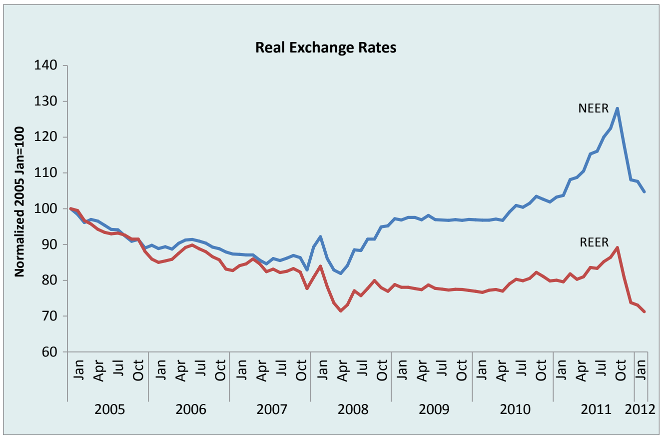




Source: Central Bank of Kenya.

Figure 1.12: The Shilling has appreciated sharply





Source: World Bank calculations based on Central Bank of Kenya.
Notes: 1) NEER (nominal effective exchange rate) is the trade weighted exchange rate; 2) REER (real effective exchange rate) is the trade weighted exchange rate but also takes into account domestic and foreign price differentials.

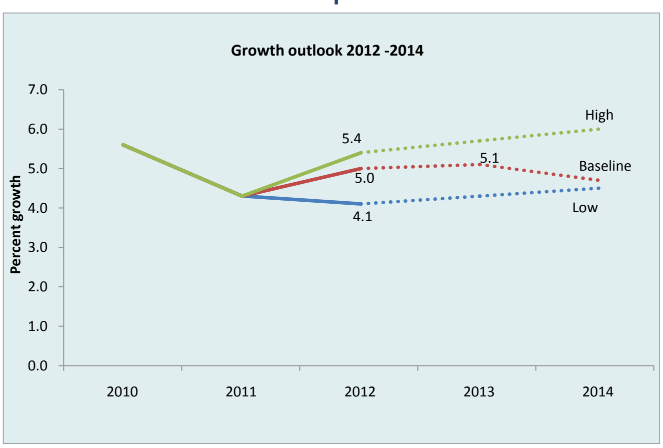
2. Growth Prospects for 2012 and 2013

The World Bank projects an average GDP growth rate of 5.0 percent in the medium-term. Macro stability has been restored but remains fragile. The prevailing conditions through the first half of 2012, call for a cautious approach to monetary and fiscal policy management. It may be too early to relax monetary policy, but high interest rates will nevertheless slow down investment. The two most significant downside risks to the growth outlook are: (i) the rising oil prices; and, (ii) the crisis in the euro zone, which could push the current account deficit to over 15 percent of GDP. The war in Somalia, preparations for general elections, and the roll-out of devolved government, are likely to increase fiscal pressure which is likely to be managed through cut backs in development spending.

2.1 Growth prospects

The World Bank maintains its growth forecast of 5.0 percent for 2012 and for 2013, a moderate rate that will be driven by consumption. Growth could reach 5.4 percent in a high growth scenario, but it could also dip further to 4.1 percent in the low case (see figure 2.1). The baseline growth scenario assumes a continuation of appropriate policy vigilance to sustain prevailing macroeconomic stability, which would see a gradual decline in interest rates and inflation while maintaining exchange rate stability. Kenya's growth outlook trends with the average for Sub-Sahara Africa (5.5 percent in 2012, and 5.6 percent in 2013) but it is still below its fast growing neighbors, Tanzania (6.7), Uganda (6.2), and Rwanda (7.6).

Figure 2.1: Growth will be moderate at 5.0 percent in 2012 and 5.0 percent in 2013



Source: World Bank.

The low growth scenario assumes the risks discussed in section 2.2 play out. A contagion of the Greek crisis to the rest of the PIGS (Portugal, Italy and Spain) would see a slowdown in the growth of Kenyan exports and tourism. The resurgence of exchange rate volatility and high inflation in the domestic market, combined with political uncertainly, would slow down consumption and investment. The high growth scenario assumes the rally of commodity prices will continue even as oil prices stabilize, see annex A2 for details. The baseline scenario is discussed in greater details in the following sections.

Aggregate demand growth was sluggish in the first half of 2012 but will recover during the second half of the year. During the first half of 2012, high inflation (and prices) and high lending rates, constrained investment and consumption; in the first six months of 2012, the CBR has been maintained at 18 percent, sustaining the pressure on interest rates. Ongoing fiscal consolidation will also see a slowdown in public investment growth. In the second half of 2012, inflation and interest rate pressure will ease, and food prices will decline after the harvest season. As the momentum of the political campaign builds, high liquidity in the economy will boost consumption. Lending to the private sector is expected to pick up, as banks try to grow their lending portfolio. The syndicate loan by the government will reduce the government borrowing from the domestic market, crowding out lending to private sector, and help build the CBK foreign exchange reserves.

Table 2.1: Fiscal consolidation as a result of shocks in 2011 (percent of GDP)

Percent growth rates	2007	2008	2009	2010	2011*	2012	2013
GDP	7.0	1.6	2.6	5.6	4.3	5.0	5.1
Private Consumption	7.3	-1.3	3.8	2.8	3.0	3.9	4.1
Government Consumption	4.4	2.3	5.5	4.8	4.5	4.3	4.6
Gross Fixed Investment	13.6	9.5	0.6	7.4	10.2	9.5	11.0
Fiscal Framework (endFY) percent of GDP							
Total Revenue	22	21.8	22.3	24.1	24.0	24.2	24.4
Total expenditure	27.3	26.6	29.5	29.5	29.3	30.3	29.8
Grants	-1.3	0.8	0.8	0.8	0.7	1.4	1.2
Budget Deficit (incl. grants)	4.0	4.0	6.4	6.4	4.5	4.9	4.4
Total debt	34.6	41.7	45.0	36.2	48.1	43.1	44.1
External Account Vol growth							
Exports, GNFS	7.3	7.5	-7.0	6.1	8.9	6.7	6.7
Imports, GNFS	11.1	6.6	-0.2	3.0	8.6	6.7	6.7

Source: MoF Budget Policy Statement 2012.

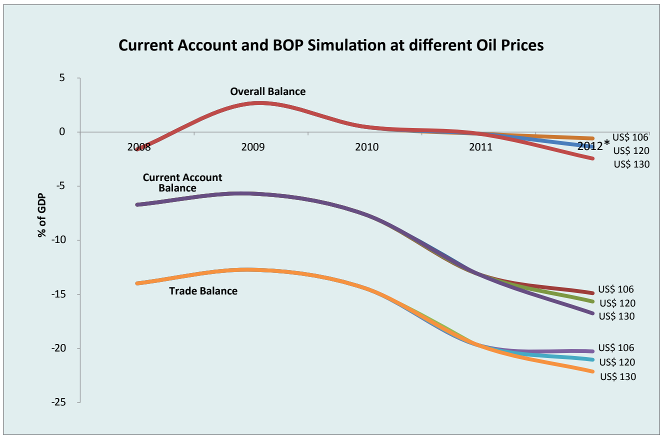
Demand for Kenya's exports will remain flat in high income countries but rapid growth within the EAC countries will provide an expanding market for goods and services. Globally, growth will remain subdued at 2.5 percent in 2012, increasing modestly to 3.0 percent in 2013. With the deepening euro zone crisis, growth in high income economies is expected to be only 1.5 percent and 2.0 percent - in 2012 and 2013 respectively. Growth in developing countries will remain robust, exceeding 5.5 percent in the medium-term. Sub Saharan Africa will be among the fastest growing regions in the world. This will impact favorably on Kenya, providing increased export opportunities.

In the real sector, agricultural output is expected to be in line with forecasts. The rains arrived later than expected in the first part of 2012, but the current forecast points to a normal growing season. Frost experienced in the early part of the year impacted tea production, which will likely be 20 to 30 percent lower than in 2011. Industry may record a mixed performance; construction remains robust, as the growth in lending to the sector suggests. Growth in services will hold, particularly wholesale and retail trade as consumption picks up. However, tourism and travel outcomes will depend on the government's ability to maintain internal security, in the face of terrorist threats, and concerns of instability in the run-up to the elections. Growth in tourist arrivals from Europe will be moderate, as a result of conflict in the region.

Pressure on the external trade and current account balances could continue in 2012. Oil prices have started rising again in 2012, as a result of uncertainties in the Middle East (especially Iran and Syria). The World Bank forecasts an average oil price of US$ 115 per barrel in 2012, but overall prices are likely to remain volatile. Further, trade balance pressure will emanate from imports of heavy equipment for ongoing geothermal projects.

Moderate export growth is expected in 2012. The cost of power is expected to decline as the heavy rains received in 2012 will boost hydropower generation, thereby improving the competitiveness of Kenya's industrial sector. However, slow economic growth in some of Kenya's main trading partners will weaken demand in key markets, and the current account deficit is expected to widen, as a result. Figure 2.2 simulates the impact of higher oil prices on the current account, and the balance of payments based on the following two scenarios (in both of which the overall balance of payments would be in deficit, and put pressure on the exchange rate):

Figure 2.2: The current account deficit could reach 15 percent of GDP if the oil price stays above US$100



Source: World Bank.

- In a scenario where the price of oil remains at US$ 120 throughout 2012, the oil import bill will increase by US$ 1.3 billion in 2012, and the current account balance will worsen by US$ 2.0 billion (1.7 percent of GDP), increasing the overall current account deficit to 14.9 percent of GDP, and;
- In a more extreme scenario, an average price of US$ 130 per barrel in 2012, would see the current account deficit deteriorate further, to 16.8 percent of GDP.

2.2 Risks to the outlook

Our key assumption is that Kenya's economy is stabilizing but remains vulnerable to shocks, and will grow at 5 percent in 2012 and 2013. It is presumed that there will be a continuation of appropriate policy vigilance to sustain prevailing macroeconomic stability, which would see a gradual decline in interest rates and inflation, while maintaining exchange rate stability. However, there are significant downside risks to this growth projection, with any of these developments, having significant adverse effects on Kenya's economy. The immediate risks are:

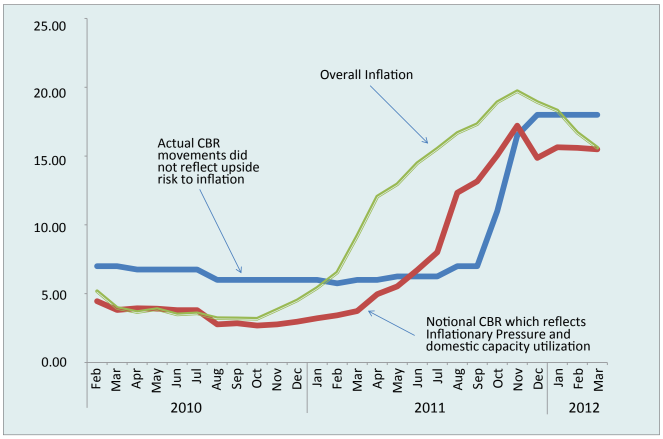
1. A sharp reduction in interest rates when inflation declines, could reverse short term foreign currency inflows, and trigger another cycle of exchange rate volatility.
2. The worsening of the crisis in the euro zone, will negatively impact Kenya's balance of payments position through three main channels: a reduction in demand of Kenya's exports and tourist arrivals from Europe; a reduction in portfolio inflows from the region; and, a reduction in migrant remittances.
3. Tensions in the wider Middle East region could lead to a potential surge in oil prices. Already, in March 2012 oil prices reached US$ 120 per barrel, and these could increase further, if conflict actually materializes, worsening Kenya's current account deficit.
4. Government's possible pursuit of a tight fiscal policy, could choke off public investment, through huge cut backs in development spending, dampening growth prospects.
5. Fiscal expansion to accommodate demands for higher expenditures by newly created departments (most notably expansion in personnel spending resulting from devolution), higher wages for teachers and other professional, as well as elections related expenses, could jeopardize macroeconomic stability.
6. Political risk associated with the forthcoming general elections, and ICC trials of major political figures, might discourage both public and private investment and growth prospects.

The risk remains that the exchange rate will continue to be volatile if current account pressure is not reduced. Kenya's weak external position makes it vulnerable to further macroeconomic instability in 2012. The high oil prices, weak external environment in Europe (one of Kenya's main export destinations and tourist sources), may trigger intense pressure on the currency. Any sharp reduction of interest rates in 2012 by the monetary authorities; when inflationary pressure subsides, could trigger another cycle of exchange rate volatility.

Skilled policy balancing will be required to maintain stability. Our simulations show that inflation has declined, and a gap is emerging between the simulated (notional) CBR, and the actual CBR (see figure 2.3). However, a premature reduction in interest rates, could reverse the gains in demand management, which could take time to contain as happened in 2011. For instance our analysis shows that monetary policy actions take up to 11 months to have an impact in the market, and that the impact can last up to two years.[4]

> "A premature reduction in interest rates, could reverse the gains in demand management, which could take time to contain as happened in 2011.

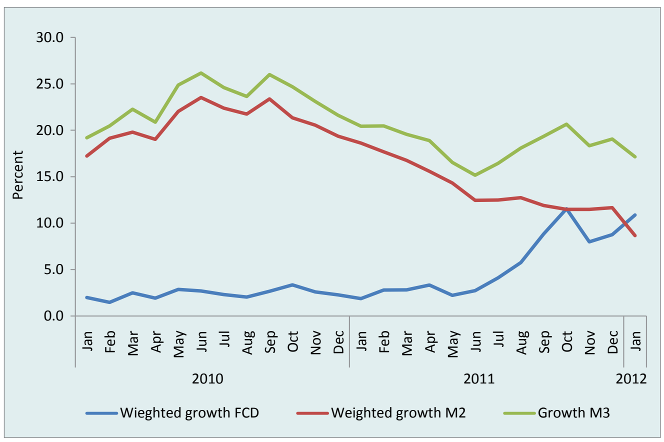
Figure 2.3: Inflation has declined but any reduction in interest rates should be gradual



Source: World Bank simulations.

Tight monetary policy has slowed down growth of narrow money, but foreign currency inflows are driving growth of broad money. The market response to the high interest rate policy has seen a degree of currency substitution, from local to foreign currency deposits, which is keeping liquidity high. The inflows of foreign currency deposits kept the growth of broad money high, even as the CBK strained to contain the growth of the money supply through high interest rates (see figure 2.4). In 2011, broad money (M3 = foreign currency deposits + narrow money) increased by 18.6 percent, and narrow money (currency in circulation and quasi money or M2) recorded a growth of 16.4 percent. The growth of narrow money (M2) slowed down to 13.9 in 2011, compared to 20.8 in 2010, while the average growth for foreign currency deposits accelerated to 5.1 percent in 2011, compared to 2.4 percent in 2010. The slowdown in the growth of narrow money explains why commercial banks have been complaining of "lack of liquidity in the market." However, measuring liquidity through broad money (M3) would signal the need for further tightening, while M2 signals the "true" liquidity position in the market. Further tightening can lead to a vicious cycle of high interest rates, growth in foreign currency deposits, growth in broad money, and contraction in narrow money; which would tax economic activity. This scenario explains the under subscriptions in the Treasury bill market in the first six months of the 2011/12 fiscal year, and higher and volatile interbank rates in the money market.

Figure 2.4: Slow growth of "narrow" money, rises in "broad" money



Source: World Bank.

[4] *IMF "Kenya: 2011 Article IV Consultation".*

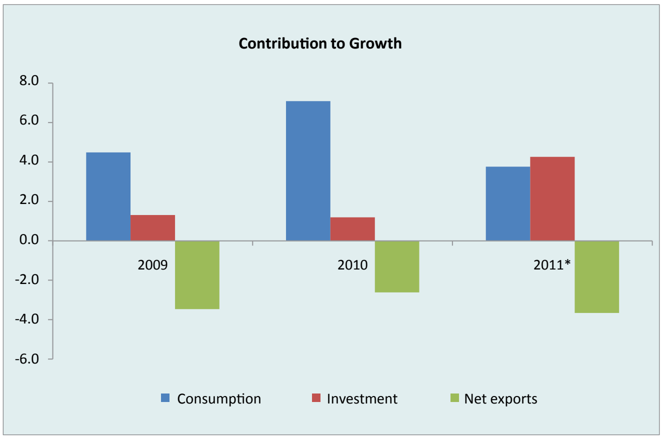
3. Rebalancing the economy

The rising current account deficit can be interpreted to mean that Kenya is living beyond its means. For Kenya to achieve and sustain a high growth rates it needs to rebalance the economy by increasing savings for investment—and also increasing exports. As Kenya seeks to diversify exports products and markets, regional integration would help to reduce the trade deficit as well as its domestic food prices.

3.1 From Short term stabilization to sustained growth

The slowdown in GDP growth in 2011 was as a result of Kenya's underlying macroeconomic imbalances. Aggregate domestic absorption slowed down as inflation constrained private consumption, interest rates constrained investment, and fiscal consolidation curtailed growth in public spending. In Kenya, private consumption accounts for over 70 percent of GDP and a combination of high domestic prices, a weak shilling and high interest rates, constrained private consumption in 2011. Investment slowed down as government cut back on development spending (see fiscal section), and growth in credit to the private sector contracted during the second half of 2011, in response to higher interest rates. The deficit in the external account widened, acting as a further drag on growth (for more details refer to section on external account).

Figure 3.1: High growth episodes have been driven by consumption...excess domestic consumption is met through imports



Source: Computation from Economic Survey.

Kenya's high current account deficit problem in 2011 was driven by high private consumption, and huge imports of machinery for public infrastructural projects. As noted above, the current account deficit is a reflection of the savings investment gap, which in part is driven by the fiscal deficit to finance infrastructural projects worsened the current account in 2011. Low savings indicate that consumption expenditure is high, relative to investment in the Kenyan economy, where development assistance (grants) is minimal. High interest rates would attract foreign savings to finance the current account

Kenya needs to undertake structural reforms to establish the foundation for long term growth. The decline of Kenya's external balance (high and widening current account deficit and real appreciation of the shilling), has been accompanied by growing tensions from internal imbalances, which have created the 2011 economic instability (high Inflation, low savings, and high unemployment). This calls for structural reforms to shift incentives away from heavy investments in non-tradable goods (i.e. building and construction, and real estate) towards the production of goods and services for export markets.

The recent oil discovery in Turkana, if commercially viable, will improve Kenya's trade balance. But for oil to catalyze development, Kenya will have to avoid the special macroeconomic and governance challenges associated with natural resources. Kenya can use the lead time to production, to lay the right foundations for a successful oil economy. This should include a strong focus on diversifying the economy, to make other export sectors more competitive. Countries as diverse as Botswana, Chile, and Norway have shown that natural resources can be a blessing, but this requires hard work and sound institutions - see Box 1.2 for a discussion of the challenges.

3.2 Leveraging the EAC Customs Union

All the key indicators of Kenya's external competitiveness have followed a worrying trend. As emphasized in previous publications, Kenya remains vulnerable to external shocks, and this has become more pronounced, as the frequency of global shocks increases. For instance, Kenya's merchandise exports can only pay for just over one third of her imports, having declined from 65 percent of imports in 2003, to about 38 percent in 2011. The widening current account deficit is worrying, and could reach 15 percent in 2012, in light of the recent oil price surge (see figure 3.1). Kenya's grain deficit has also widened, as agricultural productivity declines, and the population increases.

>> Box 3.1: Making Oil work for Kenya: Oil Management Challenges

Avoiding "Dutch disease": The oil sector has limited linkages with other sectors of the economy. A big resource boom will increase the demand for labor, drive up wages and thereby prices for non export sectors such as services and real estate. This leads to a real appreciation and thus hurts the export sector and import-competing sector. In the extreme it could lead to a deindustrialization of the country – the so called "Dutch disease". The Arab uprising has demonstrated the dangers of jobless growth.

Strong policy and legal framework to embed transparency in oil revenue management: A strong legal framework will be required to ensure there is an open and transparent system for the management and use of oil revenues. Kenya can leverage good practice to start on sound footing:

- **Kenya can learn from Ghana's Petroleum Revenue Management Act,** which is hailed as a world class piece of legislation, providing for the collection, allocation and management of upstream petroleum revenue, and defining a strong and transparent mechanism for monitoring oil receipts and for spending those revenues.

- **Kenya can participate in the Extractive Industries Transparency Initiative (EITI).** The EITI emphasizes that governments should provide up to date and credible information to citizens on revenues collected, oil reserves, production and prices and fiscal regimes for private investors. The reports are then audited and made publicly available on a regular basis. For instance, in Nigeria the EITI audited accounts for 1999 – 2004 revealed huge discrepancies, with the government found to be owed US$5 billion, the largest part of which was owed by the state-owned oil company.

Smoothing oil revenues over both the short- and long-term: In the short-term, the sheer volatility of international oil prices makes planning and budgeting for oil revenues a huge challenge. Having an oil revenue stabilization account can help to provide a buffer against short-term price fluctuations. In the long-term, Kenya can maximize the economic returns from oil by investing oil revenues in education, health and infrastructure and by saving for the future instead of spending it all at once.

Sharing the benefits with communities and counties: Several elements are important in the design of sharing systems. It is important not to undermine the efficiency and transparency of revenue reporting: this should continue to be a national responsibility. It is important to maintain simplicity and transparency in revenue sharing: if rules are clear, well-designed, and seen as acceptable by key stakeholders there will be fewer grounds for mistrust between national and sub-national actors. The draft Mining and Minerals Bill proposes 5 percent of royalties go to local communities and 15 percent to counties: the windfall of significant additional revenues for counties benefitting from a share of royalties should be factored into to calculation of the county's other fiscal transfers to avoid undermining the inter-governmental revenue sharing arrangements. Also, the policy framework should ensure that short-term volatility of oil revenues is not passed down to counties that receive a share, as they will find it far harder to manage. Building systems for improved absorptive capacity in beneficiary counties is also key.

Avoid populist policies such as fuel subsidies: No matter how high oil prices will go and no matter how tempting it would be for the government to establish price ceilings or to introduce energy subsidies, the negative impacts would be dramatic. Research has shown that oil subsidies benefit the rich disproportionately because they own cars, often big ones. Nigeria is currently struggling to cut back its inequitable fuel subsidies. Kenya should avoid this.

Source: World Bank staff.

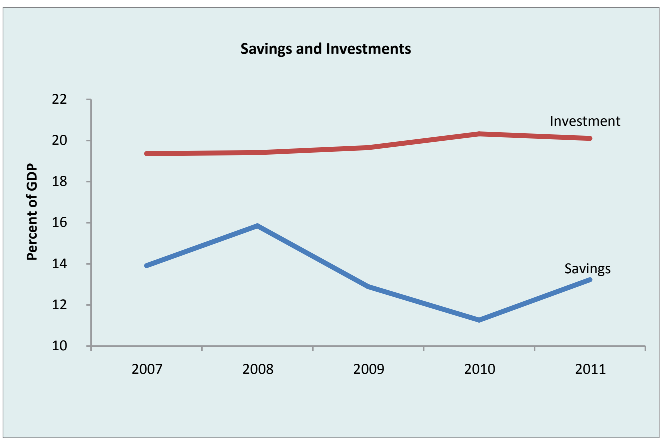
Deepening intra-EAC trade is a low hanging fruit that member states can exploit in order to reduce vulnerability to external shocks. The EAC is one of the leading export markets for Kenya, but non-tariff barriers (NTBs) in the EAC, constrains trade growth. The importance of exports to EAC economies, has significantly increased in the last decade. Exports earning increased from about US$ 6 billion in 2002, to US$ 20 billion in 2010. However this strong growth was in the major EAC countries, Kenya, Uganda and Tanzania while export growth stagnated in Rwanda and Burundi (see figure 3.2).

> "Kenya's merchandise exports can only pay for just over one third of her imports, having declined from 65 percent of imports in 2003, to about 38 percent in 2011.

Services offer new dynamic opportunities for exports. Opening up economies to imports of services and foreign direct investment is a key mechanism for increasing competition, and ultimately providing more efficient and competitive services in the domestic economy. Lower prices, higher quality, and wider access to services, raises productivity and improves competitiveness across all sectors, including agriculture and manufacturing. Kenya needs to be aware about the important role of services for export diversification and growth. For example, despite the large increase in Kenya's services trade during the last decade, there is still a widespread misconception that Kenya's comparative advantage lies solely in the export of manufactured goods.

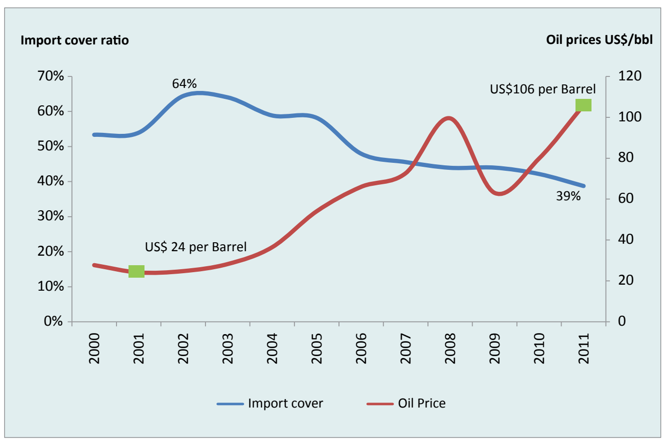
Regional integration can play a crucial role in export diversification. Growth in exports over the last decade has typically been fueled by a small number of mineral and primary products (see figure 3.5), with limited impact on the wider economy. Currently, the impact on unemployment and poverty is disappointing, and the formal sector remains small in many EAC countries. Deeper regional integration can reduce transaction costs and provide a regulatory environment, in which goods and services can flow freely, and cross-border production networks can begin to flourish. It can also relax the constraints faced by many firms in accessing the essential services and skills that are needed, to boost productivity and diversify into higher-value added production and trade. The integration agenda needs to cover services, as well as goods, given the important role of services as intermediate inputs in almost all activities.

Figure 3.2: Kenya needs to cut back consumption and increase savings



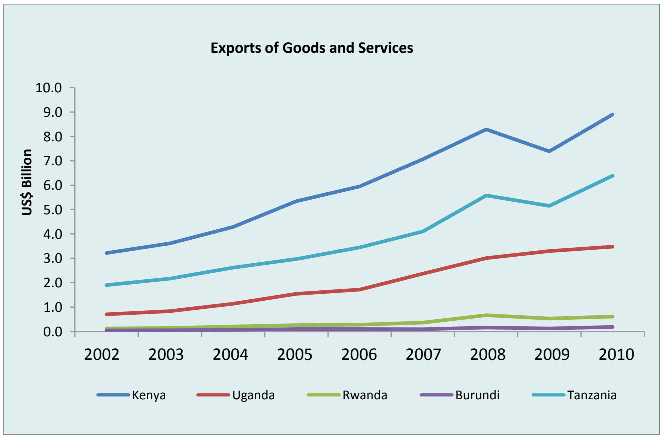
Source: World Bank.

Figure 3.3: The trade gap is widening ...import cover ratios have declined as oil prices have risen



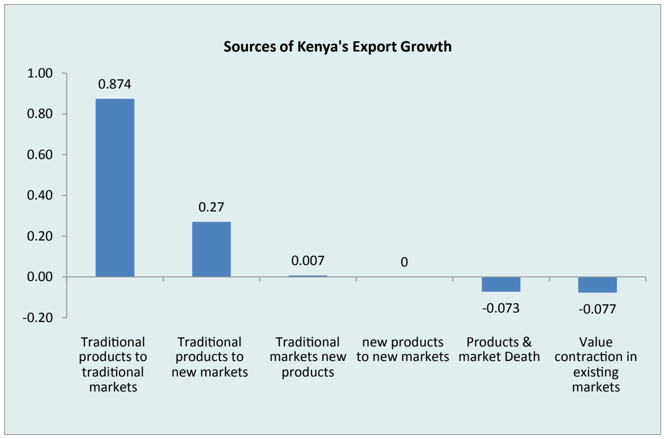
Source: World Bank.

Figure 3.4: The EAC market is growing fast …so is intra regional trade



Source: World Bank based on WDI 2012 data.

Figure 3.5: Exports have increased …but markets and products have become concentrated



Source: World Bank.

Non export sectors like construction and real estate are recording robust growth .. the share of exportable sectors in GDP is declining

Special Focus: Deepening Kenya's Integration in the East African Community (EAC)

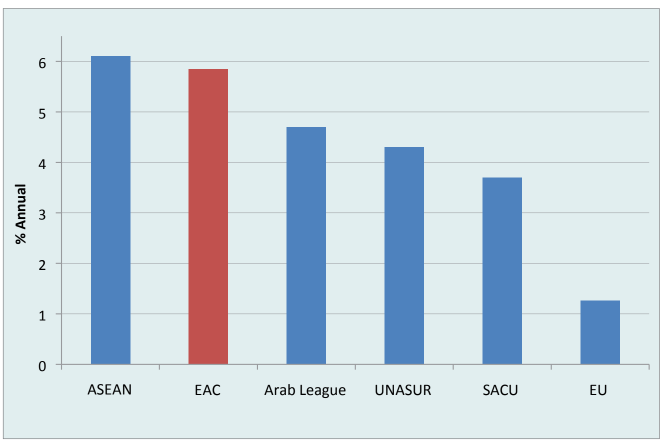
4. The EAC – A dynamic economic community

The EAC is a vibrant economic community, which now trades more with itself than with any other region of the World. Kenya can improve its trade balance, lower prices for a variety of goods and services and create jobs by reducing non-tariff barriers to trade and strengthening exports, particularly services. Although Kenya's export performance has improved over the last decade, its imports have grown much faster. Kenya's service sector has experienced recent growth, and there is room for further expansion. Kenya is in an excellent position to benefit from regional integration, and address the non-tariff barrier and regulatory reform agenda at both the national and regional levels.

4.1 Fast growth and a shift towards regional trade

The EAC is one of the fastest growing economic communities in the world. It has grown faster than all other economic communities in the last decade, except for ASEAN, which grew at 6.1 percent. The EAC grew at an average of 5.8 percent per year, between 2001-2009 (see figure 4.1) and over the last decade, each EAC country more than doubled its own GDP. The EAC also experienced unprecedented population growth – the region grew by 25 percent from 110 million people in 2002, to 138 million people in 2010. The region's high population growth has been close to 3 percent per year over the last two decades, compared to the Sub-Saharan Africa's average of 2.6 percent. The population in Kenya alone doubled over the last twenty-five years, and rapid population growth is set to continue.

Figure 4.1: Average GDP growth in the EAC has been far ahead of most other economic blocks



Source: World Bank computation based on WDI 2012 data.

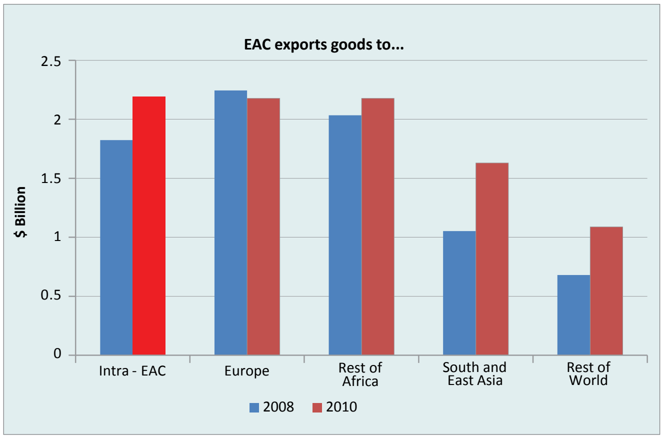
Although each EAC country grew in the last decade, growth was unevenly distributed. Tanzania, Uganda and Rwanda grew at an average of over 7 percent per year between 2002 and 2010, compared to Kenya and Burundi which grew at 3 and 4 percent respectively. Kenya is the largest economy with a GDP of approximately US$ 32 billion in 2010, followed by Tanzania, Uganda and Rwanda, and finally Burundi with a GDP of only US$ 1.6 billion in 2010. Between 2002 and 2010, GDP per capita increased at an average of 112 percent across the region, and now ranges from over US$ 800 in Kenya, to under US$ 200 in Burundi. To reach middle-income status (GDP per capita of US$ 1,000) by 2020 – the ambition of most EAC countries – the region would have to grow at an average of 8.5 percent per year, for the rest of the decade. Rwanda, Tanzania and Uganda, with per capita income somewhat behind the regional average, would have to grow at 10 percent per year, in order to meet that goal, individually[5].

EAC partner states now export more within the EAC region than to any other region. Total goods and services exports from EAC partner states more than tripled over the last decade from US$ 6 billion in 2002 to US$ 19.5 billion in 2010. In 2010, goods exports comprised of US$ 12 million and service exports US$ 7.5 million. The share of total EAC exports traded within the region increased from US$ 1.8 billion in 2008, to US$ 2.2 billion in 2010; surpassing Europe as the region's main trading block (see figure 4.2).

[5] Excluding Burundi from forecast, Regional Economic Outlook, IMF 2011.

In addition, there was a large increase in EAC trade with Asia – as expected, given ASEAN's strong growth record over the past decade. The trend in EAC exports is reflected in the compound annual growth rates (CAGR), where intra-EAC exports exceed those of EAC exports to the rest of the world (see table 4.1). Kenya, Tanzania, and Uganda (the founding members of the EAC) are the main sources of such intra-regional export growth. Over the next few years, Rwanda and Burundi are expected to increase their exports to EAC countries (albeit from relatively low levels), and both countries are expected to see export growth exceed import growth from 2015 onwards (East Africa Corridor Diagnostic Study, 2011).

Figure 4.2: EAC partner states now export more goods within the EAC region than to any other region – which was not the case in 2008



Source: World Bank illustration based on Comtrade data.

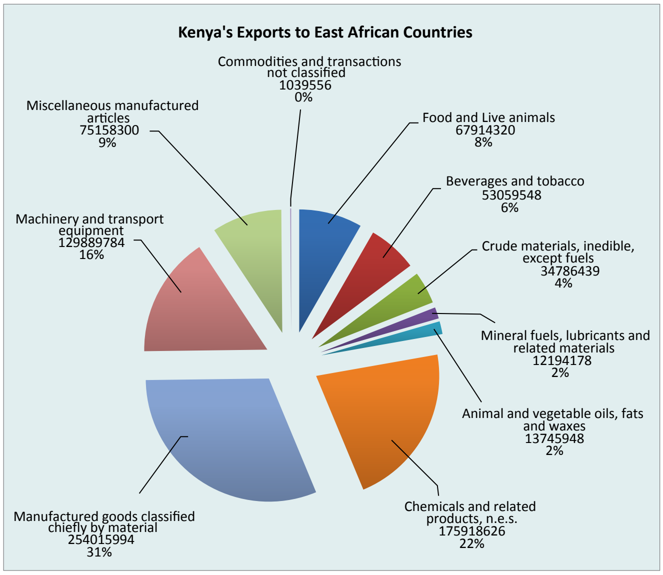
Table 4.1: Dynamic intra-regional exports in East Africa gained in the last decade

	Compound annual growth rates (CAGR) (percent)		
	2000-4	**2004-9**	**2000-9**
EAC exports to the world	13	10	11
EAC exports to the EAC	11	16	14

Source: World Bank calculation based on WITS data.

EAC goods exports are mostly simple manufactured products. Unlike EAC exports outside the region, which are mainly commodities, the bulk of intra-regional exports are manufactured goods (food products, beverages, tobacco, cement) and oil re-exports. There has been limited variation between 2000 and 2009, with the basket of top traded goods within the region remaining broadly the same (see table 1.2). Although a noticeable change is the reduction in the amount of oil traded between EAC countries, which comprised of 41 percent of the top 15 products in 2000 compared to only 11 percent in 2009. This is likely to change once investments in the recent oil discoveries in Kenya begin to come on-stream. Kenyan exports to the EAC have consisted mostly of manufactured goods, chemicals and machinery (see figure 4.3). The value of Kenya's top three products exported to Tanzania and Uganda doubled during 2000-2010, from US$ 97m to US$ 175m, and US$ 31 to US$ 73m, respectively. These consisted of oil, plastics, construction materials, and soaps.

Figure 4.3: Kenya exports mostly manufactured goods, chemicals and machinery to EAC partner states (2009)



Source: World Bank compulation based on WITS data.

Table 4.2: Top 15 products traded between the EAC countries

2000			2009		
Product	**USD 1,000**	**Percent**	**Product**	**USD 1,000**	**Percent**
1. Petroleum oils	186,603	41.4	1. Petroleum oils	160,451	11.2
2. Cement and construction material	14,664	3.3	2. Cement and construction material	115,678	8.1
3. Vegetable oil	12,372	2.7	3. Paper	52,574	3.7
4. Medicaments including veterinary	11,986	2.7	4. Manufactured fertilizers	47,037	3.3
5. Flat-rolled products of iron	11,738	2.6	5. Medicaments including veterinary	44,692	3.1
6. Other crude minerals	11,185	2.5	6. Soaps/cleansers/polishes	37,727	2.6
7. Paper	9,884	2.2	7. Alcoholic beverages	36,296	2.5
8. Articles of plastics)	8,903	2.0	8. Made-up textile articles	34,286	2.4
9. Soaps/cleansers/polishes	8,144	1.8	9. Road motor vehicles	33,396	2.3
10. Cut paper/paperboard and related articles	6,295	1.4	10. Flat-rolled products of iron, clad, plated or coated	32,789	2.3
11. Maize except sweet corn	6,071	1.3	11. Crude vegetable oil	32,065	2.2
12. Rubber tyres	6,037	1.3	12. Other crude minerals	28,638	2.0
13. Glassware	5,945	1.3	13. Cut paper/paperboard and related articles	25,283	1.8
14. Flour/meal wheat/meslin	5,191	1.2	14. Iron and steel bars/rods/etc.	24,164	1.7
15. Edible products	5,122	1.1	15. Articles of plastics	23,441	1.6
Total Trade	**450,993**	**100**	**Total Trade**	**1,430,290**	**100**

Source: World Bank computation based on Comtrade/WITS data.

Although still at low levels, there has been a notable increase in foreign direct investment in the EAC. On average, FDI flows to the EAC (2.5 percent of GDP in 2009) are below the SSA average (4.3 percent of GDP in 2009)[6]. However, FDI flows to the EAC have increased by threefold, from approximately US$ 590 million in 2000 to approximately US$ 1.7 billion in 2010. A recent FDI survey[7] by Ernst and Young shows that Kenya topped the list of East African countries, with the highest growth in new investment projects between 2003 and 2011. Most FDI inflows have been directed towards natural resource sectors. In Tanzania, gold exports already account for more than a third of total exports of goods and services, in Uganda oil production is expected to account for close to 10 percent of GDP, and in Kenya recent oil discoveries have been made. A challenge for the EAC is to stimulate investments beyond natural resources, generate linkages in their economies, and put in place structures for intra-regional FDI. Furthermore, deepening regional integrated would attract more FDI inflows (much of which is likely to come to Kenya), reducing the importance of short-term capital flows for Kenya in offsetting its current account deficit.

4.2 Regional integration can bring substantive benefits[8]

Intra-EAC trade can lead to lower prices for consumers and create more jobs for EAC citizens. Gains are expected from both traditional sources (e.g. economies of scale, increased and more diversified trade and investment), and non-traditional sources (e.g. commitment for domestic reforms, benefits from access to regional public goods, and increased bargaining power in wider trade negotiations). EAC integration will also contribute to greater regional food security. The stages, history and current status of EAC integration is explained in box 4.1.

[6] *FDI for 2009 and 2010 are approximately the same at US$ 1.7 billion, with investments in Uganda and Tanzania helping to prevent a regional downturn.*
[7] *Ernst & Young, Building Bridges in Africa Survey, 2012.*
[8] *This section is based on World Bank, Defragmenting Africa, 2012.*

More intra-EAC trade in agriculture would contribute to food security. The production of food staples for growing urban markets and food deficit rural areas, represents the largest growth opportunity for regional farmers. Given that there is population growth and increased urbanization, Africa's demand for food staples will grow dramatically in the coming decade. Indeed, demand in Africa is expected to double by 2020, primarily in cities. But agricultural resources are not allocated equally across EAC countries, or even within them, so borders often artificially demarcate food surplus areas, from food deficit ones. Regional trade integration can have a substantial impact by better linking farmers to consumers across borders, and in ameliorating the effects of periodic national food shortages, and increasing global food prices. At this stage, however, regional trade in food staples remains far from free, despite efforts for policy and regulatory harmonization. The arbitrary and erratic imposition of barriers undermines private sector confidence to invest, and distorts incentives towards cash crop production away from food staples.

Intra-EAC trade in basic manufactured goods and regional production chains can reduce unemployment. Trade in basic manufactured goods such as plastics, chemicals, paints and cosmetics, construction materials and pharmaceuticals is beginning to materialize in East Africa, but non-tariff barriers are currently limiting such opportunities through increasing production and transport costs. Similarly, prospects for regional production chains driven by trade in parts and components ("trade in tasks"), remain limited due to trade and regulatory barriers, which raise transaction costs and increase uncertainty. The removal of such barriers would encourage vertical specialization, and the emergence of regional production chains, that create employment and promote export diversification.

Intra-EAC trade in services can have significant economy-wide benefits for all EAC countries. Trade in services is particularly important for maintaining the competitiveness of landlocked countries and Uganda is now exporting education services to East Africa and beyond. Over the past 10 years, exports of services from non-oil exporting land-locked countries in Africa have increased at a rate more than three times their exports of goods. For Kenya, firms have become successful exporters of business, financial and distribution services to the EAC region. Services are important for other sectors (agriculture and manufacturing), as services provide critical inputs for most economic activities. Opening up services sectors, through liberalization and reform, improves efficiency and helps attract greater levels of foreign direct investment.

>> Box 4.1: Regional integration and the EAC

What's meant by regional integration?

There are four common stages of regional integration:

- A Customs Union is an agreement between governments to remove regional barriers to trade to form a duty-free trade area. The governments agree upon a common external tariff whereby partner states impose identical rates of tariff on goods imported from foreign countries. The intention is to increase regional economic efficiency, and establish closer ties between partner states. Examples include the European Union Customs Union (EUCU), and the Southern African Customs Union (SACU).
- A Common Market is a market established by governments where there is a free movement of capital, labour and goods. The intention is for partner states to be able to access factors of production without physical or regulatory constraints, and to improve resource allocation. Examples include the European Economic Area (EEA), and Common Economic Space (CES).
- A Monetary Union is an agreement between governments to use the same currency. The intention of a monetary union is often to reduce exchange rate risk and price variability, along with associated benefits of political union. Examples include the CFA Franc (West and Central Africa) and the Economic and Monetary Union (EMU) of the European Union.
- A Political Federation is an agreement between governments to operate under a centralized government recognized internationally as a single political entity. Article 5 of the EAC Treaty sets out the intention to form a political federation, but does not provide for its composition or structure. Examples of political unions include the United States of America and African Union.

A long history of EAC integration efforts

Kenya, Tanzania and Uganda have a long history of successive regional integration arrangements:

- 1927: Customs Union between Kenya, Tanzania and Uganda
- 1948-1961: East African High Commission
- 1961-1967: East African Common Services Organization
- 1967-1977: East African Community
- 1993-2000: East African Co-operation
- 1993: East African Co-operation
- 2000: East African Community
- 2005: East African Community Customs Union
- 2010: East African Community Common Market Protocol

The EAC Treaty establishing the community was signed on 30 November 1999 and entered into force on 7 July 2000 following its ratification by the original three partner states – Kenya, Tanzania and Uganda. Burundi and Rwanda acceded to the EAC Treaty on 18 June 2007. The EAC today is a regional intergovernmental organization of Kenya, Tanzania, Uganda, Rwanda and Burundi, with a headquarters and Secretariat in Arusha, Tanzania. South Sudan has made an application to join the EAC.

EAC collapse in 1977 and lessons learnt

The collapse of the EAC in 1977 can be attributed to a number of reasons; including governance challenges, economic imbalances (in part arising from the socialist system in Tanzania and capitalist system in Kenya), political disagreements, and an extremely limited dissemination of information. Two reasons stand out, first, the relatively low engagement of stakeholders in civil society, the private sector and amongst EAC citizens, in the decision-making and management processes of community integration. And, second, a lack of a dispute resolution process for sharing the costs and benefits arising out of EAC integration. Since 1977, steps have been taken to address some of these problems, including a Mediation Agreement (1984) for determining and diving EAC assets and liabilities, and an agreement for the establishment of the Permanent Tripartite Commission for East African Cooperation (1993). Nonetheless, citizen engagement, knowledge sharing and consensus building are, and will continue to be, key components for successful integration.

The EAC today: good progress but much remains to be done

Out of the four planned stages of EAC integration – Customs Union, Common Market, Monetary Union and Political Federation – the first two stages are currently in effect. The Customs Union protocol established a duty-free trade between the partner states (with the successful reduction of intra-regional tariffs), common customs procedures between the partner states and a common external tariff whereby an identical rate of tariff is imposed on goods imported from foreign countries. The next stage – the Common Market protocol - established a single market allowing the free movement of goods, capital and labour within the region. Partner states have been required to review domestic rules and regulations and ensure compliance with the protocol, in order to harmonize policies and regulations within the region. This involves the removal of restrictions on the free movement of factors of production, and on the right of establishment, and to pursue mutual recognition of academic and professional qualifications. The implementation of the Common Market protocol is still taking effect, with the free movement of goods, capital and labour across all partner states not an every-day reality for many EAC citizens. The third stage – Monetary Union – would bring a single currency to the region, and agreement on the Monetary Union protocol was planned for this year but is behind schedule. The fourth stage – Political Federation – would likely bring a centralized president and parliament, and is planned for 2015, but is perceived by many as too ambitious. Given delays in implementation of both the Customs Union and Common Market, it is expected that the Monetary Union and Political Federation protocols, might be postponed further.

Source: EAC Integration Process & Enabling Peace and Security, Hon. Beatrice B. Kiraso (2009) and EAC Secretariat.

5. Challenges for Advancing the Regional Integration Agenda in East Africa

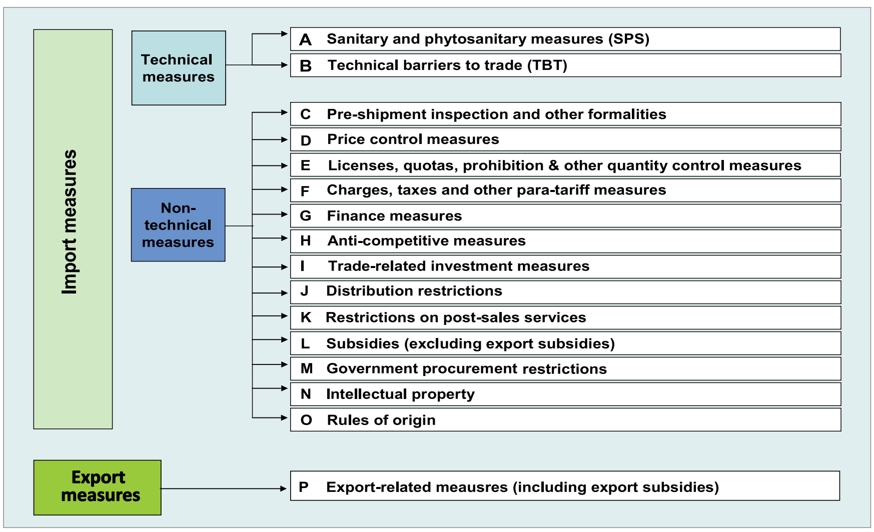
Although EAC integration offers Kenya many opportunities, two key challenges remain: ***non-tariff barriers*** *– rules and regulations that unduly restrict trade, continue to neutralize the impact from successful tariff reductions; and* ***poor export growth and limited diversification*** *– Kenya's imports continue to outgrow Kenya's exports, despite Kenya's promising service sector. These challenges are set against a regional backdrop of physical infrastructure constraints that hinder competitiveness.*

5.1 Non-tariffs barriers (NTBs)

NTBs protect domestic markets. Some of the most cited NTBs which impede regional trade of goods in East Africa are: import and export bans; multiple roadblocks; numerous weighbridges and corruption along the Northern Corridor (see box 6.4); burdensome import licensing requirements; lack of harmonization in regulations related to standards; and, rules of origin. There can be legitimate reasons for governments to introduce rules and regulations, however, such measures can also be imposed to protect domestic markets (as substitutes to tariffs) instead. Moreover, even without protectionist intent, private-sector surveys have repeatedly shown that unduly restrictive or poorly implemented rules and regulations can raise trade costs, divert managerial attention, and penalize small-exporters and those in low-income countries, especially where access to regulatory information is difficult to obtain. In these circumstances, rules and regulations can act as NTBs to trade (see figure 5.1).

NTBs in Kenya and partner states – across a high number of products – limit regional trade. The EAC Secretariat produced a report entitled the EAC Timebound Programme for Elimination of NTBs (the "EAC NTB Report") in which it identified for elimination, approximately 33 NTBs in 2008, and 47 NTBs in 2010. However, majority of these NTBs were not eliminated by the EAC partner states within the agreed timeframe (see section 6 and annexes 5-7 for details). NTBs which were not eliminated predominately concern "soft" rules and regulations, rather than "hard" infrastructure, and range from charges on food products, non-recognition of health and safety standards, lack of harmonized import/ export documentation and procedures, and delays in transit bonds cancellation. In contrast to the

Figure 5.1: Rules and regulations which can become NTBs

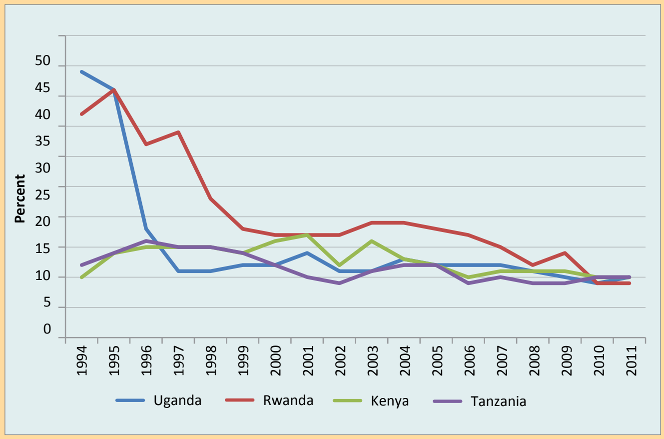


Source: UNCTAD Multi-Agency Support Team (MAST) Report on Non-Tariff Barriers 2009

>> Box 5.1: In contrast to NTBs, tariffs in the EAC have been reduced significantly

In preparation for EAC integration, as well as in response to the Customs Union protocol, intra-regional tariffs in the EAC have been reduced dramatically. In the last two decades, the EAC partner states reduced the number of tariffs from approximately 26 percent in 1994, to 10 percent in 2011 (see figure 5.2). However, the Customs Union protocols calls for tariff-free trade amongst partner states, and it is clear that there is more to be done, until all intra-regional tariffs are removed.

Figure 5.2: Tariff reduction in the EAC



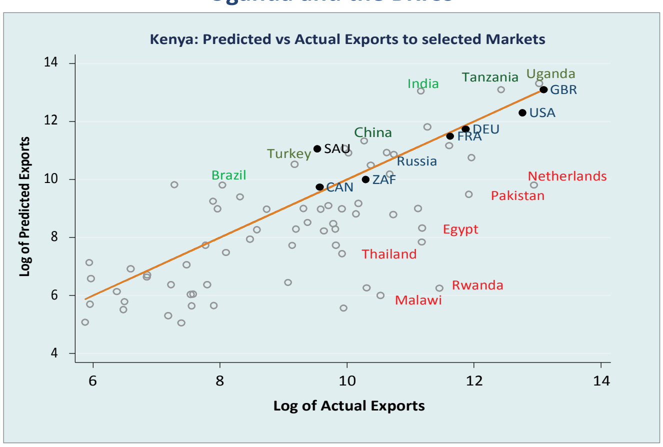
Source: Winston and Castellanos, IMF 2011.

The Common External Tariff (CET) 2007 requires partner states to impose identical rates of tariff on goods imported from foreign countries. However, this has not yet been uniformly applied in practice. An example is the preferential tariff treatment given to a list of approximately 135 imports for Uganda, such as paper board products, millstone, plastic tubes, cosmetics and cement, which would otherwise be subject to the CET 2007. The preferential treatment was agreed in 1994, following Uganda's civil war, however, Ugandan exporters are still able to benefit from that duty remission today, enhancing their competitive position vis-a-vis other partner states. The list was meant to end as the EAC region began to implement the Custom Union protocol in 2005, but it has continued in existence fuelling discontent between EAC traders (allAfrica 2011). In addition to the need for uniform application of the CET 2007, the levels of tariff are also reviewed regularly by the partner states.

Source: World Bank.

experience with NTBs, the EAC partner states have made significant progress in reducing tariffs (see figure 5.2), but the gains have not been felt due to the remaining restrictions on trade.

Figure 5.3: Kenya under exports to Tanzania, Uganda and the BRICS



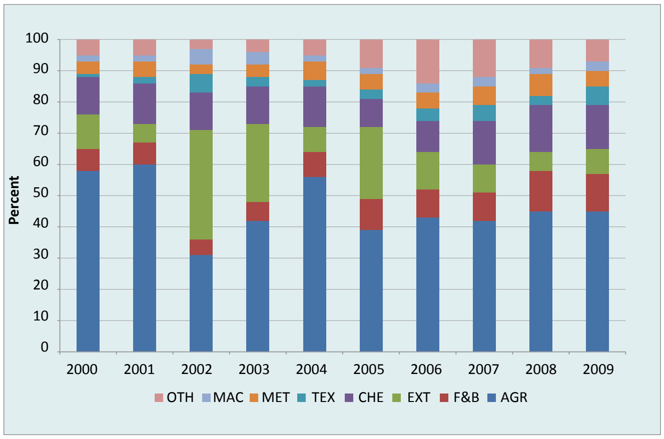
Source: World Bank estimates, Gravity model.

5.2 Poor export growth and limited diversification

Kenyan exports are poorly performing. Based on Kenya's economic size and distance from other markets, it is possible to show both actual and predicted exports (see figure 5.3). Currently Kenya under exports to Tanzania, Uganda and the BRICs (and the countries above the diagonal line in figure 5.3) and has strong export performance to Rwanda and Malawi (and the countries below the diagonal line in figure 5.3). While the geographical distance between Kenya and the BRICs might explain the below par export performance to those countries, for Tanzania and Uganda, NTBs appear to be the binding constraints.

Kenya's imports have grown much faster than exports and export composition remains largely the same. As shown in part I, Kenya's exports have expanded but import growth has been faster reflected in the widening current account deficit. The ratio of Kenya's total exports (goods and services) to GDP, fluctuated between 20 to 28 percent over the last decade, whereas Thailand's ratio increased from 20 to 60 percent during the same period. In addition, Kenya's composition of goods exports has changed little over time (see figure 5.4). Export diversification seems to have stalled since 2005, with the relative composition of exports in agriculture and amongst a variety of manufactured goods, remaining largely the same. Furthermore, export growth appears to have been driven primarily by existing products, in existing markets, with limited new product/new market discovery. Diversification is needed to provide a broader base for sustained export growth, less vulnerability to volatile world prices, and to spread the benefits of trade more widely.

Figure 5.4: Sectoral composition of exports - Since 2005 there has been little export diversification in Kenya



Source: World Bank illustration based on Comtrade 2012 data. Key: AGR = Agriculture, meat and Dairy, seafood; F&B = Food, beverages, tobacco, wood paper; EXT = Extractive industries; CHE = Chemicals, plastics, rubber; TEX = Textiles, apparels leather, footwear; MET= Iron, Steel and other metals; MAC = Machinery, electronics, transportation equipment; OTH= Other Industries. See Appendix 1 Table 1 for detailed HS level 2 codes for each category.

>> Box 5.2: Regional backdrop – Underdeveloped infrastructure, unreliable power and poor business environment

Increasing demand is exerting great pressure on existing road corridors. In 2009, total traffic on the two corridors (Northern and Central) was estimated at 28.6 million tons, which is likely to almost double to 52.5 million tons, within the next three years. Rail transport lags behind road transport, especially for international traffic, and a process to arrive at a more integrated and balanced system is required. Dar es Salaam and Mombasa ports are characterized by high dwell times, inefficient operations and customs, and represent significant time and cost bottlenecks, in particular for the region's landlocked countries. Matching capacity with demand in the ports, road and railway sectors will be key challenges to moving forward, if predicted growth rates in the EAC are to be attained.

Power remains an important infrastructure challenge in the EAC. In Keny, it is currently estimated[9] that unreliable electricity lowers sales revenues of firms by 7 percent, and reduces GDP growth by 1.5 percent annually. The high cost of supplied energy, and the even higher cost of back-up diesel generation has a significant impact on the ability of firms to be competitive. Power demand in the East Africa Power Pool (EAPP) area (comprising of Burundi, DRC, Egypt, Ethiopia, Kenya, Libya, Rwanda, Sudan and Tanzania) is expected to increase by 69 percent over the next ten years. Developing under-exploited hydropower potential in the region, through appropriate regional transmission networks and regulation, will be key to meeting demand, as well as improving security of supply, enhancing environmental quality, and ensuring better economic efficiency.

Distances from global markets hinder the movement of goods, people and services. The EAC's landlocked countries[10], which must move goods long distances over land, are particularly reliant on their neighbors' capacity and willingness, to supply substantial externalities and public goods in form of goods transit policies, regulations, infrastructure, and institutional arrangements. Current divisions associated with the impermeability of borders, and differences and inefficiencies in institutions, regulations, and currencies, exact a major cost on intra-regional trade. For example, it costs US$ 5,000 to transport a container from Mombasa to Bujumbura by road; compared to US$ 1,000 it costs to transport the original container from Japan to Mombasa.

Although the EAC business environment improved in 2010 and 2011, the five economies still lag behind globally, in implementing institutional reforms to improve competiveness[11]. The region's governments implemented ten regulatory reforms last year, to improve the business environment and encourage entrepreneurship in the region. Rwanda led the way by improving its global 'doing business' ranking from position 50 to 45 last year, mostly through improvements for businesses to obtain credit and pay taxes. However, Kenya dropped three places from 106 to 109; Uganda dropped four places, from 119 to 123; Tanzania dropped two places, from 125 to 127; and, Burundi improved eight places to a still dismal 169. As a result, the EAC region as a whole is still struggling in 'doing business' reforms.

[9] *Africa Infrastructure Country Diagnostic, World Bank, 2008.*
[10] *Uganda, Rwanda, Burundi – and, if successful in its bid to join the EAC, South Sudan.*
[11] *Doing Business in the East African Community 2012, World Bank/IFC, 2012.*

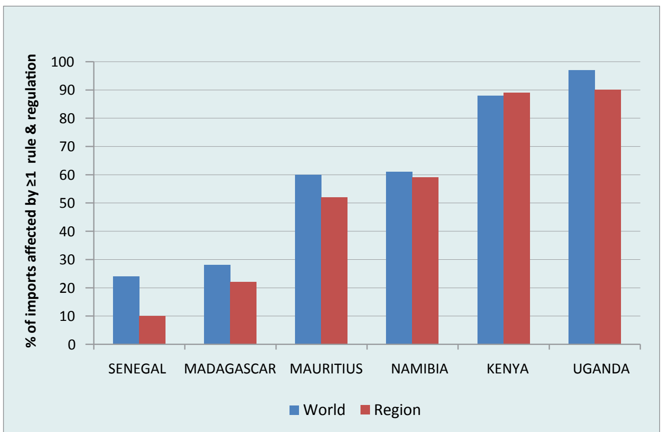
6. Lowering Costs and Increasing Trade - Reducing Kenya's Non-Tariff Barriers

Kenya imposes a large number, and wide variety, of rules and regulations on its imports, particularly from EAC partner states. Where rules and regulations are poorly designed or poorly implemented, they become NTBs. In the food sector, if Kenya were to reduce NTBs it would ease domestic food prices and help the poor. To date, there has been a slow removal of NTBs, and the monitoring committees for NTBs have been largely ineffective. A broad dissemination of the price-raising effect of rules and regulations is needed to inform the review of existing measures, as well as the design and implementation of new rules and regulations. Action is required at both national and regional levels, with effective monitoring, sanctions and appeal mechanisms being put in place.

6.1 Rules and regulations

Kenya imposes a large number of rules and regulations, compared to other African countries. The countries chosen were Kenya, Uganda, Namibia, Mauritius, Madagascar and Senegal. Kenya and Uganda impose significantly more rules and regulations on their regional imports, than do the other Sub-Saharan African countries (see figure 6.1). As mentioned previously, rules and regulations are often imposed for legitimate reasons, such as protecting domestic consumers from counterfeits and sub-standard products – which are often cited; however, such measures can be overly burdensome in design, or well designed, but poorly implemented, unnecessarily constraining the daily operations of EAC producers and traders. In addition, Kenya is the only country compared that imposes more rules and regulations on imports from its regional partners (red column) than on imports from the rest of the world (blue column).

Figure 6.1: Kenya imposes a large number of rules and regulations, particularly against EAC partner states



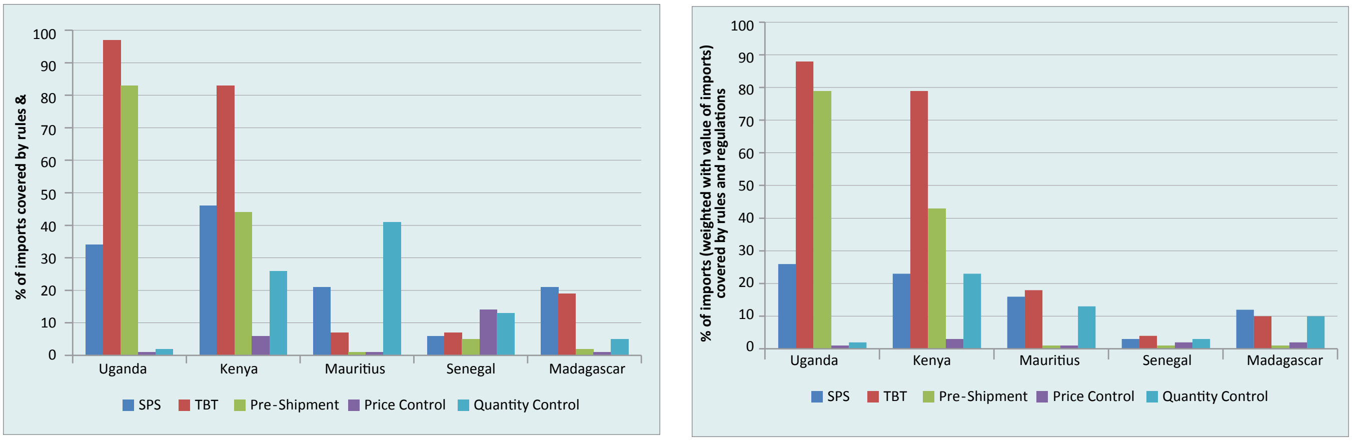
Source: Cadot and Gourdon, World Bank 2012.

Kenya and Uganda may be over-regulating their trade. The frequency[12] and coverage[13] ratios for five different categories of rules and regulations were compared across a selection of SSA countries (see figure 6.2)[14]. The categories of rules and regulations, were (i) sanitary and phytosanitary (SPS), (ii) technical barriers to trade (TBT), (iii) pre-shipment, (iv) price controls and (v) quantity controls. For Kenya and Uganda, the occurrence of pre-shipment measures, SPS measures (intended to protect humans, animals, and plants from diseases, pests, or contaminants) and TBT (which arise when standards, regulations, and assessments systems intended to ensure safety are not applied uniformly), significantly exceeded the levels of other examined African countries. This suggests that Kenya and Uganda may be over-regulating, irrespective of how well designed and implemented the rules and regulations are.

Rules and regulations affect a wide variety of sectors in Kenya. Most rules and regulations are imposed upon metals, machinery and food products (see figure 6.3). For food products, it is somehow expected, since agricultural products which include food and feed — and their control — is essential

[12] *The frequency ratio shows the percentage of import transactions covered by a selected group of rules and regulations for an exporting country. It accounts only for the presence or absence of an NTB, without indicating the value of imports covered.*
[13] *The coverage ratio gives the percentage of trade subject to rules and regulations for an exporting country at a desired level of product aggregation. It allows weighting the frequency ratio with the value of imports for the affected tariff lines.*
[14] *Annex 3 sets out the number of products covered by at least one rule or regulation.*

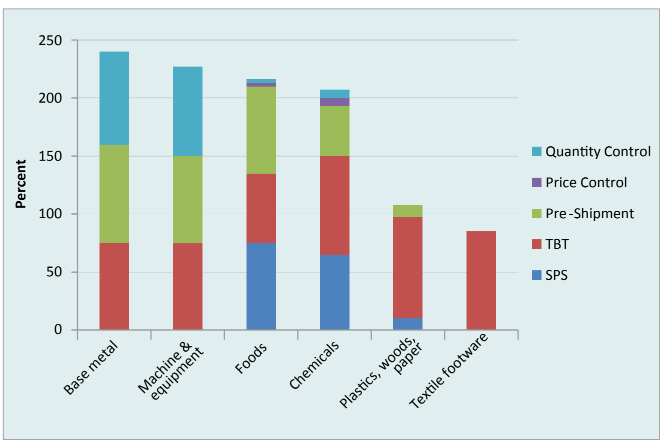
Figure 6.2: Kenya and Uganda impose a wide variety of rules and regulations



Key: Sanitary and Phytosanitary (SPS); Technical Barriers to Trade (TBT).
Source: Cadot and Gourdon, World Bank 2012.

for ensuring health and well being of consumers, and protection of the environment. These rules and regulations are normally sanitary and phytosanitary (SPS) measures (which cover 75 percent of food products in Kenya). However, TBT measures – which result from poor application of rules and regulations – cover 60 percent of food products in Kenya (while usually the average for other countries is 20 percent). TBT measures are the most common rules and regulations in Kenya, with prevalence across a wide range of products (woods, paper, textile, footwear etc). Common types of TBTs include rules for product weight, size, and packaging, as well as mandatory labeling, shelf-life restrictions, and import testing.

Figure 6.3: Kenya's sectors with the most rules and regulations – metals, machinery and…food products



Source: Cadot and Gourdon, World Bank 2012.

6.2 Stabilizing food prices in Kenya

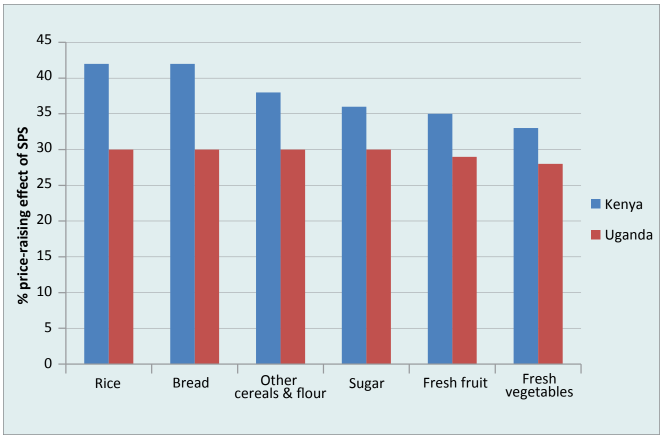
Despite Kenya being a food deficit country, rules and regulations are prevalent on food products, thereby deterring food imports, and raising the price of domestic foods. Kenya's food sector is mostly affected by SPS, TBT, and inspection rules and regulations (see figure 6.3). SPS and TBT measures raise domestic prices by increasing production costs for domestic and foreign producers. Their price-raising effect is typically a by-product, rather than, the main objective of the measures, which have non-trade objectives, such as public health. Because SPS measures can be justified by non-trade objectives, assessing their impact requires a cost-benefit analysis. For example, when the price-raising effect of a SPS measure is strong, it must bring substantial benefits, in order to be justified. The statistically significant price-raising effects of SPS measures on food categories in both Kenya and Uganda[15] is shown in figure 6.4. From this it is clear that the price of rice and bread in Kenya is 42 percent higher, and the price of fresh fruit and vegetables over 30 percent higher, than they would be otherwise[16]. As a result, Kenyan consumers are significantly losing out and domestic producers benefiting only to the extent of their limited production.

[15] Annex 4 sets out in more detail the estimated price-raising effect of NTBs, by product, for Kenya and comparator countries.
[16] The estimated "price gaps" refer to the difference between domestic prices and the sample average at the product level.

In addition to higher food prices, NTBs hamper production potential. Farmers in the food surplus countries (e.g. Uganda) would benefit from increased sales, as well as consumers in the food deficit countries (e.g. Kenya); through lower food prices and less food shortages (see box 6.1). The EAC maize balance sheet was in fact positive in 2006-2008 (see figure 6.5).

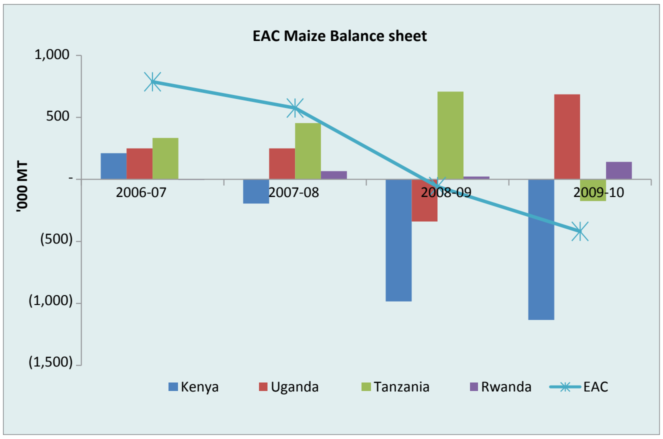
Poorest households in Kenya are mostly affected by rules and regulations on food. The number of rules and regulations on food products rank a close third after those on metals and machinery. In Kenya, as with most countries, low income groups consume relatively more of food products, and are more vulnerable to inflation (see figure 6.7). The price-raising effect of rules and regulations can be seen on

Figure 6.4: Significant price-raising effect of SPS on food types in Kenya and Uganda



Source: Cadot and Gourdon, World Bank 2012.

Figure 6.5: Food surplus and deficit countries in the EAC



Source: World Bank computations based on data from RATIN.

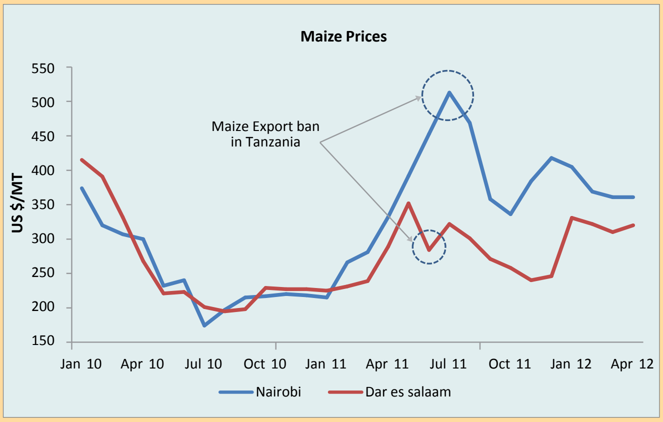
>> Box 6.1: Openness to regional trade can be a win-win.......East Africa can feed itself

2011 will be remembered for the challenging economic times, when food and fuel prices soared not just in Africa but globally. The drought in the horn of Africa unmasked the region's vulnerability to recurrent droughts. In Kenya, more than 3.7 million people were affected by the drought. The country also had an influx of refugees from neighboring Somalia, in Dadaab refugee camp, creating an additional burden to the country.

The food crisis put the spirit of EAC regional integration to the test. Tanzania is one of the countries in the region, which often produces more than its food requirements (see figure 6.5). In 2011, Tanzania produced 1.1 million tons of maize, more than its domestic requirements, while Kenya faced a food crisis. However, in July 2011 Tanzania placed an export ban on maize to the EAC region, and beyond. At this time 100,000 tons had been ear-marked for export to the region.

The end result was a lose–lose. Prices in Tanzanian fell, so the farmers lost the producer prices they would have otherwise enjoyed. Prices peaked in other countries, so the consumers lost. Figure 6.6 shows the unfolding scenario between Kenya and Tanzania; in Kenya prices peaked to US$ 513 per ton, while in Tanzania prices dropped to US$ 284 per ton. The prices shown here are retail prices, so presumably producer prices for the Tanzanian farmers were much lower. It is not clear if the ban remains, or if it has been lifted.

Figure 6.6: Restricted trade resulted in a recent lose-lose for Tanzania producers and Kenyan consumers



Source: World Bank computations based on data from RATIN.

Source: World Bank.

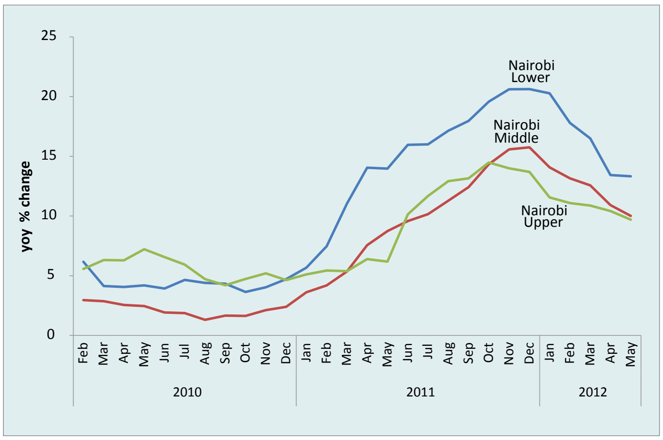
different income groups (figure 6.8). For example, due to SPS measures, the poorest 20 percent of households in Kenya will experience on average a 23 percent rise in goods they purchase, compared to only a 14 percent rise in goods purchased for the 20 percent richest households. These findings demonstrate that the NTB agenda is not only extremely important for Kenya's trade competitiveness, but also for poverty reduction (see box 6.2 on NTBs for maize in the EAC).

Certain rules and regulations have become NTBs in Kenya's food sector. There are legitimate reasons for governments to introduce rules and regulations in order to protect consumers (such as food safety regulations), but where rules and regulations are unduly restrictive or poorly designed or implemented, NTBs result. The EAC NTB report[17] identified NTBs for elimination, and those which relate to the region's food sector and have not been eliminated,[18] are set out in table 6.1. The NTBs range from non-recognition of SPS certificates by Kenya on Ugandan tea, administrative delays in maize clearance, cumbersome processes for food products, and other charges and bonds (see box 6.3 for a diary standards case study).

6.3 Institutional failures

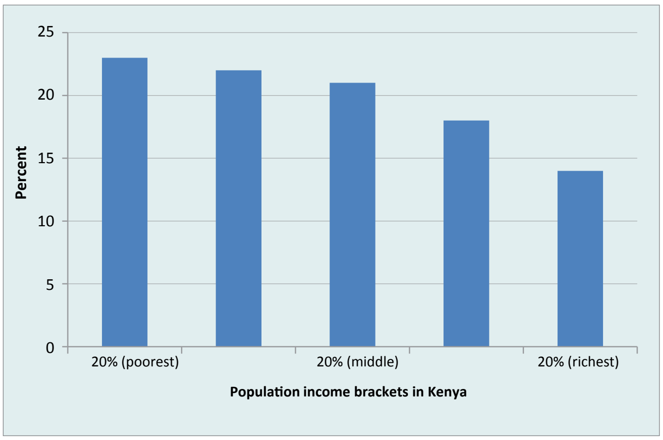
The established reporting mechanisms and monitoring committees for NTBs have so far been ineffective. Raising awareness and improving transparency are necessary steps but it is becoming increasingly apparent that they are not sufficient, due to lack of progress in removing identified NTBs. Only 50 percent of the NTBs identified by EAC in 2008, and approximately 30 percent in 2011, were eliminated by partner states within the agreed timeframe (see annex 6-8 for details). In addition, in 2008 there were more NTBs in higher categories[19] (requiring less than 6 months for removal), whereas in 2011 there were more NTBs in lower categories, especially in category D, where over one year is required to eliminate each NTB (see figure 6.9); reflecting possibly an increased political resistance to consider NTBs for more rapid removal. To date, the approach to eliminate NTBs has focused on establishing national monitoring committees and publicizing specific NTBs, but without sufficient attention being paid to the actual reduction efforts. The absence of a clearly defined monitoring mechanism with time limits for action, means that each partner state is responsible for

Figure 6.7: Lower income groups are hurt more by inflation



Source: World Bank based on CBK and KTB data.

Figure 6.8: Price-raising effect (%) of (SPS) measures hurt low-income groups the most



Source: Cadot and Gourdon, World Bank 2012.

[17] *EAC Secretariat, Draft EAC Timebound Programme for Elimination of Identified NTBs.*
[18] *As at the time of publication of the EAC NTB report.*
[19] *The EAC Secretariat has defined 4 categories of NTBs (categorized on the basis of ease of removal, and degree of trade distortion): Category A – To be addressed immediately; (ii) Category B – To be addressed in 1-6 months; (iii) Category C – To be addressed in 6-12 months; and (iv) Category D – To be addressed in >12 months. Annex 5 shows a line item analysis of each identified NTB, its period for elimination and whether or not it was eliminated on time.*

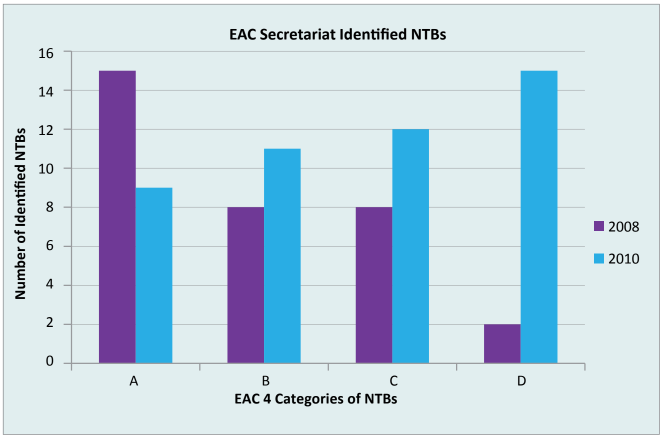
Table 6.1: Existing NTBs in the food sector – Identified in the EAC NTB Report

NTB summary description	Affected countries	Ministry, Department, or Agency responsible	Impact to businesses	Action required	Bottlenecks preventing action	Latest update from EAC Secretariat Time Bound Publication
Non recognition by Kenya for SPS certificates issued by Uganda for tea destined for Mombasa action.	Uganda.	Ministry of Agriculture Kenya.	Uganda to identify.	Mutual recognition of SPS certificates.	Resistance from issuing authority.	Kenya reported that it recognizes SPS for transit tea meant for exports. Still a problem on the ground.
Charges on plant import permit (PIP) at Malaba on Ugandan tea destined for auction at Mombasa.	Uganda and Burundi.	Kenya Plant Health Services.	Adds to cost of doing business.	Abolish charges.	Resistance from issuing authority.	SPS certificate required for tea destined for Mombasa auction. Other issues will be addressed once the EAC draft protocol on SPS is finalized. Timeframe pushed to December 2012.
Ugandan ban on beef & beef products from Kenya.	Kenya.	Uganda Departments of Veterinary Services; Ministries of livestock development and Agriculture.	Ban on market entry and loss of potential markets.	Political goodwill to mutually recognize inspection procedures, inspection reports and certificates.	Pressure from businesses not to recognize products from within EAC due to fear of loss of markets.	Uganda to report when it will lift the ban.
Uganda's certification procedures on exports of milk from Kenya.	Kenya.	Uganda dairy board.	Denial of market entry. Loss of potential market valued at USD 1 million for one Kenyan milk processor.	Political goodwill to mutually recognize inspection procedures, inspection reports and certificates.	Pressure from businesses not to recognize products from within EAC due to fear of loss of markets.	Uganda to report when it will lift the ban.
Requirement that to export herbal products to Tanzania one must either be a member of the Tanzania Herbalists Organization or declare the formulas used.	Uganda.	Tanzania Herbalists Organization.	Ban of products.	Abolition of the requirement.	Unknown.	Tanzania to report back.
Tanzania require cash bonds for transportation of sugar to Rwanda.	Rwanda.	Tanzania Revenue Authority .	Adds to cost of doing business.	Abolition of the requirement.	Unknown.	Tanzania to report back.

NTB summary description	Affected countries	Ministry, Department, or Agency responsible	Impact to businesses	Action required	Bottlenecks preventing action	Latest update from EAC Secretariat Time Bound Publication
Charge of Kshs 5,000 by Kenyan Plant Health Inspectorate Services for every truck entering Kenya carrying Rwandan Tea.	Rwanda.	Kenya Plant Health Services.	Increases cost of doing business.	Abolishment of the charge.	Unknown.	Kenya to remove charges.
Complaints on administrative delays in maize clearance in Busia and Malaba borders.	Uganda.	Kenya.	Delays in clearance; increased cost of doing business.	Harmonize policies on SPS and GMO.	EAC SPS Protocol to address the matter.	Kenya to comply with regional laws and policies.
Cumbersome registration, testing and certification procedures for food products.	Kenya.	Tanzania Food and Drug Administration.	Delays in food trade.	Need to harmonize national export / import procedures under one body.	Insistence by TFDA to duplicate efforts of the Bureau of Standards.	Need to harmonize the procedures.
Wheat flour value addition into Rwanda and Kenya.	Tanzania.	Rwanda and Kenya.	Delays in clearance of goods. Increases cost of doing business.	Verification exercise to be conducted urgently.	Unknown.	The EAC Secretariat to obtain information from Tanzania and report back.
Konyagi has been refused entry into Kenya for not meeting international standards of alcohol content (37.5%) vs 35%.	Tanzania.	Kenya.	Increases cost of doing business.	Mutual recognition of standards to be adhered to.	Kenya must be willing to accept Konyagi standard.	Urge Kenya to comply with regional standards.

Source: World Bank analysis of EAC NTB Report.

Figure 6.9: More and more NTBs identified, but more and more time given for removal



Source: World Bank analysis of the EAC NTB Report.

voluntarily removing NTBs, without being subject to possible sanctions for non-compliance (R. Kirk, Defragmenting Africa, World Bank 2012).

With the high prevalence and price raising effects of rules and regulations, trade in food products in the EAC remains restricted. Kenya is a maize deficit country, yet interventions such as those by the National Cereals and Produce Board (NCBP) (see box 6.2) serve to discourage the development of intra-regional trade and do little to support job creation amongst smallholders, who have little interaction with the NCBP, and who buy most of their maize from large farms in the Rift Valley. Any reforms where the status-quo benefits a small group, and the costs are borne by many, are difficult. The challenge to activate a critical mass for consensus and reforms is often huge. Groups in danger of losing their privileges will be determined to prevent restructuring. Nevertheless, the potential gains to the economy and to producers and consumers of food, are substantial.

Export taxes impose costs and inhibit the development of regional chains and export diversification. A case in point is the illegal imposition of cess charges by county and local councils, on export products which affect the competitiveness of Kenya's horticulture sector, by raising the costs of doing business. These authorities are governed by directives from the Ministry of Local Government, and efforts by the Ministry of Agriculture to prevent the practice, are not successful. In addition, levies, taxation, licenses and permits differ between local authorities, and can be revised without consultation with the business community. A producer who was interviewed, said that government bodies seem to look upon the export horticulture sector, as a cash-cow that is easily milked. Cess charges at road blocks can add up to KES. 40,000 per month for a single truck, with one grower estimating that his lorries spend a total of 45 hours each month at roadblocks, between Nairobi and Naivasha (World Bank discussions with traders, 2012). Such charges increase the cost of

>> Box 6.2: Case Study – NTBs affecting maize, who's capturing the rents?

Maize policy in Kenya is characterized by efforts to support and stabilize prices through the operations of the National Cereals and Produce Board (NCPB). In the 1980s, the NCPB played a major role in the domestic maize market, purchasing 600,000 to 800,000 tons annually. Since then, maize markets have been liberalized and private sector trade plays a much larger role. However, NCPB continues to purchase maize to defend a floor price. Since 2000, NCPB purchases have been 30,000 to 190,000 tons per year. NCPB operations are estimated to have increased domestic maize prices by 20 percent during 1995-2004. Its purchases had a large effect on prices, because they account for 25 to5 percent of all maize sold by the agricultural sector in Kenya. Most of the maize purchased has been directly from large-scale farmers in the Rift Valley. To defend high maize prices, the government has limited maize imports. In mid-2001, a temporary ban was imposed on cross-border imports of maize, because of low prices associated with a good harvest. Another temporary ban was introduced in 2004, in response to an outbreak of aflatoxin poisoning argued to be caused by imports from Uganda. And recently Kenya prevented Tanzanian trucks carrying maize, from entering Kenya, forcing them to off-load and reload onto Kenyan trucks. The main beneficiaries from high maize prices within the country have been the farms, while the main losers have been the net buyers, i.e. urban consumers and maize purchasing rural households.

Source: Based on World Bank Kenya Economic Update analysis (2009).

Kenyan goods, making farmers less competitive than they would normally be in the EAC market. Also, these charges are illegal, and only compound national efforts to remove NTBs agreed regionally.

Standards need to be specific to the market. The development of an appropriate standard may be desirable at a regional, rather than national level, in order to exploit economies of scale in regulatory expertise, prevent fragmentation of the market by differences in standards, and to limit the scope for regulatory capture. However, it is important to tailor those standards to the specific preferences and needs of regional actor, in order to avoid non-compliance or unnecessary implementation costs (see box 6.3).

>> Box 6.3: Case Study – Harmonized EAC dairy standards are a potential NTB

Consistent with developed country norms, the newly developed EAC standards focus on pasteurization as the key to ensuring product safety. This technology is widespread in developed countries, but is difficult and expensive to apply in the context of smallholder dairying, which is the dominant form of production in East Africa. While smallholders in Africa can, and do supply perfectly good raw milk for pasteurization, the infrastructure and quality control systems needed for delivery of smallholder supplies to a processing plant, results in consumer prices that are four to five times higher than for raw milk traded through informal channels.

Moreover, consumers in East Africa have found an alternative to reducing health hazards not recognized in the EAC standards, which is to consume raw milk after boiling. This practice reduces the otherwise high bacteria levels found in East African milk, to safe levels, a point not recognized during the harmonization process, because the Codex standards were developed for Western countries, which consume pasteurized milk.

As a result of setting the regional standards too high, the EAC's harmonized dairy standards have been difficult to implement, and provide little practical guidance for farmers, dairy traders, and large processors, on how to upgrade their operation. According to the letter of the law, more than 95 percent of the EAC's milk supply is technically illegal because it does not comply with the new standards requirements, and could be stopped from regional trade at any time.

Source: World Bank, Africa Can Feed Africa, 2012.

>> Box 6.4: What really happens along the northern transit corridor? Things you need to know…

This case study is based on the experience of thirteen drivers who made fifteen trips along the Northern Corridor. Thirteen trips transported imports from the port of Mombasa, and two of the trips transported exports back to the port.

At the port of Mombasa and its licensed Container Freight Stations drivers can wait for more than 5 hours to load their trucks unless they pay 'facilitation' fees. The longest waiting duration along the entire corridor is at the port of Mombasa. If trucking companies are large enough, they may be able to build warehouses in Mombasa, to cut down on the loading duration and inefficiency. However, this response further entrenches the cartel structure of the trucking industry.

Queues can take between 1 to 2 hours at each weighbridge. There are 6 weighbridges in Kenya, and 3 in Uganda. It takes approximately 20 minutes to weigh a truck but the greatest challenge is the long queues before reaching the weighbridge. As a result, there is a clear incentive for truck drivers to pay bribes in order to skip the queues.

Travel costs are significantly affected by fuel costs. Fuel cost accounts for about 20 percent of the transport cost. In addition to the direct cost of fuel, trucks have to pay for the weight of the fuel on weighbridges. A Mombasa-Kigali journey requires 1,000 litres of fuel, which translates to 1 ton in weight. This takes the space of one ton of the payload and if the truck is overloaded there is a fine of US $ 115 and the truck is detained at the weighbridge.

Overloaded trucks damage the Kenyan roads. The Kenyan authorities impose a maximum axle load requirement to protect their roads; however, the limit has become a controversial issue in the EAC region. In practice, many overloaded trucks manage to avoid being caught at weighbridges with drivers paying a small price (e.g. 500skh) in individual bribes, compared to the significant cost to the Kenyan economy of the damaged roads.

Competition amongst industry players, and recklessness amongst some truck drivers, contributes to many road accidents. Some truck drivers rush to make deliveries so that they can return quickly for more business. Should an accident occur and the driver not be injured, a lot of time is spent waiting for the police to respond and, since the police lack the necessary equipment for moving damaged trucks, waiting for the truck company to send a towing vehicle.

Trucks have been prevented from carrying return cargo – which acts as a NTB – but rules are changing. Protectionist policies have prevented trucks from carrying return goods, even if it is within the EAC – leading to idle capacity, inefficiencies, increased levels of transit traffic and associated higher transport costs. However, late last year, KRA announced that this rule will be reversed, to permit cargo to be carried, but only if trucks are fitted with an electronic tracking system. The Kenyan Transport Association has raised concerns on whether or not the policy will be applied evenly amongst EAC partner states.

Source: World Bank.

7. Growing and Diversifying Kenya's Exports – Services Matter

Although Kenya's export performance has improved over the last decade, imports have grown much faster. Kenya's top exports consist of traditional agriculture (tea and coffee) and horticulture products, as well as manufacturing and services. Kenya's services have experienced dynamic growth and the sector has further potential for expansion. However, regulatory barriers restrict services, particularly in the banking, professional and business sectors. Services trade liberalization and regulatory reform are needed to build compatibility, harmonize standards, recognize qualifications, and strengthen the business environment to enable Kenya to benefit fully from EAC integration

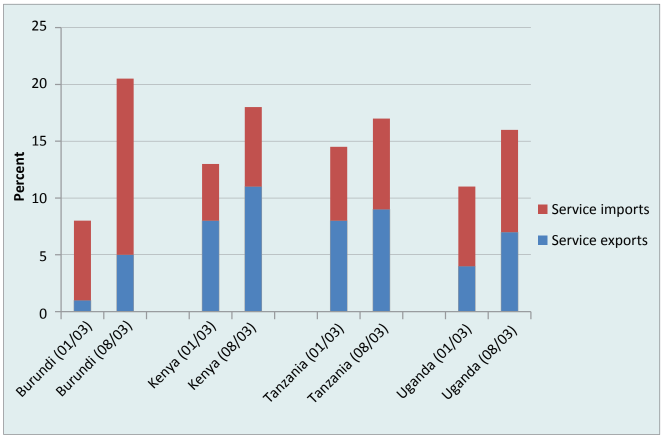
7.1 Kenya's promising service sector

Kenya's exports can be classified into four categories. Traditional agricultural exports (tea, coffee), non-traditional agricultural exports (horticulture), manufacturing and services. While Kenya has historically depended upon tea for export earnings, manufacturing and services have grown in recent years. Dependent upon oil imports, Kenya's manufacturing sector is vulnerable to trade shocks, and global competitiveness depends upon infrastructure investments and reducing NTBs, and the ability to modernize and strengthen the port of Mombasa as a coastal hub.

Kenya's trade in services[20] has experienced recent growth. In 2010, Kenya's services exports as a percentage of GDP were higher than the ratios registered by countries at similar levels of development, implying that the country's services exports are above the sample average conditional on the level of per capita income. This suggests that Kenya has a comparative advantage in the export of services. Services exports in Kenya increased from less than 8 percent in 2001-2003 to 11 percent of GDP in 2008-2010 (see figure 7.1), and registered a positive balance throughout the last decade (see figure 7.2).

Furthermore, Kenya has additional scope to develop its services sector, and the compound average growth rate (CGAR) for Kenya's services exports in 2000-2008 was almost 15 percent, whereas for services imports it was 10.5 percent. The EAC region as a whole, has also performed strongly in service exports; Rwanda's CGAR for services exports over the same period was 19.5 percent (albeit from a lower base), and for services imports was 14.6 percent; while Uganda's CGAR for services exports was 17 percent and for services imports was almost 15 percent.

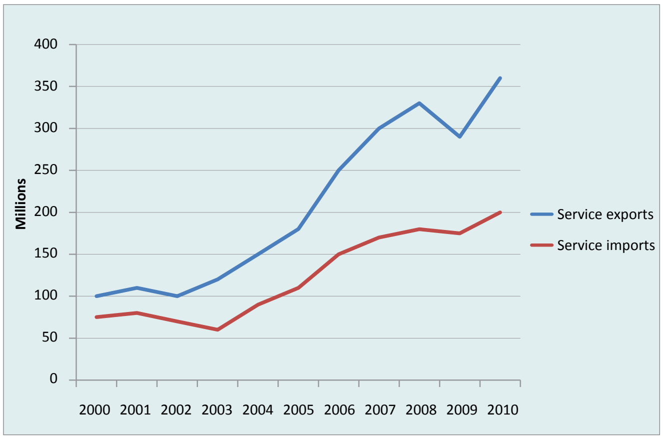
Figure 7.1: Service exports have increased for all EAC countries, but particularly Kenya



Source: World Bank analysis based on IMF BOP and WDI 2012 data.

[20] *Trade in services takes four different forms: (i) cross-border supply– similar to trade in goods – that involves services flows from one country to another such as banking services transmitted via email; (ii) consumption abroad that refers to situations where a consumer – a tourist or a student – moves to another country to obtain the service; (iii) commercial presence that implies that a service supplier of one country establishes a territorial presence, including through ownership or lease of premises, in another country to provide a service (for example, domestic subsidiaries of foreign insurance companies or hotel chains); and (iv) presence of natural persons that consists of persons of one country entering the territory of another country to supply a service (for example, doctors or teachers).*

Figure 7.2: Kenya is exporting more services than ever before, and the gap between service exports and imports is growing



Source: World Bank analysis based on IMF BOP 2012 data.

Kenya is in early stages of exporting higher value added services. Kenya's revealed comparative advantage[21] in services exports is in four sub-sectors: transportation, communication, financial and cultural services (see table 7.1). These figures suggest that consistent exports of other higher value added sectors such as business process outsourcing (BPO), information communication technology (ICT), and insurance services have yet to fully emerge. But anecdotal evidence suggests that Kenya has already started to take advantage of the growing opportunities, in these areas.

Table 7.1: Kenya has a revealed comparative advantage in services shown in bold (2010)

Commercial	0.82
Transportation	**1.30**
Travel	0.62
Communication	**1.80**
Insurance	1.02
Financial	**2.09**
ICT	0.02
Personal, cultural & recreational	**1.68**

Source: World Bank analysis based on IMF BOP 2012 data.

7.2 Unleashing Kenya's services

Financial services[22]

Kenya-based banks are leading regional integration in the EAC banking sector... About eleven multinational and Kenyan owned banks, use Kenya as a hub to expand their operations in the EAC region. There are four indigenous Kenyan banks with branches within the region. These banks include Kenya Commercial Bank (KCB), Equity Bank, Fina Bank, and Commercial Bank of Africa. These banks have a total of 63 branches outside Kenya (16 in Tanzania, 31 in Uganda and 16 in Rwanda). A 2009 World Bank survey revealed that 56 percent of the banks operating in the East African region are hubbed in Kenya. Most of the banks surveyed have yet to achieve full integration of their operations in the region, but partial integration has taken place in the areas of ICT, risk management, customer service, and treasury operations. Two-thirds of the banks state that regionalization has facilitated the introduction of financial products and services, which would not have been possible in the absence of scale.

...but differences in regulations limit their benefits from regional integration. The establishment of a single licensing regime, which would remove barriers to entry posed by separate capitalization requirements for each subsidiary, and enable cross-border branching, is favored by a majority of the banks as a measure which would promote deeper integration. Major impediments to attaining full integration cited by banks are: the lack of a common tax regime; resistance from bank supervisors (particularly in Tanzania and Uganda, who are averse to banks under their jurisdiction, being managed by Kenyan parents); differing regulatory requirements; restrictions on the mobility of labor; and, the existence of differing capital movement polices within the EAC.

[21] *The index of revealed comparative advantage (RCA) initially introduced by Balassa (1965) can be used to assess the structure of a country's exports. The RCA for a services sector is the country's share of world exports of a service divided by its share of total world services exports. A value of the index greater than unity implies that a country is relatively specialized in the services sector and thus has a revealed comparative advantage in such exports compared with the world average.*

[22] *The section, including policy recommendations, is based on Wagh, Lovegrove and Kasangaki, World Bank, Defragmenting Africa 2012.*

Distribution services[23]

Kenyan supermarkets began establishing foreign operations in the EAC in about 2002 and have since stepped up their efforts to penetrate the regional market. Currently, the three largest Kenyan supermarkets have a combined total of seven branches in Uganda, and two in Rwanda. The main market entry strategy employed by these supermarkets has been the acquisition of existing supermarket chains. In 2011, Tuskys acquired the Ugandan supermarket chains, Good Price and Half Price, and has now four stores in Uganda. The estimated Kenyan FDI in the East African supermarket segment amounts to about US$ 22 million (see table 7.2). Total Kenyan FDI outflow in distribution services is estimated to be around US$ 26 to 32 million, over the period 2002–2009. Expected investment in the EAC distribution services sector over the next five years is projected to be between US$ 30 to 50 million.

Table 7.2: Kenyan Supermarkets with EAC Presence[24]

Kenyan Supermarket	No. of Branches in EAC Countries		Estimated FDI Investment Flows* ($ millions)
	Uganda	Rwanda	
Nakumatt	2	2	8.25
Tuskys	4		11
Uchumi	1		2.75
Total	**7**	**2**	**22**

Source: World Bank (2011).

With a population of approximately 140 million people, the East Africa region provides a vast retail market for formal retail traders, with important benefits for consumers and producers. According to Nakumatt Holdings Research, the current regional population has an opportunity to sustain at least 10 major retail stores in each town. In the next ten years, Nakumatt Holdings is forecasting that close to 25 million customers across the region will have access to formal retail trade facilities, with monthly sales reaching the US$ 700 million mark, and selling space reaching close to 40 million square feet, up from 15 million square feet today (Nakumat CBC, 2011).

Kenya's presence in the distribution sector of the East African economies has been made possible by extensive trade liberalization measures, adopted by the EAC, but regulatory barriers remain. Major drivers of investment in East Africa include the adoption of the EAC Common Market Protocol, and the harmonization of tax regimes, and customs import regulations. Although all East African countries have made progress in removing explicit restrictions to trade, the lack of regulation in critical areas, and onerous regulation affecting the entry and operation of firms, continue to pose serious problems to competition, and affect trade and investment in the distribution sector.

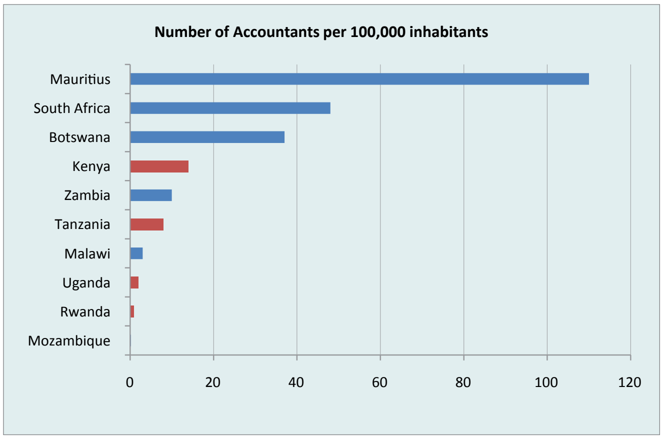
Business services[25]

Kenya has several world class firms that already provide and export business services[26] **to the region, and beyond.** A recent survey of over fifty Kenyan business services exporters undertaken by the World Bank reveals that the subsectors with greatest export turnover totals are insurance, accounting, non-banking financial, and BPO services. The substantive scope for trade in certain professional services, such as accounting is further confirmed by the heterogeneity of professional endowments across countries. Kenya has a relative abundance of professionals, whereas in Rwanda, there is a relative scarcity of professionals, suggesting a good potential for intra-regional trade, based on comparative advantage (see figure 7.3).

Kenyan firms are starting to export higher value business services. Despite the novelty of exporting business services, and in contrast with most developing countries that tend to export

[23] *The section, including policy recommendations, is based on Dihel (2012), World Bank, Defragmenting Africa 2012.*
[24] *Average investment required for establishing a supermarket in EAC is US$ 2.75 million. This figure was calculated using past investment spend of Kenyan supermarkets in EAC. Nakumatt invested about US$ 3 million for each of its Uganda branches, US$ 2.5 million of their Rwanda branch. Uchumi invested about US$ 2 million for its branch in Uganda, and are poised to spend US$ 2.5 million for their planned branch in Tanzania.*
[25] *This section, including policy recommendations, is based on World Bank, Exporting Services 2012 and World Bank, Developing Professional Services in Africa, 2011.*
[26] *Business services are generally provided on a private sector basis and require a high level of skills that are usually certified, and include accounting, architectural, engineering, legal, BPO, ICT, information communication technology enabled services (ITeS), and more.*

Figure 7.3: Kenya can export professional services to Uganda and Rwanda



Source World Bank, Developing Professional Services, 2011.

basic business services (such as back office tasks, or low value offshoring), Kenyan firms are starting to export higher value offshoring services, such as product development, R&D, business ventures, and transformational sourcing (see box 7.1). There could be substantial gains for Kenya's economy from expanding the number of these firms.

The recent success of Kenyan services exporters has occurred at both the regional and international levels. At the regional level, Kenyan firms are premium quality service providers, especially in countries which lack skilled professionals. Kenyan firms are perceived as superior, and offer better services compared to local counterparts, and at lower rates compared to international or developed countries' providers. Kenyan firms have a competitive advantage in understanding target markets in the East Africa region, due to their knowledge of soft or cultural issues, such as the slow pace of conducting business or the insistence on face to face meetings. South African and developed countries' service firms that do not possess such skills, have failed to penetrate the EAC market. At the international level, Kenyan firms are value service providers, able to provide quality services at lower costs, compared to providers from the foreign market.

But Kenyan exporters of business services are facing a variety of challenges. At the regional level, numerous barriers limit the mobility of professionals, and differences in regulation, further segment the markets for business services in East Africa. Skills mismatches and skills shortages, pose as a significant challenge to many Kenyan exporters. Another factor that constrains service providers from exporting, is a widespread lack of knowledge about exporting opportunities, markets, and processes, and a lack of awareness, on how to acquire such knowledge. Very often, Kenyan service providers - especially smaller ones - lack international networks, and find it very difficult to obtain market intelligence on foreign markets (see box 7.1). Finally, difficulties in penetrating foreign markets, also come from Kenya's low international brand equity, as a business service provider.

>> Box 7.1: Knowledge sharing for service sectors

To assist with the implementation of MRAs, the World Bank Professional Services Knowledge Platform for Eastern and Southern Africa is being developed to provide:

- Information and analysis of the current situation regarding the performance of the particular sector, and its impact on other sectors, and the wider economy. This may require surveys of both users and providers of the service.
- An assessment of barriers to trade and foreign investment, and current regulatory policies in the form of a trade, and regulatory audit together with an assessment of their impact on entry and conduct in the market.
- A review of the necessary steps to remove explicit barriers to trade, and the regulatory options for an integrated services market, including measures that can be pursued at the national level, and those that are likely to be more effective in collaboration with partner countries, at the regional level.
- An assessment of capacity building that will be necessary for effective implementation, and monitoring of outcomes in the sector, and the impact of current regulation.

In pursuing these outputs, the platform aims to support a process that ensures regular consultation between private and public stakeholders; effective communication between the regulator, sector specialists, and government ministries; and extensive dissemination of information at national and regional levels, for increased awareness of policy issues.

Source: World Bank.

8. Policy Recommendations

Non-Tariff Barriers at the National Level

Establish a trade regulatory committee to review existing rules and regulations – removing those that cannot be justified – and inform the design and implementation of new rules. More specifically the trade regulatory committee should oversee the implementation of new rules and regulations which affect regional trade, and facilitate the inter-ministry coordination that is essential to address a wide range of non-tariff barriers.

Inform firms and individuals. An inclusive and transparent process for the design and implementation of rules and regulations is crucial for deeper regional integration. The political economy constraints and vested interests can make the removal of NTBs a challenging task, particularly when consumers lack sufficient information, and fail to organize themselves. The case studies show that it is important to consult with the private sector and other stakeholders, and develop a framework for providing information to them.

Introduce an appeal mechanism to allow affected stakeholders – both domestic and foreign – to contest decisions made by civil servants. There should be a channel to allow firms and individuals to dispute the decisions made by officials, in implementing regulations, especially for small producers, who do not have access to the mechanisms that are available to large firms, to influence decisions (World Bank, Defragmenting Africa, 2012).

Review capacity of government ministries and agencies to address the regulatory reforms. Assessing capacity gaps that undermine the effective and efficient implementation of new rules and regulations. There are clearly critical gaps in the standards and conformity assessment infrastructure, which need to be identified and prioritized. For example, are there sufficient officers at the border to apply SPS requirements? – A lack of staff can lead to long delays and spoilage.

Non-Tariff Barriers at the Regional Level

Disseminate the price-raising effect of rules and regulations. A significant number of SPS or TBT measures that are unnecessarily burdensome to trade are still in place in many EAC countries, including Kenya. It is important for the Government of Kenya to put in place procedures to ensure that SPS and TBT measures are designed and implemented, in the least trade-restrictive way, without compromising legitimate public policy objectives, and set an example for EAC partner states to follow.

Develop an effective monitoring mechanism with possible sanctions for non-compliance. The EAC Secretariat has already identified NTBs for removal, but implementation is not adequately taking place. The COMESA-EAC-SADC Tripartite online reporting and resolution system is showing signs of encouraging progress and good practice. The binding dispute settlement process of the WTO, and the experience of the EU in establishing a legally binding mechanism with sanctions for non-compliance, provide additional relevant models for the EAC to consider.

Consider the development of appropriate standards at a regional, rather than national, level. This would exploit economies of scale in regulatory expertise, prevent fragmentation of the market, by differences in standards, and limit the scope for regulatory capture. However, it would be important to tailor those standards to the specific preferences and needs of regional actors, in order to avoid non-compliance, or unnecessary implementation costs.

Service Exports at the National Level

Eliminate regulatory barriers that limit the development of service markets. Domestic regulations on the entry, and on the operations of services firms often undermine competition, and constrain the growth of strong services sectors in the EAC. Reforms should focus on eliminating such disproportionate entry requirements, or regulatory measures that limit competition. For example, in distribution services, lengthy registration procedures, multiple licenses, or inadequate zoning regulations, need to be addressed. Price controls imposed across the region, and the cartels in place in several East African countries, represent a serious impediment to competition and should be removed. Furthermore, rules and regulations which strengthen the business environment, have to be put in place. Inadequate codes on investment, commerce, labor, and taxation, as well as the lack of bankruptcy procedures, create significant uncertainty and burden for firms which are trying to conduct business operations, in the formal distribution sectors of East African countries.

Reduce costs of access to, and improve quality of, education. Encourage collaboration between universities, professional associations, and the private sector. Education-related reforms that address skills-shortages and skills-mismatches need to be encouraged. Solutions that equip students with market-relevant skills, and address the absence of institutions which offer specialized courses, need to be addressed.

Involve the Export Promotion Council. The EPC can collect and disseminate to Kenyan service firms market information, and highlight available opportunities. Most Kenyan service exporters feel that direct incentives to exports, such as tax incentives, are unnecessary. Rather, what they consider to be crucial is for the government to facilitate access to foreign markets. The Government of Kenya could, through its trade supporting institutions, and in collaboration with business and professional associations and the private sector, develop a services export strategy and play an important role in helping to reduce the barriers that Kenyan service firms face in their export development efforts.

Service Exports at the Regional Level

Remove remaining trade in services barriers. Examples of these barriers include restrictions on the free movement of labor, including visa and immigration laws and regulations, and labor policies preventing the mobility of professionals. The EAC Common Market Protocol has initiated the integration process in services in East Africa. All five EAC partner states have scheduled commitments in seven services sectors, and have adopted the annexes on removing restrictions, on the free movement of workers and on the right of establishment. But barriers affecting trade, investment and labor mobility remain in place.

Encourage regional education-related reforms to address skills-shortages and skills-mismatches. This could take the form of establishing regional education hubs, in order to address the fragmented market.

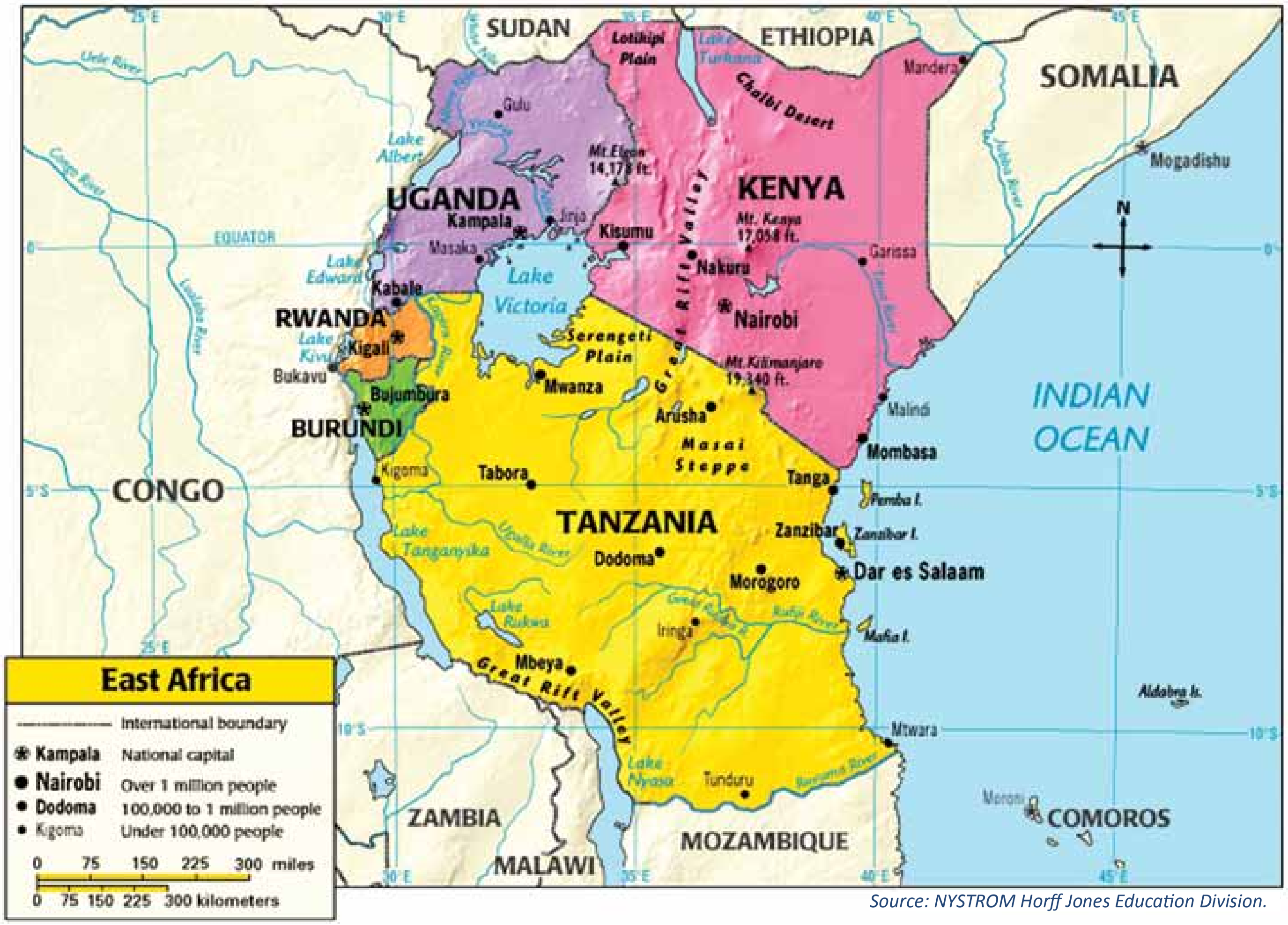
Align regulatory and supervisory frameworks and reporting requirements in financial services. Banks surveyed cite single licensing as an important aid to further integration. Adopting single-licensing will have to be accompanied by mutual recognition among regulators, and this will require that national regulators converge around some broadly defined international principles[27]. It is also important to build-up regionally compatible financial infrastructure. Kenya, Tanzania and Uganda have already made substantial progress in integrating their real time gross settlement systems. Rwanda and Burundi also need to align their payments systems with the regional system. Deepening links between financial institutions warrants a similar deepening of cooperation between supervisors. Home-host supervisory communication, and consolidated supervisions are important, to ensure that weaknesses in one financial institution/ market, do not put the regional financial system at risk.

[27] *For example, the Basel core principles for bank supervision developed by the Basel Committee on Banking Supervision, which is an international committee of banking supervisory authorities established in 1974, the International Organization of Securities Commissions (IOSCO) and others.*

Recognize professional qualifications in professional services. The free movement of EAC professionals across the borders needs to be complemented by the recognition of their qualifications. The implementation of full-fledged mutual recognition agreements that cover areas such as education, examinations, experience, conduct and ethics, professional development and re-certification, scope of practice, and local knowledge, would likely benefit Kenyan service firms (as well as firms in neighboring countries), in their exports of services to the region. The five EAC partner states have taken the first steps towards mutual recognition in professional service, in the context of the EAC Common Market negotiations – they have already signed MRAs in accounting and architectural services, and additional MRAs are expected to follow in engineering and other sectors.

ANNEXES

Annex 1: Map of EAC



Source: NYSTROM Horff Jones Education Division.

Annex 1.1: GDP Growth rates, Kenya and Sub Saharan Africa

Percent

	2007	2008	2009	2010	2011	2012f
GDP growth rate Kenya	7.0	1.6	2.6	5.6	4.4	5.0
GDP growth rate SSA	6.5	5.2	2.0	4.8	4.9	5.3
GDP growth rate World	3.7	1.5	-2.2	4.1	2.7	2.5
GDP Per capita growth rate Kenya	4.4	-1.0	-0.1	3.0	1.9	2.4
GDP per Capita growth rate SSA	4.1	3.1	-0.3	2.7	3.3	3.5

Source: Global Economic Prospectus January 2011, KNBS.
***f –forecast.*

Annex 1.2: Key Macro-economic indicators low case, baseline and high case scenario

Percent

	2007	2008	2009	2010	2011	2012**	2013**
Baseline							
GDP	7.0	1.6	2.6	5.6	4.4	5.0	5.5
Private Consumption	7.3	-1.3	3.8	2.8	3.0	3.9	4.1
Government Consumption	4.4	2.3	5.5	4.8	4.5	4.3	4.6
Gross Fixed Investment	13.6	9.5	0.6	7.4	10.2	9.5	11.0
Exports, GNFS	7.3	7.5	-7.0	6.1	8.9	6.7	6.7
Imports, GNFS	11.1	6.6	-0.2	3.0	8.6	6.7	6.7
Low case scenario							
GDP	7.0	1.6	2.6	5.6	4.4	3.1	4.5
Private Consumption	7.3	-1.3	3.8	2.8	3.0	3.9	4.1
Government Consumption	4.4	2.3	5.5	4.8	4.5	4.3	4.6
Gross Fixed Investment	13.6	9.5	0.6	7.4	10.2	6.8	7.9
Exports, GNFS	7.3	7.5	-7.0	6.1	8.9	2.0	6.0
Imports, GNFS	11.1	6.6	-0.2	3.0	8.6	6.7	6.7
High case scenario							
GDP	7.0	1.6	2.6	5.6	4.4	5.5	6.0
Private Consumption	7.3	-1.3	3.8	2.8	3.0	3.9	4.1
Government Consumption	4.4	2.3	5.5	4.8	4.5	4.4	4.6
Gross Fixed Investment	13.6	9.5	0.6	7.4	13.9	11.0	12.1
Exports, GNFS	7.3	7.5	-7.0	6.1	9.0	7.0	7.2
Imports, GNFS	11.1	6.6	-0.2	3.0	8.6	6.7	6.7

Source: CBK; KNBS; World Bank estimates.

Annex 1.3: Kenya's GDP per capita

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
GDP/Capita (US$)	402	397	438	461	523	611	719	774	738	760	774
GDP growth rate	4.5	0.5	2.9	5.1	5.9	6.3	7.0	1.6	2.6	5.6	4.4

Source: WDI & KNBS.

Annex 1.4: Sectoral Growth rates

Percent

Sector/ Year	Share of GDP	2007	2008	2009	2010	2011
Agriculture	(25.0)	2.1	-5.0	-1.4	6.3	1.6
Industry	(18.4)	7.1	4.8	3.4	5.3	2.8
Service	(56.6)	8.1	2.6	4.3	5.4	5.1
GDP		7.0	1.6	2.6	5.6	4.4

Source: KNBS.

Annex 1.5: GDP growth rate of other African countries

Percent

	2009	2010	2011	2012f
Ethiopia	8.8	8.1	7.7	7.2
Tanzania	6.0	7.0	6.5	6.9
Ghana	4.7	7.7	13.4	10.0
Rwanda	4.1	7.5	7.0	6.8
Uganda	7.1	6.3	6.5	6.6
Kenya	2.6	5.6	4.4	5.0
SSA average	1.7	4.8	4.9	5.3
South Africa	-1.8	2.8	3.5	4.1

Source: Global Economic Prospectus 2011.

Annex 1.6: Kenya's Inflation

Percent

		Overall Inflation	Food Inflation	Transport Inflation
2011	January	5.4	8.6	8.4
	February	6.5	9.8	13.1
	March	9.2	15.1	15.9
	April	12.1	19.1	20.4
	May	12.9	20.1	22.2
	June	14.5	22.5	22.7
	July	15.5	24.0	23.6
	August	16.7	23.9	24.3
	September	17.3	24.4	24.8
	October	18.9	26.2	26.2
	November	19.7	26.2	28.0
	December	18.9	25.0	25.6
2012	January	18.3	24.6	22.4
	February	16.7	22.1	16.2
	March	15.6	20.3	13.0
	April	13.1	16.2	10.1
	May	12.2	14.6	8.4

Source: KNBS.

Annex 1.7: Kenya's foreign exchange rates

		KSH/US$	KSH/Euro
2011	January	81.0	108.2
	February	81.5	111.3
	March	84.3	117.9
	April	83.9	121.1
	May	85.4	122.4
	June	89.1	128.1
	July	89.9	128.5
	August	92.8	133.0
	September	96.4	132.7
	October	101.4	138.7
	November	93.7	127.1
	December	86.7	114.2
2012	January	86.3	111.4
	February	83.2	110.1
	March	82.9	109.6
	April	83.2	109.6
	May	84.4	108.0

Source: CBK.

Annex 1.8: Capital markets indices

		Dow Jones Industrial Average Index	Nairobi Stock Exchange Index
2011	January	11,823	4,527
	February	12,130	4,265
	March	12,221	3,873
	April	12,811	4,006
	May	12,442	4,078
	June	11,935	3,968
	July	12,143	3,733
	August	11,285	3,444
	September	10,913	3,292
	October	11,955	3,382
	November	12,046	3,401
	December	12,218	3,128
2012	January	12,633	3,203
	February	12,952	3,184
	March	13,212	3,337
	April	13,214	

Source: CBK & Dow Jones Industrial Average.

Annex 1.9: Interest rates

Percent

		Lending rates	Central Bank Rate
2011	January	14.03	6.00
	February	13.92	5.75
	March	13.92	6.00
	April	13.92	6.00
	May	13.92	6.25
	June	13.92	6.25
	July	14.14	6.25
	August	14.32	7.00
	September	14.8	7.00
	October	15.21	11.00
	November	18.51	16.50
	December	20.04	18.00
2012	January	19.54	18.00
	February	20.28	18.00
	March	20.34	18.00
	April		18.00

Source: CBK & Dow Jones Industrial Average.

Annex 1.10: Credit distribution to the private sector

Ksh Billions

	Total Private Credit	Agriculture	Manufacturing	Trade	Building & construction	Transport & communication	Finance & insurance	Real estate	Mining & quarrying	Private house-holds	Consumer durables	Business services	Other activities	Percent Growth yoy
Mar-09	15.4	3.0	-0.8	-0.7	-0.9	-1.0	-0.6	5.2	3.0	-4.8	2.3	-3.5	14.1	28.6
Jun-09	20.2	-1.4	-3.1	2.2	3.4	-1.5	2.8	4.3	8.1	-1.4	4.2	12.2	-9.5	22.5
Sep-09	1.8	5.6	1.8	8.9	-2.1	4.2	-1.3	3.1	-15.9	18.4	2.2	-7.1	-16.1	10.6
Dec-09	52.4	0.4	-0.3	26.6	7.9	5.1	5.3	6.5	2.7	-12.1	6.5	-9.0	13.0	13.9
Mar-10	21.1	-1.1	4.7	-12.2	-9.9	1.9	4.3	0.9	5.8	24.6	3.2	4.2	-5.5	14.4
Jun-10	39.9	2.4	6.2	7.5	-4.8	0.6	-4.4	27.9	2.3	2.8	-4.2	8.8	-5.2	16.8
Sep-10	43.7	1.9	10.9	9.5	0.6	-6.4	-2.4	11.3	-0.2	-0.9	2.1	8.6	8.7	22.9
Dec-10	45.5	1.2	2.6	13.7	0.9	0.1	1.5	5.9	-1.5	6.5	5.4	4.2	5.2	20.3
Mar -11	66.0	2.0	4.9	4.7	3.6	3.7	-1.1	6.1	7.8	15.3	5.9	-4.8	17.8	25.7
Jun -11	90.2	5.6	11.8	12.0	3.3	11.6	2.6	13.0	3.1	13.7	1.7	2.2	9.5	30.7
Sep -11	114.9	5.6	15.2	19.6	4.9	7.7	2.6	10.5	2.4	16.4	7.3	11.1	11.6	36.3
Dec -11	116.3	5.3	14.5	19.1	5.1	8.7	3.0	13.7	2.5	16.4	7.3	8.3	12.2	30.9

Source: CBK.

Annex 1.11: Oil price movements 2011

		Pump Prices - Petrol (Ksh/Lt)	Murban oil price ($/barrel)
2011	January	95.67	94.8
	February	98.08	101.27
	March	102.44	111.63
	April	111.17	116.62
	May	115.35	113.60
	June	114.93	112.15
	July	115.39	113.95
	August	117.22	109.05
	September	117.75	110.09
	October	120.50	108.95
	November	124.10	114.35
	December	119.10	111.80
2012	January	112.00	114.20
	February	111.30	120.45
	March	111.70	127.00

Source: KNBS, World Bank.

Annex 1.12: Kenya's Fiscal position

Percent of GDP	2008/09	2009/10	2010/11	2011/12	2012/13*	2013/14**
Revenue and Grants	22.6	22.4	24.8	25.4	25.4	25.5
Revenues	21.8	22.3	24.1	24.0	24.2	24.4
Tax Revenues	20.4	20.6	22.0	21.6	22.0	22.3
Income tax	8.2	8.5	9.3	9.4	9.5	9.6
Value-added tax	5.7	5.8	6.2	6.8	6.0	6.1
Import duty (net)	1.7	1.7	1.7	1.7	1.7	1.6
Excise duty	3.1	3.0	2.9	2.5	2.5	2.5
Nontax Revenue	3.2	2.9	3.6	4.7	4.6	3.5
Grants	0.8	0.8	0.7	1.4	1.2	1.1
Expenditure and Net Lending	26.6	29.5	29.3	30.3	29.8	29.3
Recurrent expenditure	19.5	20.5	21.1	20.5	19.7	19.2
Interest Payments (4+5)	2.3	2.6	2.7	2.6	2.5	2.4
Wages and Benefits (civil service	6.9	7.0	7.2	7.0	6.8	6.7
Development and Net Lending	7.2	8.7	7.9	9.6	9.6	9.7
Budget Deficit (commitment basis)	-4.0	-6.4	-4.5	-4.9	-4.3	-3.8
Public Debt to GDP (Net)	42.1	44.8	48.8	43.1	44.1	41.9

Source: Ministry of Finance.

Annex 1.13: Simulating the effects of crude oil price increase on the Current Account

US$ Billions	2009	2010	2011	2012base	2012SC1	2012SC2	2012SC3
1. CURRENT ACCOUNT	-1,671	-2,512	-4,489	(6,108)	(6,108)	(6,771)	(7,245)
2. MERCHANDISE ACCOUNT	-5,768	-7,169	-9,056	(11,004)	(11,004)	(11,667)	(12,141)
2.1 Exports (fob)	4,528	5,225	5,726	6,348	6,348	6,348	6,348
2.2 Imports (cif)	10,296	12,395	14,782	17,352	17,352	18,016	18,490
Oil	2,192	2,673	4,081	5,023	5,023	5,686	6,160
Chemicals	1,324	1,603	1,947	2,237	2,237	2,237	2,237
Manufactured Goods	1,411	1,774	2,250	2,641	2,641	2,641	2,641
Machinery	3,065	3,808	3,686	4,090	4,090	4,090	4,090
Other	2,205	2,380	2,605	3,123	3,123	3,123	3,123
3. SERVICES	4,097	4,657	4,567	4,896	4,896	4,896	4,896
4. CAPITAL & FINANCIAL ACCOUNT	2,451	2,675	4,439	6,188	6,188	6,188	6,188
4.1 Capital Account	290	154	204	225	225	225	225
4.2 Financial Account	2,161	2,522	4,235	5,962	5,962	5,962	5,962
5. OVERALL BALANCE	781	163	-51	80	80	(584)	(1,058)
GDP	29,400	33,029	34,163	43,252	43,252	43,252	43,252
Oil price		79.5	106	106	106	120	130
As percent of GDP							
1. CURRENT ACCOUNT	-6	-7.6	-13.1	-14.1	-14.1	-15.7	-16.8
2. MERCHANDISE ACCOUNT	-20	-21.7	-26.5	-25.4	-25.4	-27.0	-28.1
2.1 Exports (fob)	15	15.8	16.8	14.7	14.7	14.7	14.7
2.2 Imports (cif)	35	37.5	43.3	40.1	40.1	41.7	42.7
Oil	7	8.1	11.9	11.6	11.6	13.1	14.2
Chemicals	5	4.9	5.7	5.2	5.2	5.2	5.2
Manufactured Goods	5	5.4	6.6	6.1	6.1	6.1	6.1
Machinery	10	11.5	10.8	9.5	9.5	9.5	9.5
Other	7	7.2	7.6	7.2	7.2	7.2	7.2
3. SERVICES	14	14.1	13.4	11.3	11.3	11.3	11.3
4. CAPITAL & FINANCIAL ACCOUNT	8	8.1	13.0	14.3	14.3	14.3	14.3
4.1 Capital Account	1	0.5	0.6	0.5	0.5	0.5	0.5
4.2 Financial Account	7	7.6	12.4	13.8	13.8	13.8	13.8
5. OVERALL BALANCE	3	0.5	-0.1	0.2	0	-1	-2

Source: CBK and World Bank staff calculations.

Annex 1.14: Balance of Payment (2009-2011)

	US$ Millions			Percent change yoy		
	2009	2010	2011	2009	2010	2011
1. CURRENT ACCOUNT	-1671	-2512	-4461	-15.3	50.3	77.6
2.1 Exports (fob)	4528	5225	5756	-10.3	15.4	10.1
Tea	892	1159	1153	-3.5	29.9	-0.5
Horticulture	692	725	678	-9.3	4.8	-6.6
Manufactured Goods	526	608	729	-15.8	15.5	20.0
Chemicals	407	434	557	-15.9	6.6	28.3
Other	811	1032	1077	-8.2	27.3	4.3
2.2 Imports (cif)	10,296	12,395	14,782	-10.4	20.4	19.3
Oil	2192	2673	4081	-28.2	21.9	52.7
Chemicals	1324	1603	1947	-8.4	21.1	21.5
Manufactured Goods	1411	1774	2250	-11.2	25.7	26.9
Machinery & Transport						
Equipment	3065	3808	3686	0.1	24.3	-3.2
Other	2205	2380	2621	-1.7	8.0	10.1
3. SERVICES	4097	4657	4566	-8.3	13.7	-2.0
3.1 Non-factor services	1876	2527	2344	-14.1	34.7	-7.2
3.2 Income account	-38	-158	84	-16.3	316.8	-153.6
3.3 Current Transfers account of which remittances	2259	2288	2137	-3.1	1.3	-6.6
4. CAPITAL & FINANCIAL ACCOUNT	609	642	891	-0.3	5.4	38.8
5. OVERALL BALANCE	2451	2675	4418	62.9	9.1	65.2
	781	163	-43	266.5	-79.1	-126.3
As percent of GDP						
Overall Balance	2.5	0.5	-0.1			
Current Account	-5.3	-7.9	-14.1			
Capital & Financial Account	7.8	8.4	14.0			
Exports	14.4	16.5	18.2			
Imports	32.8	39.1	46.7			

Source: CBK.

Annex 1.15: Maize production 2009 and 2011

Province	2009			2010			Percent Increase in Maize
	HA '000	Bags (90 Kg) Millions	Yield	HA '000	Bags (90 Kg) Millions	Yield	
Central	123	1.2	9.4	176	1.4	8.0	21
Coast	118	1.4	12.0	137	1.96	15.5	38
Eastern	465	6.0	13.0	455	3.8	8.3	-38
NEP	2	0.001	0.5	4	0.009	2.1	812
Nairobi	0.3	0.003	12.0	0.7	0.014	19.0	349
Rift Valley	618	14.2	23.1	675	21.1	36.5	48
Western	227	4.5	20.0	233	5.1	22.0	14
Nyanza	296	5.05	17.0	327	5.1	17.3	0
Total	**1,850**	**32.4**	**17.5**	**2,008**	**38.5**	**19.2**	**19**

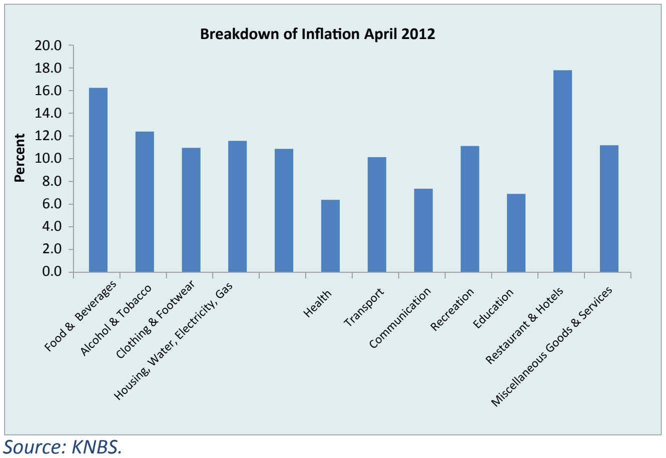
Source: Ministry of Agriculture.

Annex 1.16: Price Comparison Selected Commodities

Commodity	Units of Measure	Average Price : March 2011	Average Price : March 2012	Percent Change
Potatoes (Irish)	1 Kg	57.03	59.32	5.8
Cooking Fat	1 Kg	210.76	220.50	13.8
Cooking Oil	1 litre	202.58	210.45	14.6
Kerosene	1 litre	84.92	84.99	0.1
Diesel	1 litre	95.27	105.97	11.2
Petrol	1 litre	103.32	112.44	8.8

Source: KNBS.

Annex 1.17: Inflation April 2012



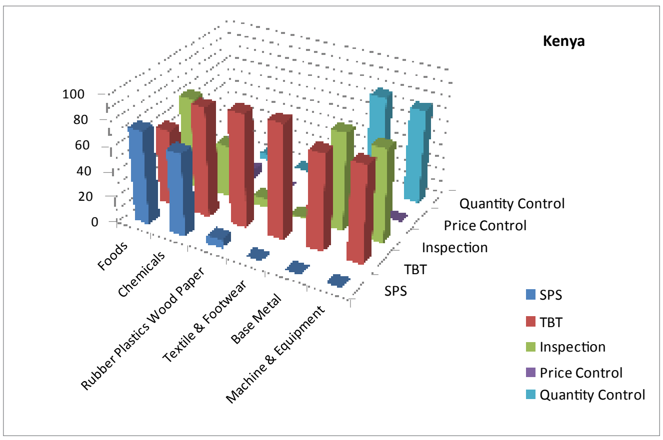
Source: KNBS.

Annex 2: Number of products covered by at least one non-tariff measure

Non-tariff measure	Kenya	Uganda	Mauritius	Senegal	Madagascar
Sanitary and phytosanitary measures	1,277	1,487	1677	139	702
Technical barriers to trade	4,245	4,838	144	163	516
Pre and shipment formalities	2,370	4,348	22	38	4
Price control measures	126			57	138
Quantity control measures	1,272	41	699	156	564
Para tariff measures	1,845	4,874		123	333
Finance measures					
Anti-competitive measures	23			31	3
Trade-related investment measures					
Distribution restrictions	23				
Restriction on post sales services					
Subsidies					
Government procurement restrictions	21				
Intellectual property					
Rules of origin	169				
Export-related measures	944	426	40	58	280
Total	**12,315**	**16,014**	**2,582**	**765**	**2,540**

Source: Cadot and Gourdon, World Bank 2012.

Annex 3: Sectoral distribution of non-tariff measures in Kenya



	Foods	Chemical	Rubber, plastice Woodpaper	Textile & footware	Base metal	Machine & equipment
A: SPS	75	66	7	0	0	0
B: TBT	61	87	90	91	77	77
C: Inspection	73	42	7	1	78	74
D: Price control	4	7	0	0	0	0
E: Quantity control	0	5	0	0	78	75

Source: Cadot and Gourdon, World Bank 2012.

Annex 4: Estimated price raising effect of non-tariff measures by product, country comparison (%)

	Kenya (SPS)	Uganda (SPS)	Nambia (QR)	South Africa (QR)
Rice	42.10	29.90	41.16	
Bread	42.10	29.90	41.16	
Poultry	42.10		41.16	
Fresh milk	42.10		41.16	
Cheese	42.10		41.16	
Spirits	42.10	29.90	41.16	
Beer	42.10	29.90	41.16	
Other cereals and flour	38.73	29.90	41.16	
Lamb	37.46		41.16	
Coffee	36.62	11.96	41.16	
Sugar	36.20	29.90	41.16	
Other meats and preparations	35.78	16.44	41.16	
Fresh fruit	34.94	29.30	40.33	
Beef and veal	34.10		41.16	
Pasta products	33.68	29.90	41.16	
Fresh vegetables	33.26	29.00	41.16	
Frozen or preserved vegetables	33.26	28.10	41.16	
Tobacco	32.83	29.90	41.16	
Preserved fish and seafood	32.83	16.74	39.51	
Preserved milk and milk products	32.83		36.63	
Other edible oils and fats	29.47	29.30	41.16	2.57
Fresh or frozen fish and seafood	28.20		41.16	
Butter and margarine	28.20		41.16	
Eggs and egg-based products	25.26		41.16	
Potatoes	21.05		41.16	64.35
Pork	18.10		41.16	
Household textiles			20.58	
Footwear			18.93	
Major tools and equipment			15.64	
Garments			13.17	
Small electric household appliances			5.76	
Small tools and miscellaneous accessories			5.76	

Only significant effects (at the 5 percent level) are reported. Source: Econometric estimation using ICP price data and World Bank/UNCTAD non-tariff measure data.

Annex 5: EAC Time-Bound Programme for Elimination of NTBs – 2008

No.	NTB summary description	Timeframe for elimination set in 2008 (yellow for starting position)	Category in 2008	Status in December 2010 (green is ontrack, red is delayed) and, if applicable, new timeframe set	Category set in December 2010	Status in August 2011 (green is ontrack, red is delayed) and, if applicable, new timeframe set
1.	Corruption along the Northern and Central Corridors (police roadblocks, weighbridge and border gates.	Immediate	A	Immediate	A	Immediate
2.	Non recognition by Kenya for SPS certificates issued by Uganda for tea destined for Mombasa action.	Immediate recognition SPS certificate issued by Uganda	A	Still a problem. To be resolved within 3 months	B	Still a problem. To be resolved
3.	Charges on plant import permit (PIP) at Malaba on Ugandan tea destined for auction at Mombasa.	Immediate action	A	12 months	C	December 2012.
4.	Inadequate Police Escort mechanism.	Immediate	A	Partner States to report the status during the EAC meeting of Regional Forum in August 2011.	D	Partner States to report the status during the next EAC meeting of Regional Forum
5.	Ugandan ban on beef & beef products from Kenya	Immediate	A	To be considered by the next Sectoral Council on Finance. Trade, Industry and Investment.	D	Uganda to report when she will lift the ban during the meeting of 5th Regional Forum slated for 1st to 3rd September 2011.
6.	Uganda's certification procedures on exports of milk from Kenya	Immediate	A	Uganda to report during the EAC meeting of Regional Forum on NTBs in August 2011.	D	Uganda to report during the 5th meeting of Regional Forum slated for 1st to 3rd September 2011.

No.	NTB summary description	Timeframe for elimination set in 2008 (yellow for starting position)	Category in 2008	Status in December 2010 (green is ontrack, red is delayed) and, if applicable, new timeframe set	Category set in December 2010	Status in August 2011 (green is ontrack, red is delayed) and, if applicable, new timeframe set
7.	Several Police roadblocks along Northern and Central Corridors, estimated at 36 between Mombasa-Kigali and 30 between Dar Es Salaam to Rusumo border point (Ref: RPSF study 2010))	Immediate	A	Kenya and Tanzania to report during the EAC meeting of Regional Forum on NTBs in August 2011.	D	Kenya and Tanzania to report whether they have reduced the roadblocks during the 5th meeting of Regional Forum slated for 1st to 3rd September 2011.
8..	Lack of interface within the customs' systems in the Revenue Authorities in Partner States.	1 – 6 months	B	Within 6 months	B	The interface of the Revenue is ongoing.
9..	Lack of harmonized import/export documentation and procedures	1-6 months	B	Nov-11	C	April 2012.
10.	Delays in transit bonds cancellation	1-6 months	B	Aug-11	C	Immediate
11.	Port Charges are not harmonized. (the Port charges should be benchmarked with international port charges)	1-6 month	B	Claimed done in 2010, but still outstanding in 2011	A	September 2011.
12.	Customs working hours are not harmonized.	On-going	D	On-going	D	On-going
13.	Inadequate quality of infrastructural services.	Long-term	D	Long-term	D	Long-term

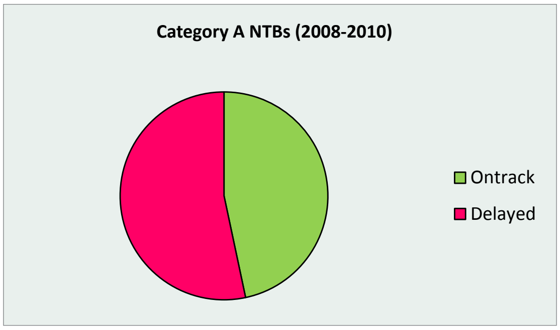
No.	NTB summary description	Timeframe for elimination set in 2008 (yellow for starting position)	Category in 2008	Status in December 2010 (green is ontrack, red is delayed) and, if applicable, new timeframe set	Category set in December 2010	Status in August 2011 (green is ontrack, red is delayed) and, if applicable, new timeframe set
14.	Charges by Container freight stations	n/a	n/a	By January 2011	B	Kenya to report the status during the 5th meeting of Regional Forum slated for 1st to 3rd September 2011.
15.	Existence of several weighbridge stations in the Central and Northern Corridors	n/a	n/a	January – March 2011	B	Kenya and Tanzania to report September 2011 whether they have reduced weigh bridges during the meeting of 5th EAC slated for early September 2011.
16.	Simplified certificates of origin are not available at all border posts	n/a	n/a	immediate	A	Not addressed in 2011 update
17.	Charge of Kshs 5,000 by Kenyan Plant Health Inspectorate Services (KEPHIS) for every truck entering Kenya carrying Rwandan Tea	n/a	n/a	immediate	A	Not addressed in 2011 update
18.	Lack of adequate time by TBS to allow companies to comply with labeling requirements even when there is no consumer risk	n/a	n/a	March, 2011	B	Not addressed in 2011 update
19.	Ugandan businessmen charged US$ 100 visa fee at Mutukula and Bukoba	n/a	n/a	Jan, 2011	B	Not addressed in 2011 update

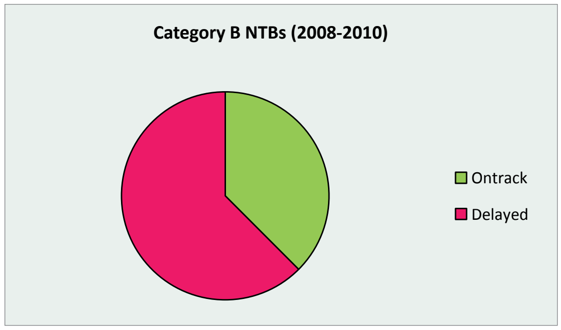
No.	NTB summary description	Timeframe for elimination set in 2008 (yellow for starting position)	Category in 2008	Status in December 2010 (green is ontrack, red is delayed) and, if applicable, new timeframe set	Category set in December 2010	Status in August 2011 (green is ontrack, red is delayed) and, if applicable, new timeframe set
20.	Complaints on administrative delays in maize clearance in Busia and Malaba borders	n/a	n/a	March, 2011	B	Not addressed in 2011 update
21.	Requirements of all export cargo to be in container	n/a	n/a	March, 2011	B	Not addressed in 2011 update
22.	Privately driven cars of 8 and above seating capacity are categorised as commercial vehicles irrespective of purpose of use	n/a	n/a	Jan, 2011	B	Not addressed in 2011 update
23.	Charging of Import Declaration Form (IDF) fees of 2.5 percent by KRA for imports from Uganda	n/a	n/a	March, 2011	B	Not addressed in 2011 update

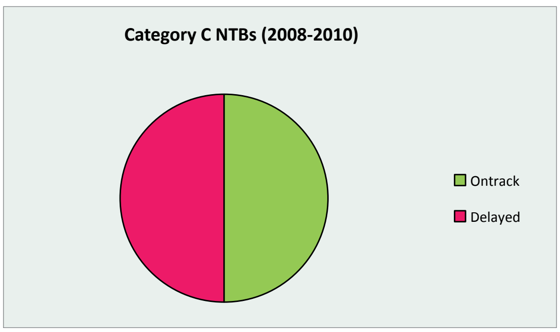
Source: World Bank analysis of EAC NTB Report.

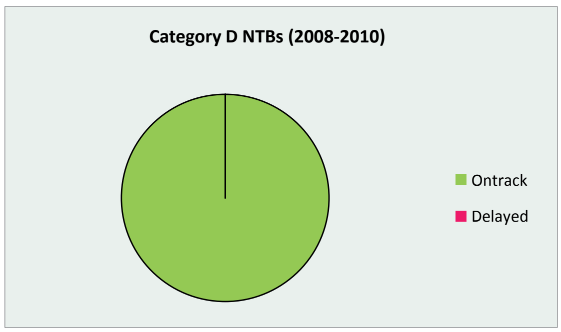
Annex 6: Elimination of NTBs – 2008-2010

Category	Ontrack	Delayed	Total
A	7	8	15
B	3	5	8
C	4	4	8
D	2	0	2
Total	**16**	**17**	**33**





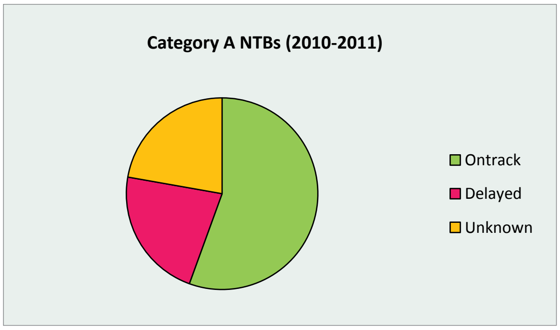


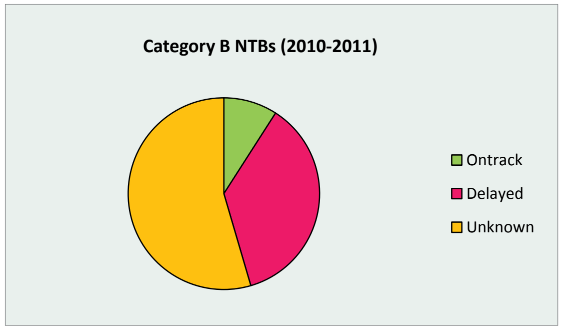


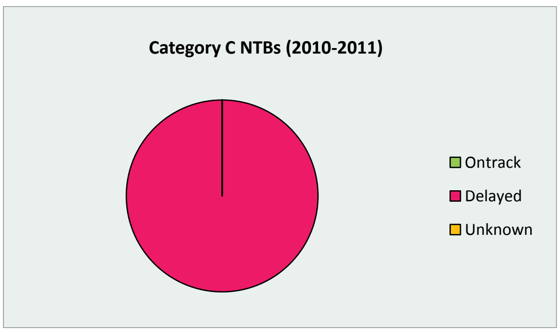
Source: World Bank analysis of EAC NTB Report.

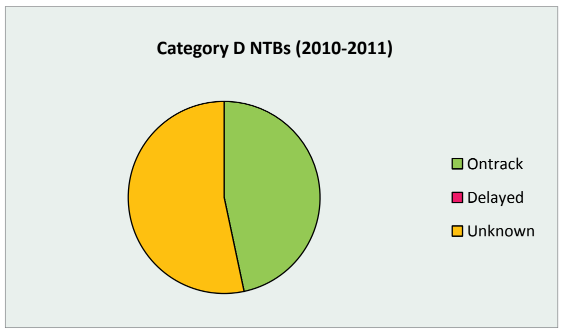
Annex 7: Elimination of NTBs – 2010-2011

Category	Ontrack	Delayed	Unknown	Total
A	5	2	2	9
B	1	4	6	11
C	0	12	0	12
D	7	0	8	15
Total	**13**	**18**	**16**	**47**







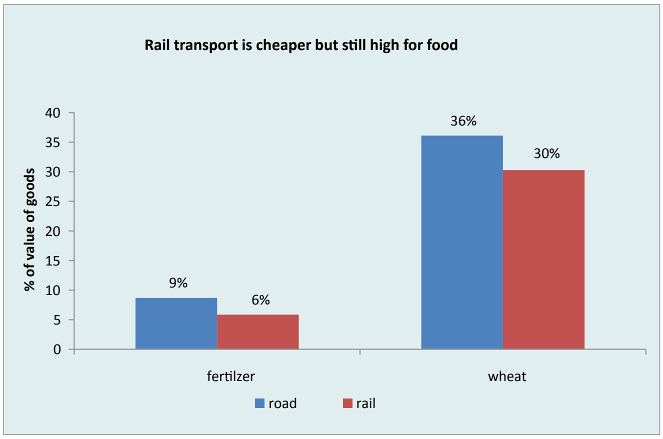


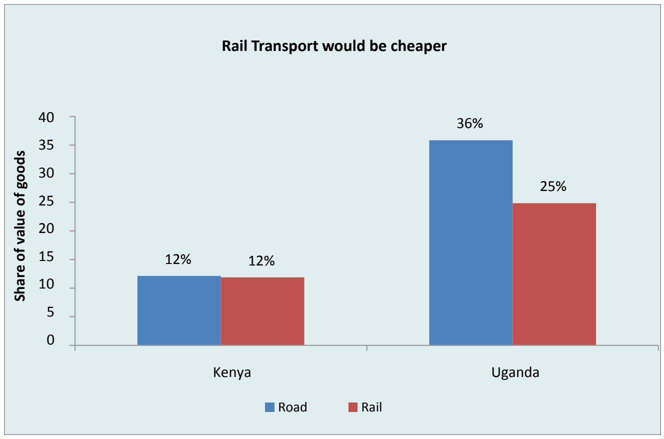
Source: World Bank analysis of EAC NTB Report.

Annex 8: Case Study - Truck Drivers journey along the Northern Corridor

Transport costs increase the cost of goods significantly. Transport costs are high along the Northern Corridor particularly for the land locked countries. In Kenya transport costs increase the landed cost of goods by about 12 percent, and in Uganda the cost triples to about 36 percent. The transport cost to Uganda would significantly reduce to 25 percent if the rail was used as an alternative.

Transport costs increase the landed costs of imports by 12 percent in Kenya and 36 percent in Uganda

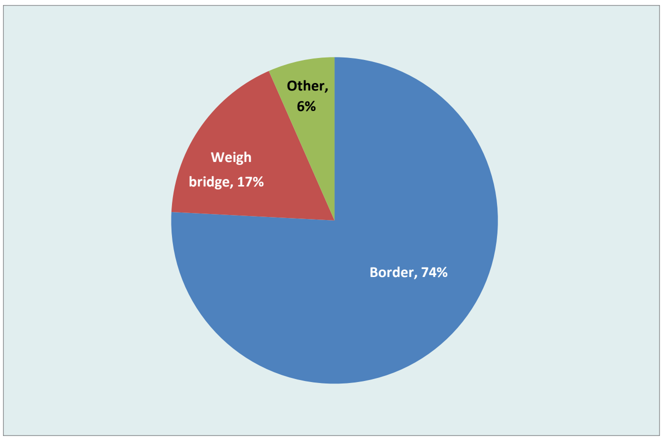


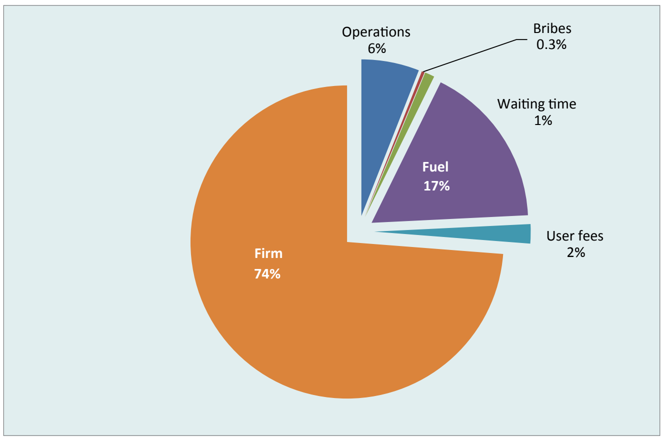


Source: World Bank staff.

Bribes are a small proportion of transport costs. Breaking down the transport costs into different components to isolate the cost of NTBs along the corridor, fuel accounts for 16 percent of the transport charges, bribes at the border posts and weighbridges are persistent but comprise a negligible component of total cost. Drivers pay the bribes from their transport allowance which might explain why they are not significant. All the same bribes are more prevalent at the borders than at the weighbridges.

Bribes are a small share of the transport costs and are more prevalent at the border





Source: World Bank staff.

Walking on a Tightrope

Rebalancing Kenya's economy with a special focus on regional integration

In 2012, Kenya's economy has been on a tightrope. Policy makers have had to walk a fine line between stabilizing the economy and maintaining the growth momentum. While inflation has declined, the exchange rate stabilized, and the fiscal position improved, fundamental economic imbalances continue to make Kenya vulnerable to shocks.

In the absence of economic and social turbulence, Kenya should grow at 5 percent in 2012 and 2013, which would still be substantially below its neighbors. Kenya has been benefitting from the integration and growth momentum in the East African Community (EAC), which has become one of the most vibrant economic regions in the world.

However, despite impressive increases in trade between the five EAC partners in recent years, there is still a large untapped potential. EAC trade could increase by several-fold, if unnecessary restrictions in the trade of goods and services–particularly non-tariff barriers- were removed.

The World Bank
Hill Park Building
Upper Hill Road
P. O. Box 30577-00100
Nairobi, Kenya
Telephone: +254-020-322 6000
Fax: +254-020-3226382
Website: www.worldbank.org/kenya/keu

THE WORLD BANK

Produced by Poverty Reduction and Economic Management Unit Africa Region
Photo credits: page 1: © World Bank and page 19 courtesy of the East Africa Community.
Design by Robert Waiharo