KENYA ECONOMIC UPDATE

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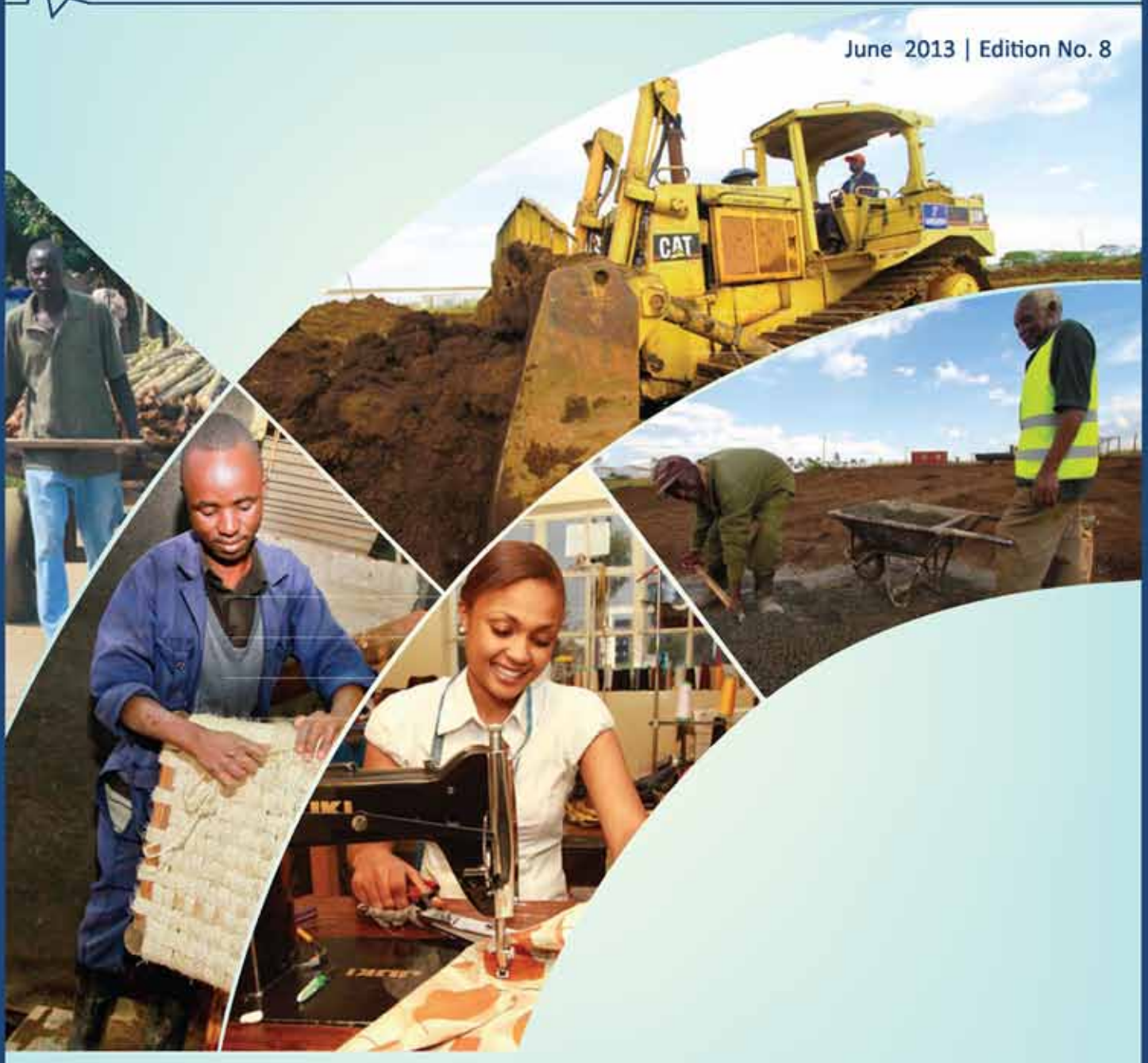

Time to shift gears

Accelerating growth and poverty reduction in the new Kenya

THE WORLD BANK

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ABBREVIATIONS AND ACRONYMS

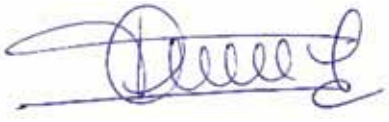
BPS	Budget Policy Statement
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CDF	Constituency Development Fund
CIP	Crop Intensification Program
CPI	Consumer Price Index
CRR	Cash Reserve Ratio
DHS	Demographic and Health Survey
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNI	Gross National Income
HFC	Health facility committee
HSSF	Health Sector Services Fund
HOI	Human Opportunity Index
IBEC	Intergovernmental Budget and Economic Council
ILO	International Labour Organization
IMF	International Monetary Fund
KES	Kenya Shillings
KEU	Kenya Economic Update
KIHBS	Kenya Integrated Household Budget Survey
KNBS	Kenya National Bureau of Statistics
KPLC	Kenya Power and Lighting Corporation
KRA	Kenya Revenue Authority
LATF	Local Authorities Transfer Fund
LIC	Low Income Country
LWH	Land Husbandry, Water Harvesting and Hillside
MIC	Middle Income Country
MPI	Multi-Dimensional Poverty Index (MPI)
MRC	Mombasa Republican Council
MTP	Medium Term Plan
NPLs	Non-performing loans
NSE	Nairobi Stock Exchange
NSPP	National Social Protection Policy
PFM	Public Finance Management
REER	Real effective exchange rate
SSA	Sub-Saharan Africa
SRC	Salaries and Remunerations Commission
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
VAT	Value Added Tax

FOREWORD

It is my pleasure to present to you the eighth edition of the World Bank's Kenya Economic Update. Since the start of 2013, Kenyans have witnessed historic times. The successful elections in March and the peaceful transition of power in April, ushered in a new era of political leadership, which will guide the implementation of Kenya's ambitious program of devolution.

The report has three main messages. First, the economy is expected to achieve higher growth targets in 2013 (5.7 percent) and 2014 (6 percent) over what it achieved in 2012 (4.6 percent), as a result of the smooth election process. However, the government will need to make a concerted effort, if it wishes to approach the 10 percent annual growth rate foreseen in Vision 2030. The report's second message emphasizes on the steps that the government needs to take to create an enabling framework for significant private sector-led growth. The Government needs to continue to invest in infrastructure, to increase domestic energy production, to address the other bottlenecks that affect the cost of doing business, and to continue following sound monetary and fiscal policies. Finally, the report's third message focuses on the poverty situation in Kenya, noting progress made since 2005, when an estimated 47 percent of the population lived below the poverty line, to the present, where poverty estimates range between 34 and 42 percent, the imprecision resulting from the lack of any recent survey data. The report notes the spatial dimension of poverty, and the poor tend to live in the arid and semi-arid regions in the north and north east. It concludes with thoughts about a poverty reduction strategy, which would emphasize on job creation, enhanced productivity of smallholder farms, strengthening and expanding cash transfer programs, targeted public spending programs to provide quality education to the rural poor, and improved poverty monitoring, so that the government can rapidly see which activities have the greatest impacts on improving the lives of the poor.

The World Bank remains committed to helping Kenya as it launches a new political administration that will have the challenging task of implementing a devolved form of government. The World 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, which puts a special emphasis on knowledge and partnerships. With these reports, we aim to support all those who want to improve economic management in Kenya. As in the past, we are proud to have worked with many Kenyan economic 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, to achieve a permanent reduction in poverty, and to bring shared prosperity to all Kenyans.



Diarietou Gaye
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ACKNOWLEDGEMENTS

This Eighth edition of the Kenya Economic Update was prepared by a team led by John Randa and Paul Gubbins together with BorkoHandjiski and supervised by Wolfgang Fengler. The core team consisted of Tom Bundervoet, Roger Sullivan, Allen Denis, Angelique Umutesi, Geoff Handley, Kathy Whimp, Lucy Wariara and Sophie Rabuku. The team acknowledges contributions from Robert Waiharo.

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Partnership with key Kenyan policy makers was instrumental in the production of this report. On May 30, 2013, a draft of the report was presented at the Quarterly Economic Roundtable. The meeting was attended by senior officials from the National Treasury, Ministry of Devolution and Planning, the Central Bank of Kenya, the Kenya National Bureau of Statistics, the Kenya Revenue Authority, Kenya Institute of Public Policy Research and Analysis, the International Monetary Fund, and the National Economic and Social Council.

MAIN MESSAGES AND KEY RECOMMENDATIONS

Main Messages

- **Kenya's economy is still operating below its potential.** However, given the domestic and global environment, growth was satisfactory in 2012. After a peaceful election and transition in 2013, growth is projected to rise to 5.7 percent in 2013 and 6.0 percent in 2014, supported by lower interest rates and higher investment growth.
- **The economy is still vulnerable to external shocks, which can erode the significant gains it has achieved.** This external vulnerability can be reduced by increasing both domestic and foreign savings. Structural reforms that improve the business environment would incentivize more FDI to flow to Kenya, and increase the rate of growth and savings. These reforms must involve tax and expenditure measures that increase both savings and investment so as to allow Kenya to take advantage of low labor costs, and its coastal location to expand manufacturing exports.
- **Poverty has likely declined.** Kenya's poverty level is estimated to have declined from 47 percent in 2005, to between 34 to 42 percent today (imprecise estimates due to the fact that the last household survey was conducted in 2005-06). Kenya needs to undertake a new survey to update poverty estimates, and inform government's poverty reduction strategies.
- **Kenya remains a country of contrasts, especially in service delivery.** On average, Kenyans are healthier, more educated, and receive better infrastructure services than they did a decade ago. At the same time, a large fraction of the population continues to live with sub-standard access to water, sanitation and energy.

Key Recommendations to sustain the growth momentum

- **For the medium term, Kenya needs to boost productivity and regain its competitiveness.** To maintain high growth rates, Kenya needs to continue investing in infrastructure and human capital, improve the business and regulatory environment, and diversify exports. The challenge for Kenya is to engineer policies to boost productivity growth and foster job creation, i.e. reinvigorate both engines of the economy. The best way to achieve this is to maintain macroeconomic stability, to develop a business environment that promotes investment and job creation, and to increase the stock of physical and human capital.
- **Foreign Direct Investment is key to Kenya's development agenda.** Since domestic savings are low, attracting FDI would supplement domestic savings in financing Kenya's growth agenda. Kenya should aggressively seek more productivity enhancing FDI to diversify its economy, and develop its private sector, encouraging technology transfer to sharpen its competitive edge in the external market.
- **The ultimate objective of Kenya's development strategy is to make it more inclusive.** The new administration promises to make growth more inclusive. This can only be done through reforms to promote economic diversification and job creation, and tackling infrastructure gaps.

Key Recommendations to make poverty history

- **A system of poverty monitoring is needed—with nationally representative household budget surveys as a foundation—to understand how, where and why poverty is changing, and to inform public policy.** Without more frequent surveys, there has been a missed opportunity to understand whether economic gains and government policy have generated pathways out of poverty for the poor.
- **Sustained poverty reduction requires the creation of more productive jobs.** To encourage the growth of the low and middle skills jobs that will represent pathways out of poverty for the poor, the government can work to improve the competitiveness of manufactured exports, and the investment and business environment. In addition, as the majority of Kenya's poor depend on agriculture for their livelihood, helping them gain access to inputs and markets can drive poverty reduction in the short term.
- **Poverty reduction can be accelerated with greater equity in Kenyan society through more effective public spending and stronger cash transfer programs.** Public spending should work to remove the role that geography, gender, ethnicity and wealth play in influencing access to key services, so that everyone is in a good position to seize the opportunities being generated in a growing economy. Strengthening, harmonizing and expanding Kenya's array of cash transfer programs with will help reduce poverty, by enabling poor households to consume more, invest in productive assets, and achieve their education and health goals.

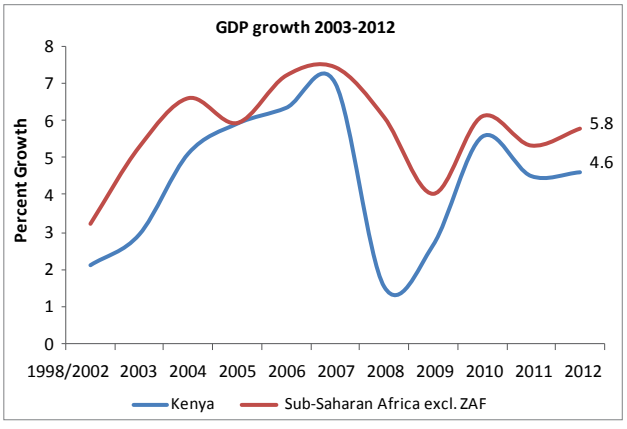
EXECUTIVE SUMMARY

Kenya Rising?

The new Kenyan government has taken office at a time when there is a new optimism for Kenya rising. While Kenya's economic performance over the past decade has lagged behind the average for sub-Saharan Africa, even when resource rich countries are excluded, there is palpable sense that Kenya has turned a corner with peaceful elections in March 2013, and the smooth transition of power in April. If these developments reflect the maturing of Kenya's political system, there is equal optimism that Kenya has put behind the troubling economic periods that have regularly followed its previous election cycles. Kenya's economic performance for 2012, proved stronger than anticipated at 4.6 percent, historically high compared with recent election year periods, and the forecasts for 2013 (5.7 percent) and 2014 (6.0 percent) are encouraging. Yet Kenya could do much better, and there is no doubt that the new government wants to unleash the potential of the Kenyan economy.

What will it take for the Kenyan economy to break its pattern of underperformance? Over the past decade, Kenya's economy grew at an average of 3.8 percent. This is better than in previous decades, but below its potential, its ambition, and its peers. While an increasing number of African countries have already reached Middle Income status, Kenya has lagged behind. Today, out of 48 sub-Saharan African countries, 22 countries have reached a per-capita income of US$ 1025—the official threshold of middle income. At about US$ 820 Kenya's GDP per capita, it ranks 24th and only represents about half the sub-Saharan Africa (SSA) average. Excluding South Africa, sub-Saharan Africa grew at an average of 6 percent since 2002. East Africa as a whole grew even more, at 6.5 percent, and without Kenya it would have grown at almost 7 percent (see Figure 1). Kenya has been following, not leading Africa's growth momentum. Part of the problem has been a series of exogenous shocks that have periodically set back the economy. There have been droughts, oil price spikes and the blow back from the recession in the European Union, a major trading partner. Kenya's neighboring countries have experienced most of the same shocks, yet managed more robust growth. Why has Kenya lagged? This report delves into this problem and identifies the structural issues that separate Kenya from its peers. Fortunately, many of the challenges, such as the business environment constraints affecting the private sector, can be addressed in the short- and medium-term.

Figure 1: Kenya is lagging its peers



Source: World Bank estimates

For Kenya to grow higher, it needs more stability and a new approach to economic development. For Kenya to grow beyond 5 percent, it needs to enhance the contribution of exports as an engine of growth which is now dominated by consumption. Today, net exports are a drag on growth, having reduced overall growth by 4.1 percent in 2012 (see Figure 1.6)—and as reflected in a large and widening current account deficit. This is holding back the growth momentum. If Kenya was to balance its external position, i.e. matching imports with exports, while maintaining current levels of consumption and investments, it's overall growth would already be at 8 percent.

[1] *Devarajan Shantayanan/Wolfgang Fengler. 2012. Is Africa's Recent growth sustainable?, IFRI, Paris.*

Kenya entered 2013 on a strong economic footing, and peaceful elections are giving it an additional boost. Agriculture and manufacturing are benefitting from stable rains, which both stimulate production and drive down the costs of Kenya's hydro-generated electricity. Monetary and fiscal policies also contributed to the recovery. Declining inflation allowed the Central Bank of Kenya to lower its benchmark interest rate to 8.5 percent, and the shift from recurrent towards development expenditure, especially for infrastructure, is also supporting the growth momentum.

However, the current growth model cannot spur growth rates of 10 percent, as envisaged under Vision 2030. The structure of the Kenyan economy would need to change in order to attain sustainable growth rates of around 10 percent. First, the overall level of savings and investment, needs to increase in order to raise the economy's potential growth. To raise the investment rate, the economy would also need to attract more foreign savings in form of foreign direct investment. Second, exports, which have been subdued for almost a decade, would have to contribute more to growth.

> Kenya's poverty rate is estimated to be in the range of between 34 and 42 percent. Given the absence of a household survey since 2005

Several challenges would need to be addressed for the economy to make this desired shift. The quantity and quality of public infrastructure need further improvement, in order to lower transport costs and facilitate trade in goods and services (tourism). Facilitating trade also requires streamlining procedures for exporting and importing, as well as efforts to avoid overvaluation of the real exchange rate. The exchange rate should support exports and make domestic goods more competitive vis-à-vis imports. A weak business environment is another constraint to investment and economic activity: a more conducive business environment would generate new economic activity, which would translate into more jobs, including the formal sector. In addition to raising the stock of physical capital, improvements in human capital (in particular through education and health) are needed to raise potential output.

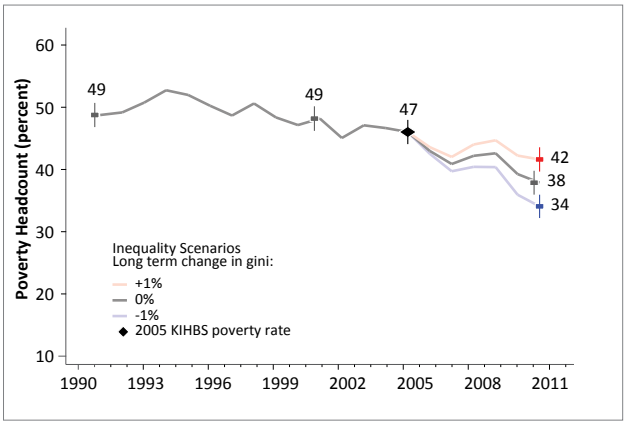
The state of poverty

Today, Kenya's poverty rate is estimated to be in the range of between 34 and 42 percent. Given the absence of a household survey since 2005—the year Kenya last conducted one, more recent poverty estimates are based on projections, and depend on various assumptions, including on the evolution of inequality in Kenya. If recent economic growth benefited all Kenyans in a similar way (i.e. if inequality remained stable), the poverty rate would be close to 38 percent. But poverty would be lower (or higher) if inequality increased (or decreased) say by one percent per year, poverty would have fallen to only 42 percent (34 percent). A more complex projection using the more recent census and other data sources of social wellbeing come to a similar conclusion: Over the last decade, Kenya's poverty has probably declined slowly (at about 1 percentage point per year), but remains at very high absolute levels about 42 percent in 2009.

As in other countries, poverty in Kenya is much deeper and much more pronounced in rural and remote regions. Poverty rates are highest in the arid and semi-arid regions in the north and north east. Geographically, areas with very little annual rainfall, and thus, low agricultural potential have acute poverty. These regions have also been historically neglected, reflecting Kenya's unbalanced geographical development. In 2005, poverty rates in arid regions (78 percent) were nearly double the poverty rates in medium and high potential agricultural areas (with a poverty rate of 41 percent).

However, Kenya's poorest places are not the same places where most of the poor live (see Figure 2). Kenya's lagging areas are sparsely populated and more isolated from it's urban

Figure 2: Has growth and inequality driven poverty down?



Source: World Bank

economic engines—Nairobi, Mombasa and Kisumu. The majority of Kenya's poor live in the denser and higher potential agricultural zones, in the vicinity of large urban centers. In this context, better integration of high potential rural areas to large urban markets and providing access to quality basic services everywhere is critical. Kenya's development—as elsewhere—has been unbalanced geographically, and characterized by the growth of economic and population density in towns and cities. Urbanization is driven by an increasingly mobile and educated population, that is meeting economic opportunities where they are created. Facilitating migration and managing the urbanization process are two strategies that will support poverty reduction in Kenya. At the same time, promoting a more productive and healthy agricultural sector supports this process, helping towns and cities to prosper, as well as the villages that many people leave behind.

As expected, poverty is strongly associated with low levels of education and large households. Primary and secondary school completion rates are the lowest amongst the poorest individuals. In 2009, the average size of households among the poorest 20 percent of households was 5.2 compared to a national average of 4.3 and an average of 3.5 among the wealthiest households.

Between 1989 and 2009, Kenya has also experienced positive developments in several non-income dimensions of poverty, but not all of them. On average, Kenyans are increasingly healthy and more educated, enjoying better living conditions, and an expanded set of consumption opportunities. At the same time, a large fraction of the population continues to live with sub-standard access to water, sanitation and energy (see Table 1). Inequality of opportunity is quite high. Indeed, for many, the sheer luck of where in the country a person is born, one's ethnicity and one's family wealth play an outsize role in determining access to basic opportunities.

When it comes to delivery of critical opportunities and services, Kenya's performance is mixed: Extraordinary success stands side by side with resounding failures (see Table 1):

- In the past 8 years, Kenya has experienced a true telecommunications revolution with household phone ownership increasing at an average rate of 30 percent per year since 2005.
- Kenya has also made significant gains in making basic education accessible broadly—primary enrollment rates are now almost universal. The next challenge for Kenya is to strengthen classroom learning, by reducing teacher absenteeism (a recent study found that almost one in two teachers (45 percent) are not in the classroom during scheduled teaching times) and improving teacher knowledge and performance through training.

> "Kenyans are increasingly healthy and more educated, enjoying better living conditions

- This past decade has been a major success for child health: under-five mortality fell by over 4 percent per year, driven in part by the scaling of evidence-based child health interventions. Maternal health and child nutrition however, remains a challenge.
- While household access to electricity increased in Kenya between 1989 and 2009 by about 4 percent per year, over three in four households

[2] *This projection relies on estimating the relationship between household characteristics and consumption using regression analysis from a survey with consumption data and applying these estimates to censuses or surveys that do not measure consumption directly. The strongest assumption with this approach is that the parameter estimates that capture the relationship between household assets and consumption are stable, i.e. they do not change over time.*

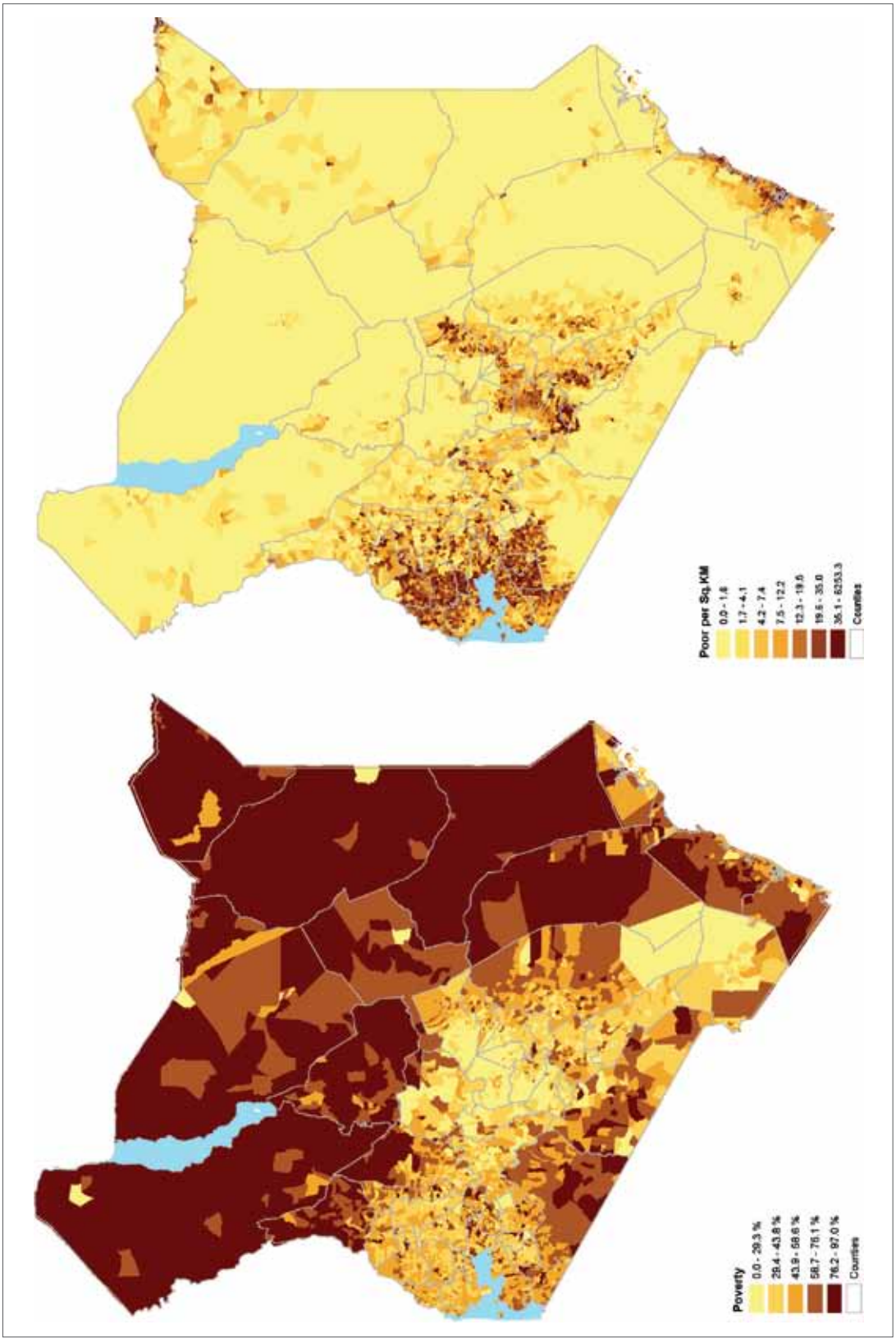


Figure 3: Focusing on poor regions ...or poor people?

Source: World Bank

still do not have access to electricity, and the improvements were more concentrated in the counties around Nairobi.

- Access to clean water and decent sanitation facilities remains elusive to a majority of Kenyans. There is evidence that access to clean water is not keeping up with rates of urbanization in the towns and cities outside of Nairobi, where access to piped water or public tap water declined by over 2 percent per year between 1989 and 2009.

Making poverty history

Kenya needs higher growth to reduce poverty faster. With the historic GDP growth rates of 4-5 percent, average per-capita incomes are only rising by about two percent a year, given that Kenya's population growth rate is still at a high 2.6 percent. If the wealthier are benefitting more, which is probable even though not proven, the poverty reduction benefits of Kenya's moderate growth momentum have arguably been very limited.

In shifting gears, Kenya also needs to complement rapid growth with equity. At times Kenya achieved higher growth but these periods were short-lived because—like a car driving at 80 kilometers per hour in the third gear—Kenya has not been able to shift gears to grow at a higher speed for a sustained period. But in addition to addressing barriers to higher sustained growth, Kenya needs to address its still quite high levels of poverty. This in turn, will most probably require reducing its high levels of inequality. Indeed, Kenya can only eliminate extreme poverty by 2030, the World Bank's global poverty target, if it reduces poverty by 2 percentage points each year. Such a high rate of poverty reduction is only possible if growth is accompanied by a reduction in inequality. This means that the poor need to benefit to a disproportionate extent from economic growth, both through new economic opportunities and by ensuring that safety nets are adequately buffering the vulnerable form shocks.

Table 1: Kenya: A country of contrasts in service delivery

Social and infrastructure indicators	Assessment	Trend	Indicators
Connectivity	100 percent connectivity almost achieved; calling rates among the lowest in the world	Kenya experienced a true telecoms revolution	Percentage of households with at least one mobile phone increased 30 percent per year since 2005
Education	Primary enrollment almost universal but quality remains a major challenge	Some improvement but low "value for money"	
Health	Sharp reduction in child mortality; high levels of maternal mortality	Some improvements	Under-five mortality fell by over 4 percent per year since 2000
Electricity	While household access to electricity increased in Kenya between 1999 and 1989 the improvements were more concentrated in the counties around Nairobi.	Some improvement	Households with access to electricity increased by over 4 percent per year since 1990
Water (urban)	Connectivity did not keep the same pace as urban population growth	Deteriorating	Percent of households with access to piped water or public tap water declined by over 2 percent per year since 1990 in urban areas outside Nairobi

Source: World Bank computations
Note: Colors indicate strong progress (green), some progress (orange), no progress (red).

The analyses presented in this report point to five elements of a poverty reduction strategy. These are:

(i) Fostering pro-poor economic growth and job creation. To encourage the growth of low and middle skills jobs, especially in manufacturing, the government needs to improve export competitiveness and improve the investment and business environment more broadly.

(ii) Enhancing the productivity of smallholder farms. Since the majority of Kenya's poor depend on smallholder agriculture for their livelihood, increasing their productivity through the use of fertilizer, improved seeds and access to markets, will lead to significant poverty reduction in the short to medium term.

(iii) Strengthening and expanding the cash transfer programs that protect and provide income support to the poor. Stronger cash transfer programs and more equitable and effective public spending for leveling the playing field in access to key opportunities—such as quality education, energy, water and sanitation—will be key to increasing equity in the Kenyan society.

(iv) Using public spending to make key opportunities available to Kenyans of all backgrounds. Particularly important in this regard is ensuring that children from households in all income groups have access to quality education, which will have positive effects on poverty reduction, both through a growth effect (skilled workers earn more) and an inequality effect (having a higher supply of skills would drive down the skills premium and reduce inequality).

(v) Investing in a system of routine household budget surveys to monitor poverty and inequality. To convincingly monitor the impact of Government policies on household consumption, equity and poverty reduction, comprehensive and comparable household surveys need to be implemented regularly.

The State of Kenya's Economy

1. Economic Performance

The Kenyan economy has stabilized and could again be in a position for a takeoff. Inflation has declined to below the 5 percent target, and expectations are anchored at a lower level for the rest of 2013, the international reserves have climbed to over US$ 5b (over four months of import cover), public debt to GDP level has declined to below 45 percent, and credit has started to flow back to finance economic activities. The optimism of Kenya's economy is reflected by high volumes of trading in the fixed income securities and equities market. GDP growth in 2012 was 4.6 percent, and is projected to grow to 5.7 and 6 percent in 2013 and 2014, respectively. Despite the optimism, risks do remain. The economy is still vulnerable to exogenous shocks as the large current account deficit threatens macroeconomic stability, the real appreciation of the shilling is eroding Kenya's competitiveness and stifling the export sector, which is supposed to be at the center point for poverty reduction.

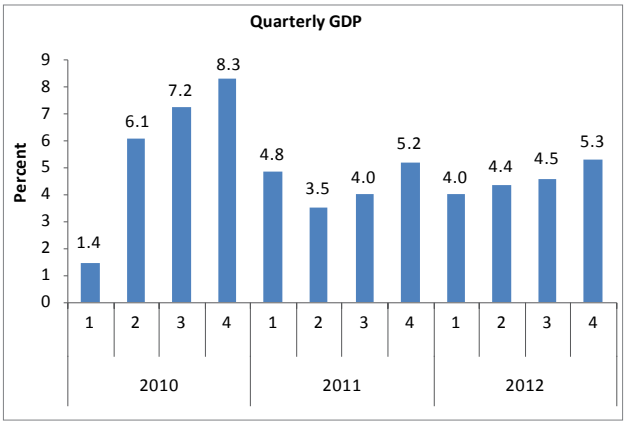
1.1 A resilient economy in times of adversity

Kenya grew at 4.6 percent in 2012 amid a weak global economy. In early 2012, the economy was weak, mainly due to high interest rates resulting from high inflation which peaked at the end of 2011. Over the course of 2012, the Government succeeded in stabilizing the economy. Inflation declined to below 5 percent at the end of 2012—overall average for 2012 was 9.6 percent—which helped to stabilize the exchange rate, and allowed for a gradual easing of monetary policy. However, that success came at a cost. The tight monetary policy stance which started in the second half of 2011 triggered a noticeable slowdown in economic activity in 2012, as domestic demand remained low on account of the high cost of capital.

Economic growth picked up in the second half of 2012. After growing at only 4.2 percent in the first half of 2012, the economy accelerated to 4.9 percent in the second half. Fourth quarter growth was 5.3 percent, which represented the highest economic performance since the end of 2010 when the economy grew at 8.3 percent. The strong performance in the second half of the year was driven by domestic demand, as exports continued to suffer from the weak global environment.

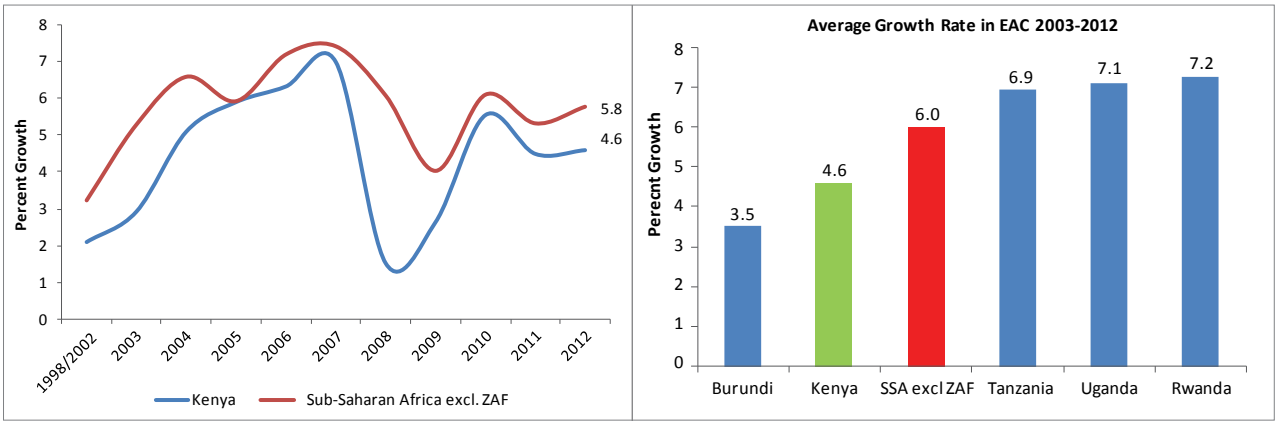
Kenya's economic performance continued to lag behind the rest of sub-Saharan Africa (SSA), particularly, when compared to other East African Community (EAC) countries. For the last ten years, other than in 2005, Kenya recorded lower annual GDP growth than the average for sub-Saharan Africa, and compared to its neighbors in the East African Community. Kenya's annual growth rate for the decade averaged 4.6 percent, compared to 6 percent for SSA, 6.9 percent for Tanzania, 7.1 percent for Uganda, and 7.2 percent for Rwanda. Since the beginning of the global crisis in 2008, the economy has struggled to recover from a number of shocks, including the aftermath of the violence that followed the elections in 2007, reduced demand in the Euro zone, Kenya's largest trading partner, and the impact resulting from high international oil prices. These shocks resulted in low export growth and higher imports. Unfavorable climatic conditions hurt agriculture output, and hydro power generation in 2009

1.1: Growth picked up during the second half of 2012



Source: World Bank Staff calculations based on KNBS data

Figure 1.2: Kenya is lagging behind SSA



Source: World Bank Staff calculations based on Global Economic Prospects, 2013

and 2010. Security threats impacted growth in the service sector, through reduced numbers of tourists.

Economic growth in 2012 was broad based. Unlike in 2011 when growth was driven predominantly by service sectors, industry and agriculture also had a good year in 2012. Agriculture output grew by 3.8 percent, more than twice its growth in 2011. Agriculture's strong growth resulted from good rainfall in the first quarter, which boosted the production of maize, beans and sugarcane among other crops. Tea production declined by 2.2 percent in 2012, due to adverse weather conditions characterized by frost attack in some tea growing areas. A bumper harvest of staple food—maize and beans—eased their prices and contributed to reduced food inflation in the second half of 2012. Maize production increased by 16.3 percent, as Kenya produced 40 million

>> Box 1.1: Why is Kenya underperforming?

Kenya's economic growth rate has not matched even once Africa's growth rate in the course of the past decade, though the two were close in most years. Kenya's relatively weak economic performance can be attributed to three main factors: internal shocks, lack of natural resources, and economic fundamentals. Internal shocks explain the widening gap between Kenya's and Africa's growth rate in 2008-09 and 2011, while the other two explain Kenya's overall underperformance.

Kenya's economy was hit by several disruptive events over the last five years. The post-election violence of 2008 caused economic activity to plummet in fear of violence and political uncertainty. As the political situation calmed, the agriculture sector faced a severe drought in 2009 which continued to dampen economic output. The outlook improved in 2010, but 2011 brought signs of macroeconomic instability, fueled by expansionary monetary policy; and economic growth again slowed.

One key reason behind Africa's strong performance over the past decade has been the commodity boom. Various natural resources were discovered across the continent, which, in a global environment of raising demand and prices, generated a substantial share of the economic growth. Kenya has not been as fortunate –though this may change in the medium-term-, hence this explains part of the gap vis-à-vis the continent's performance.

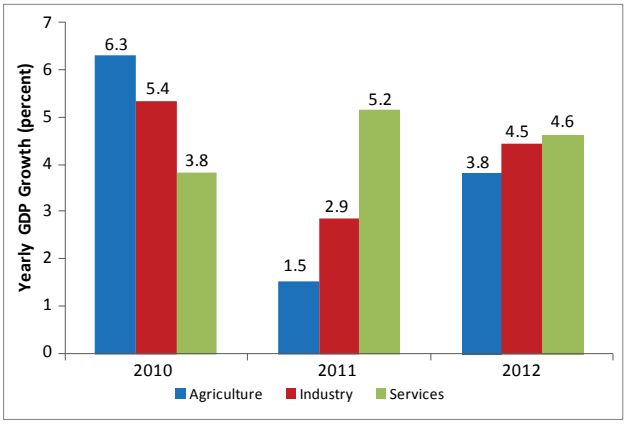
The remainder of the gap in growth, in particular compared to other East African countries, can be explained by differences in economic fundamentals. First, Kenyans save less than their neighbors, hence they invest less, and investment is a key ingredient for rapid and sustainable growth. Second, infrastructure bottlenecks continue to be a drag on economic activity. The dire situation in railways, the inefficiencies at the Mombasa port and the congestion on Kenya's roads attest to this. Finally, the business environment has not seen the improvement it needs to unleash Kenya's growth potential. Other neighbors, e.g. Rwanda, have made great progress in streamlining business regulations. In Kenya, on the other hand, paying taxes, getting electricity, registering a property, and starting a business, continue to be excessively time-consuming and costly.

Source: World Bank

bags in 2012 compared to 34.4 million bags in 2011. Wheat production increased by 54 percent in 2012 to 163 thousand tonnes.

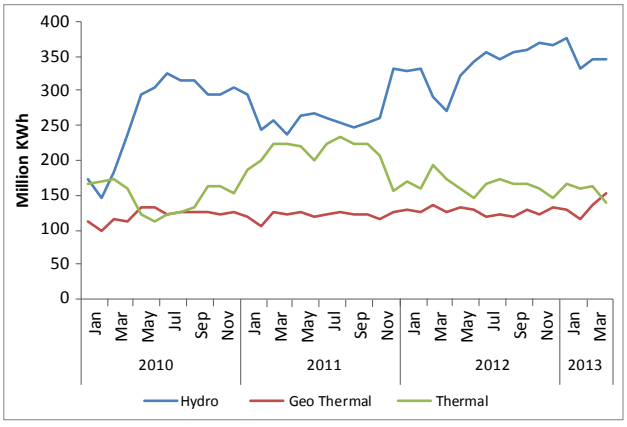
Industrial output rose by 4.5 percent in 2012 compared to 2.9 percent in the same period for 2011. The main driver of industry growth was electricity and the water sector which grew by 10.3 percent in 2012, after a negative growth in 2011. Installed electricity capacity expanded by 4.7 percent from 1534 MW in 2011 to 1606 MW in 2012. Hydropower generation grew by 21.6 percent in 2012 accounted for 50.7 percent of total power generations. Manufacturing sector recorded a 3.1 percent growth in 2012, compared to 3.4 percent in the same period in 2011. The slowdown in manufacturing was as a result of stiff competition from imported goods, high costs of credit and political uncertainties, due to pre-election jitters. Building and Construction is the only subsector which recorded a higher growth rate in 2012 when compared to 2011. It grew by 4.8 percent in 2012, compared to 4.3 percent in 2011. The growth in this subsector was driven by loans and advances which increased by 36.2 percent in 2012, and increased government expenditure in the Ministry of Roads which increased by 29 percent in 2012.

Figure 1.3: Growth in 2012 was broad based



Source: World Bank Staff calculations based on KNBS data

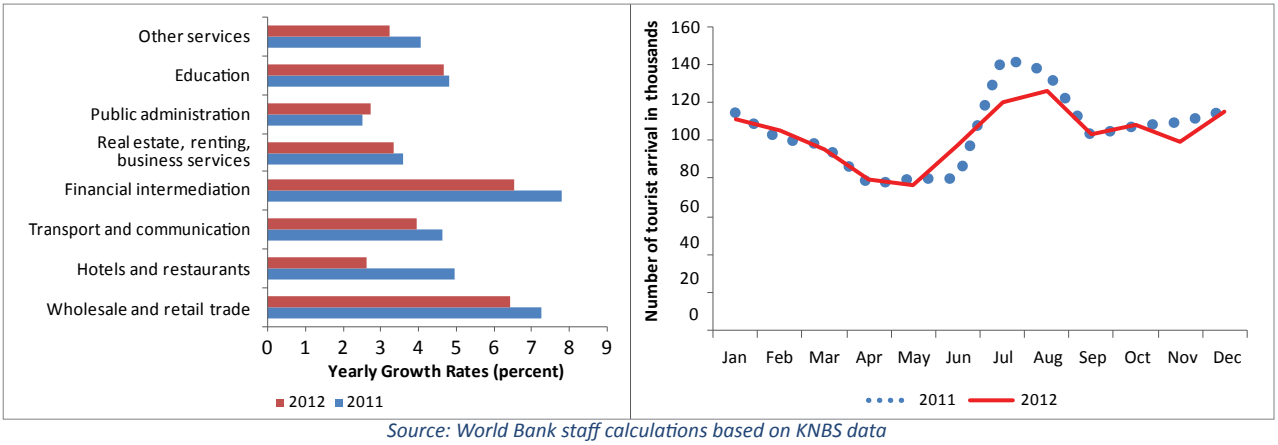
Figure 1.4: Hydro generation rebounded in 2012



Source: World Bank staff calculations based on KNBS data

Although most service sectors grew in 2012, growth was in many instances lower compared to 2011. From 5.2 percent growth in 2011, services grew by 4.6 percent in 2012. The deceleration of growth came as a result of tight monetary policy. All other subsectors recorded a slowdown in growth as: wholesale trade grew at 6.4 in 2012, compared with 7.3 percent in 2011; financial intermediation growth stood at 6.5 percent in 2012 against 7.8

Figure 1.5: Growth in services declined in all sectors including tourism except public administration

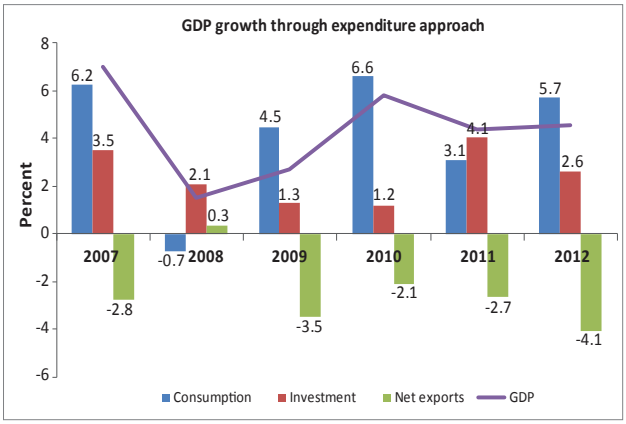


Source: World Bank staff calculations based on KNBS data

percent in 2011; real estate growth slowed to 3.3 percent from 3.6 percent in 2011; and, hotels and tourism activity grew by 2.6 percent (compared to 5.0 percent in 2011). Tourist arrivals at both Jomo Kenyatta and Moi International Airports declined by 6.1 percent in 2012—from 1.8 million visitors in 2011 to 1.7 million in 2012—due to security threats in the region and the Euro-zone economic crisis. On the other hand, transport and communication growth accelerated from 4.1 percent in 2011 to 5.3 percent in 2012.

Private consumption continues to underpin aggregate demand and growth. Real domestic demand grew sharply in 2012, supported by a recovery in private and government consumption. Gross domestic expenditure grew by 6.8 percent in 2012, up from 5.8 percent in 2011. This was mainly driven by private consumption (which constitute 65 percent of aggregate demand and 79 percent of Real GDP) growth which increased to 5.5 percent in 2012 from 3.0 percent in 2011. The mild growth in private consumption was explained by a high interest regime in 2012. Government final consumption expenditure (which constitutes 12 percent of aggregate demand and 15 percent of Real GDP) grew sharply by 9.3 percent in 2012, the highest in 5 years, to cater for the new constitutional offices and election related expenditure.

Figure 1.6: Consumption continues to be the key driver of Kenya's growth offsetting net export weakness



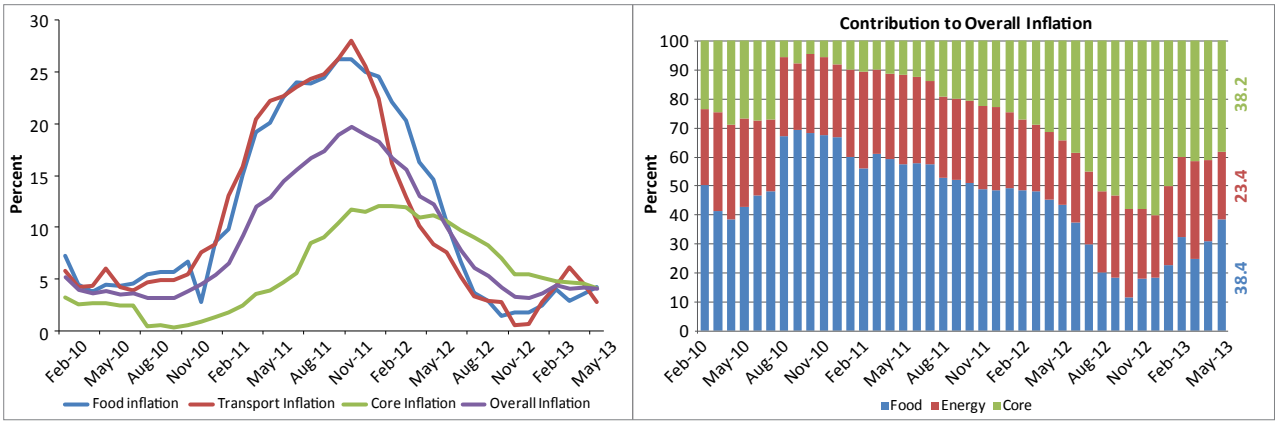
Source: World Bank staff calculation Based on KNBS data
Note: Statistical discrepancy explains the difference the sum of (consumption, investment and net exports) and actual GDP growth

Investment growth was strong in 2012, but lower than in 2011. Gross investment moderated slightly in 2012, as high interest rates and political uncertainty slowed down demand for investment goods. Gross fixed capital formation grew by 11.5 percent in 2012, down from 12.6 percent in 2011. The drop is explained by other machinery and equipment (which constitutes 38 percent of gross fixed capital formation) which grew by 11.4 percent in 2012, significantly down from 27.1 percent in 2011, as a result of political uncertainties related to 2013 election jitters. Building structures (which constitute 43 percent) grew modestly in 2012 at 4.4 percent, up from 3.5 percent in 2011, due to the prevailing high interest rate. Transport equipment (constituting 18 percent) grew sharply in 2012, growing at 27 percent as demand for vehicles to carry out elections campaigns intensified.

Net exports continued to be a drag on Kenya's GDP growth, with a negative contribution of 4.1 percentage points. Even though both exports and imports growth moderated in 2012, the gap between exports and imports widened. In local currency terms, exports growth slowed down to 4.7 percent in 2012, compared to 6.6 percent in 2011, while growth of imports declined from 15.6 percent to 12.5 percent in the same period. The strength in imports growth reflect the importation of transport equipment and machinery for oil and gas exploration, while the weakness in export growth is mainly due to a strong shilling and weak global demand, especially in the euro zone.

High frequency indicators present a picture that is broadly consistent with subdued growth. High frequency data reflected the weakness of the demand side, and underperformance on the supply side. On the production side, cement production plummeted from a growth of 20.7 percent in 2011, to 3.6 percent in 2012, while sales dropped from a growth of 24.7 percent to 1.7 percent in the same period. The fall was attributed to low access to credit and higher interest rates. Total motor vehicle registrations declined by 15.9

Figure 1.7: inflationary pressures have come under control



Source: World Bank staff calculations based on KNBS data

in 2012, after a 5 percent growth in 2011, and motorcycle sales declined by 33 percent in 2012, compared to a 20 percent growth in 2011.

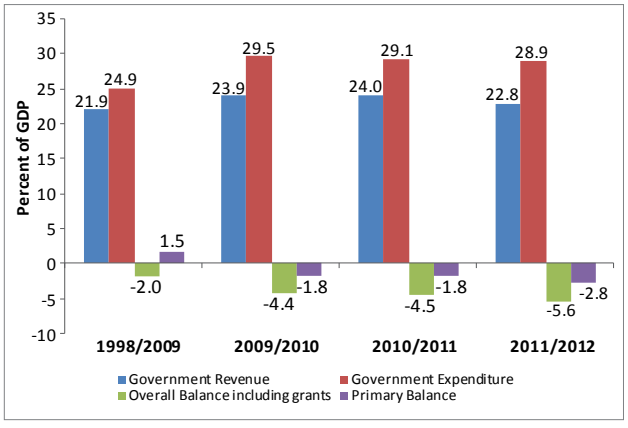
Inflationary pressure moderated in 2012. Month on month overall inflation declined for 12 consecutive months in 2012 from 18.9 percent in December 2011 to 3.2 percent in December 2012. Average annual inflation declined from 14 percent in 2011, to 9.6 percent in 2012. This was as a result of monetary policy tightening, and the absence of any new fuel and food price shocks. On the contrary, international oil prices fell in 2012, and abundant rainfall reduced electricity prices. Bumper harvests in quarter three eased food inflation. Core inflation (which excludes food and oil price movements) declined from 11.6 percent in December 2011, to 5.5 percent in December 2012. Overall, Inflation has edged a notch higher in the first quarter of 2013, but remains below the medium target level of 5 percent.

1.2 Kenya's fiscal prudency is paying off

The government's fiscal framework continues to support macroeconomic stability. The government has successfully maintained fiscal discipline in the face of election year pressures, and the high costs of security operations in Somalia. Moreover, the economic slowdown—and the resulting lower than anticipated revenue—did not shake the Government's commitment to fiscal discipline. Despite a decline in total revenue of 0.8 percent of GDP in 2011/12, the primary deficit was kept at around 2 percent of GDP, and the same deficit is projected to be achieved in 2013.

The aggregate fiscal position remains sound, despite the overall fiscal deficit having increased in 2011/12 and 2012/13. The deterioration of the deficit (commitment basis[3]) from 4.5 percent of GDP in 2010/11, to 5.6 percent in 2011/12, and the budgeted 6.7 percent in 2012/13 has come as a result of increased spending on infrastructure, in particular geothermal power and roads. The boost in development expenditure has been accompanied by a constraint on recurrent spending: capital spending increased by 1.3 percent of GDP in 2011/12, while recurrent spending declined by 1.5 percent of GDP.

Figure 1.8: Fiscal position remains strong despite deterioration of the overall balance

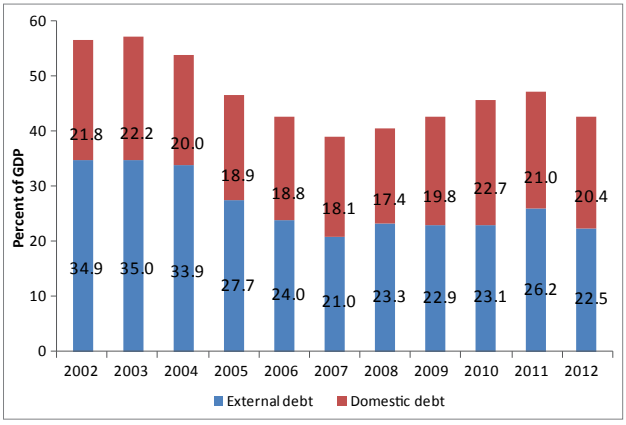


Source: World Bank Staff calculations based on Ministry of Finance data

[3] *The gap between the projected and actual deficits is a result of expected underperformance in spending.*

Kenya is on track to return public debt levels to their healthy 2007 level of less than 40 percent. This level of public debt would give it ample room for policy maneuvering. Lowering public debt would also help mitigate the widening current account deficit.

Figure 1.9: Kenya's public debt declined in 2012

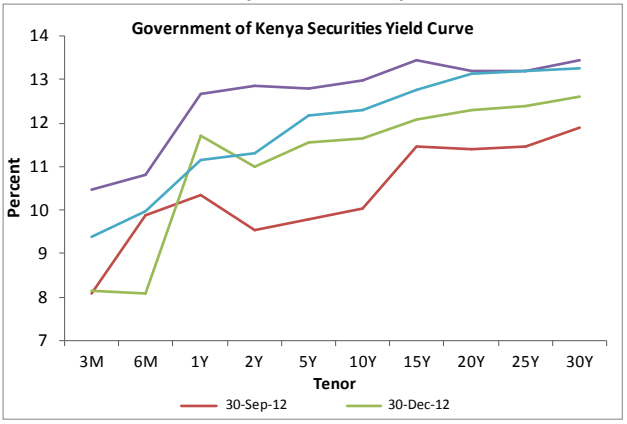


Source: IMF/World Bank: Kenya DSA 2013

Fiscal policy has strengthened Kenya's debt sustainability, as the trend in rising public debt was reversed in 2012. Kenya's total net public debt-to-GDP ratio declined in 2012, as a result of prudent fiscal policy and a stable macroeconomic environment. At the end of 2012, Kenya's public debt stood at 42.9 percent of GDP, compared to 47.2 percent in 2011. Public external debt declined from 26.2 percent to 22.5 percent of GDP in the same period, mainly on account of exchange rate movement, and in part on the retirement of the syndicated loans issued in 2011.

The structure of public debt is favorable. Most of Kenya's public external debt remains on concessional terms, although its commercial component increased to about 10 percent at the end of 2012, mainly as a result of a syndicated loan of about US$ 600 million. External debt portfolio is mainly owed to multilateral creditors (59.9 percent), followed by bilateral (31.2 percent) and commercial (7.1 percent) creditors. Overall, the maturity structure of Kenya's external debt is long term, with over 77 percent with a maturity of over 10 years, 20.7 percent with 5-10 years maturity, and less than 3 percent with less than 4 year maturity.[4] The external debt is mainly denominated in the Euro (33 percent), the US Dollar (31 percent) and the Japanese Yen (16 percent).[5] Government's net domestic debt fell from 21 percent of GDP at the end of 2011, to 20.4 percent of GDP at the end of 2012. Most of the domestic debt is held by commercial banks in form of T-bills and government bonds (comprising of 19 percent and 75 percent of domestic debt, respectively). The share of domestic debt held by non-banks increased from 40.8 percent to 43 percent of the total between 2011 and 2012, reflecting a diversification of the domestic investor base.[6]

Figure 1.10: Yield curve movements in the last 9 months reflected political developments



Source: World Bank Staff calculations based on Bloomberg data

The yield curves movements reflected political developments in the last 9 months. The yield curve shifted outwards in response to political uncertainty of the March 2013 general election. Between September 2012 and March 2013, the average interest rates on government securities increased by an average of 170 basis points (for securities of over 10 years), 307 basis points (over one year but up to 10 years), and 188 percent (less than one year). However by May 2013, the

[4] *Data for June 2011, Source: Ministry of Finance: Annual Public Debt Management Report December 2011.*
[5] *Among Others: Yuan - 6 percent and Sterling pounds - 5 percent.*
[6] *By March 2013, holders of domestic debt were distributed as follows Commercial Banks 48.45 percent, non-banks 45.1 percent, CBK 5.6 percent and non-residents 0.9 percent. Non-banks include Pension Funds (majority in terms of share), insurance companies, and parastatals.*

risk related to elections has started to decline, and the yield curve has shifted downwards (see figure 1.10). Between March and May 2013, yields have reduced by 24 basis points (securities of over 10 years), 95 basis points (securities of over one year but up to 10 years), and 115 basis points (securities of one years and less).

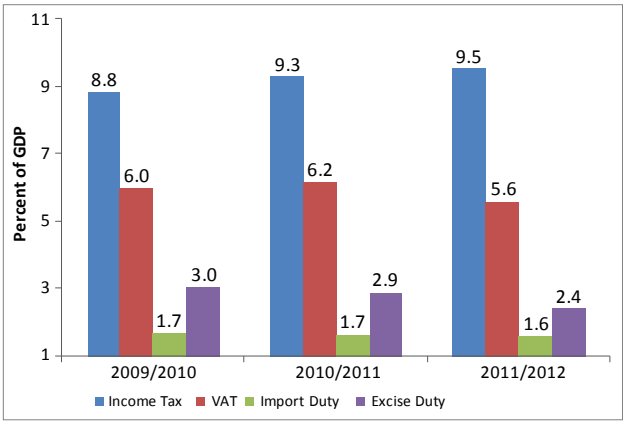
The decline in public debt has increased the fiscal space which Kenya plans to use to borrow on international markets. A US$ 1 billion sovereign bond issue is planned for September 2013. The government will use the funds partly to repay the syndicated loans issued in 2011/12, and partly to finance infrastructure projects. Debt sustainability indicators are not expected to deteriorate significantly following the sovereign bond issuance.

The government faced some challenges in implementing fiscal policy in 2012/13, as revenue underperformed, while pressures for increasing personnel expenditures through higher wages and new constitutional offices grew. For the first half of 2012/13, the overall fiscal deficit deteriorated to 3.2 percent as a share of GDP, slightly lower than the targeted level of 3.3 percent of GDP, but higher than the 2 percent of GDP in the same period in 2011/2012. The deterioration came as a result of lower revenue and increased government spending in the first half of 2012/2013. The deficit was financed largely by domestic borrowing (of 3 percent of GDP), while new foreign borrowing was 0.3 percent of GDP. The primary fiscal deficit reached 1.6 percent of GDP in the first half of the fiscal year, higher than the 0.75 percent of GDP deficit in the same period of 2011/12.

Government revenue as share of GDP has declined slightly over the last two years. Revenues declined from a peak of 23.9 percent of GDP in 2009/10, to 22.8 percent in 2011/12. In the first half of 2012/2013 tax revenues continued to decline further to 10.2 percent of GDP, against the target of 12.4 percent, and less than the 2010/11 outturn of 10.5 percent of GDP, mainly on account of reduced VAT collection.

Lower revenue collection is a consequence of weaker VAT and excise duty collection. VAT and excise revenues declined by 0.6 percent and 0.5 percent of GDP, respectively in 2011/12. Parliament's delay in approving the new VAT Bill on which targets were based, partly explains the lower VAT collection. Government's collection of income taxes, which accounts for about 40 percent of domestic tax revenue, increased slightly.

Figure 1.11: Principle sources of government revenue have remained the same over the years



Source: World Bank calculations based on data from Ministry of Finance

Despite lower collection, fiscal revenue was sufficient to fully finance the budget's recurrent expenditure, and part of its capital spending. The ratio of total revenue to recurrent expenditure has increased from 1.07 in 2007/08 to 1.16 in 2011/12. This signals that fiscal revenue is catering for the entire recurrent spending, and part of capital spending.

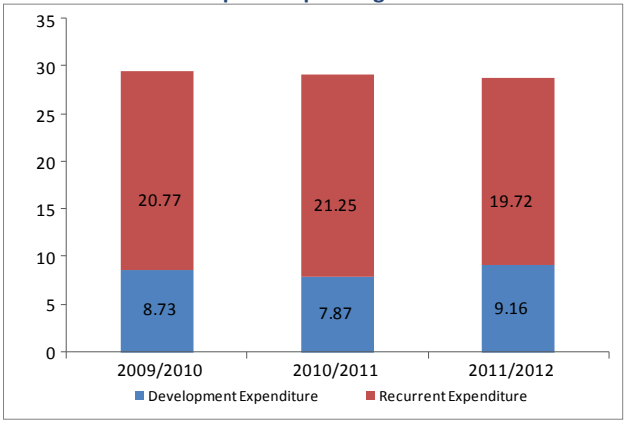
Table 1.1: Kenya's revenue mobilization fully catering for its recurrent expenditure and part of development

	2007/08	2008/09	2009/10	2010/11	2011/12
Total Revenue (KES billion	432.2	487.9	586.4	667.5	748.2
Recurrent spending (KES billion)	403.4	435.5	510.5	592.4	647.1
Revenue to Recurrent spending ratio	1.07	1.12	1.15	1.13	1.16

Source: World Bank calculations based on data from Ministry of Finance

The government is constraining the growth of its overall spending, but allowing development spending to increase. As revenue underperformed, government has rationalized expenditure by cutting recurrent spending, but allowing capital spending to increase. In 2011/12, government spending declined from 29.1 percent of GDP to 28.9 percent. However, spending cuts were fully absorbed by reductions in recurrent budgets (from 21.2 percent of GDP in 2010/11 to 19.7 percent in 2011/12), while capital spending increased (from 7.9 to 9.2 percent of GDP). The fiscal outturn in the first half of fiscal year 2012/13 showed an overall increase in government expenditure to 13.4 percent of GDP, compared to 12.5 percent of GDP for the same period in 2011/12.

Figure 1.12: Budget Cuts absorbed by recurrent spending while development spending was increased

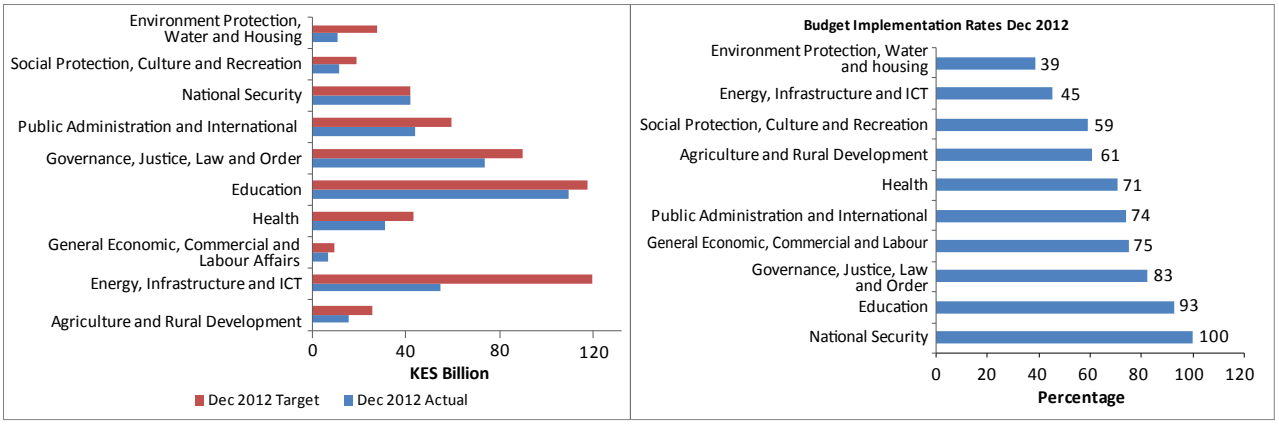


Source: World Bank staff calculations based on Ministry of Finance data

The increased development expenditure was directed to infrastructure. Ministry of Roads accounted for 25.9 percent of the actual ministerial development expenditure. The other top beneficiaries of ministerial development expenditure were the Ministry of State for Planning and National Development and Vision 2030, which spent 16.27 percent (for CDF projects), the Ministry of Finance (7.64 percent for LATF—urban investment), Ministry of Energy (7.10 percent for geothermal power generation), and the Ministry of Water and Irrigation (4.06 percent for infrastructure). Infrastructure improvements are among the key factors that are expected to boost Kenya's economic growth.

Human capital also matters for economic development and some restructuring in spending on social sectors may be needed. The quantity and quality of human capital is determined by health and education outcomes. In this regard, health and education spending accounts for 2.2 percent and 6.4 percent of GDP, respectively. The spending on education is comparable or higher than in other peer countries, which is good. However, education outcomes depend also on the quality of service provision, and here there is lot of room for improvement, in the efficiency and effectiveness of the education system. Health expenditure on the other hand would need to be increased—so will the efficiency of spending—to be able to meet Kenya's health MDGs.

Figure 1.13: Implementation of the budget remains a major challenge

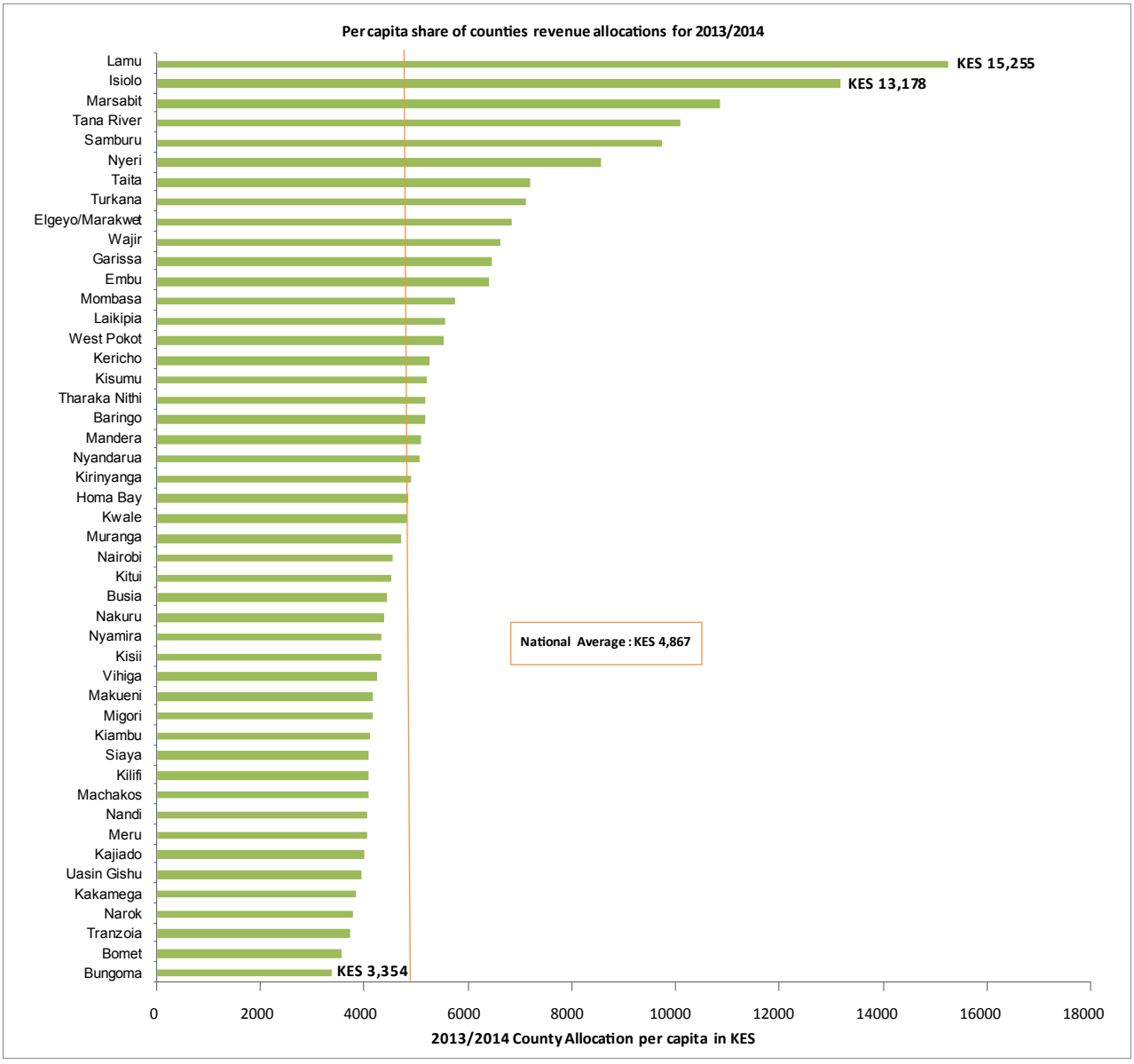


Source: World Bank staff calculations based on Ministry of Finance data

A key challenge that continues to follow on development expenditure is the low execution rate. Poor implementation of the budget affects service delivery. The overall rate of absorption has remained the same at 72 percent. Recurrent expenditure absorption rate was 90.2 percent (higher than 84 percent at the end of June 2012), and development expenditure absorption rate stood at 45.8 percent (compared to 55 percent at the end of June 2012).

A new challenge that the budget will face over the next three years comes from the devolution process. In line with constitutional obligations, the government has allocated KES 210 billion in 2013/14 to the counties. These funds are to cater for devolved functions, such as agriculture, health and infrastructural projects. There are two immediate fiscal challenges related to the devolution process. First, as Figure 1.14 shows, there is wide variance in per capita allocations

Figure 1.14: Per capita allocation for counties shows wide variations



Source: World Bank staff calculations based on Ministry of Finance data

>> Box 1.2: Macroeconomic implications of devolution

The macroeconomic implications of devolution are, in the short-term, primarily fiscal: devolution is likely to be costly, significantly increasing total public expenditure by national and county governments compared to pre-devolution levels. This expansion is likely to be driven by a number of factors:

- **The proposed county equitable share (vertical allocation) for 2013/14 is significantly larger than the estimated cost of inherited devolved functions in the 2012/13 budget.** In the 2012/13 budget, devolved functions to be financed by the county equitable share in future years were identified with a "98" code and amounted to approximately Ksh 130 billion, not including CDF, which the 2013/14 budget indicates will not be devolved. However, the Budget Policy Statement estimates counties should receive 198 billion, including conditional grants. Even allowing for inflation (which the BPS estimates at around 16.3 percent for devolved functions between 2012/13 and 2013/14) this represents a significant increase which is not clearly explained or itemized in the BPS.
- **Negotiations around revenue sharing in Parliament suggest these amounts may be increased.** The Division of Revenue Bill passed by the National Assembly on 9th May increased the allocation to counties to 213 billion (including an equitable share of 190 billion) and the Senate has recommended an equitable share of Ksh 238 billion.
- **The most obvious way to create the fiscal space needed to pay an increased allocation to counties will be to reprioritize funds away from national programs.** In many cases, it may be assumed that counties will now absorb the cost of these programs. If counties are not clearly advised which functions they are expected to fund, the national budget may have to absorb unbudgeted costs of paying for these services in the short term to avoid service collapse.
- **It is particularly important that counties understand what salary costs they will be responsible for.** Allocations to health, agriculture and other sectors in the national budget suggest these salaries of many staff at county level are no longer provided for.
- **Redistribution of public resources through the new formula (horizontal allocation) for the distribution of the county equitable share is costly.** This is because implementing a widely redistributive formula while also maintaining historically privileged counties at the funding levels required to sustain their 2012/13 levels of service delivery requires extra resources. The distribution of the equitable share may leave some counties with relatively little to spend on development.
- **Devolution creates significant new activities (the cost of county assemblies, county executives, the Senate, etc.),** without proposing many immediate efficiency savings (District treasuries will continue to administer the finances of national functions in the counties for example). Counties have yet to have time to explore possible efficiency savings that may in the medium- to long-term mean devolution results in lower total spending per capita in certain counties due to reduced administrative costs.
- **Possible return of seconded staff to national government by counties that either cannot afford** to or do not want to pay the salaries of employees seconded from the national government in support of devolved functions may represent an unbudgeted burden on the national level.
- **Subnational investment spending**—especially for education and health infrastructure that was formerly financed by e.g. the Local Authorities Transfer Fund (LATF)—must now be financed from the county equitable share. Since in some counties the equitable share will not be adequate to meet inherited recurrent costs because of the distributional impact of the formula, and no additional infrastructure grants are being proposed (although the CDF may be maintained as a conditional grant), these counties will either need to suspend investment spending or borrow to finance new infrastructure.
- **County governments are likely to seek to borrow in order to finance increased expenditures.** Although the PFM Act sets clear limits on county borrowing, to be determined by the Intergovernmental Budget and Economic Council (IBEC) and approved by Parliament, these mechanisms are yet to be set up. Anecdotal evidence regarding early draft county budgets for 2013/14 appears to suggest that many draft budgets envisage significant borrowing.

If not carefully managed, these expansionary pressures could undermine Kenya's hard won macroeconomic stability, either by contributing to larger national government fiscal deficits and an increasing debt stock, or by an expansion of subnational borrowing which the national government may be expected to guarantee.

Source: World Bank

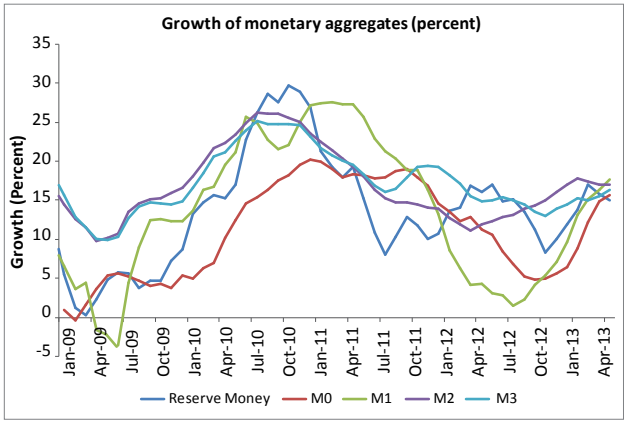
between counties. Second, the devolution formula is different from the previous approach to geographical distribution of spending, and will lead to large variation between what will be spent and what used to be spent. Some counties will receive a big boost in funding, while others will face substantial cuts. Both cases pose fiscal challenges: How to absorb spending in the former? And; How to rationalize expenditure in the latter?

1.3 Monetary conditions have eased but policy must keep an eye on inflation while supporting growth

After an aggressive and successful tightening, the Central Bank of Kenya has reversed gear, now that inflation is under control, and cut its policy rates to forestall a prolonged economic slowdown. The CBK's action to tighten monetary policy in order to fight inflation and stabilize the exchange rate, triggered a climb in interest rates, which in turn cooled off the economy. As inflation has come down below the targeted 5 percent, and with inflation expectations anchored at a lower level, the CBK reduced the central bank rate (CBR) by 950 basis points, signaling the market to lower lending rates and ease credit conditions.

Monetary aggregates are increasing in response to the policy easing. Following a significant reduction in the growth of monetary aggregates in the first half of 2012, monetary aggregates have started to increase to reflect CBK's monetary easing (see Figure 1.15). M1's rate of growth increased from 2.1 percent in July 2012, to 20 percent in April2013, while M2's growth increased from 13.9 percent to 18.5 percent in the same period. The growth of reserve money, the monetary instrument that CBK has direct control over, increased from 6.7 percent in October 2012 to 9.5 percent in April 2013.

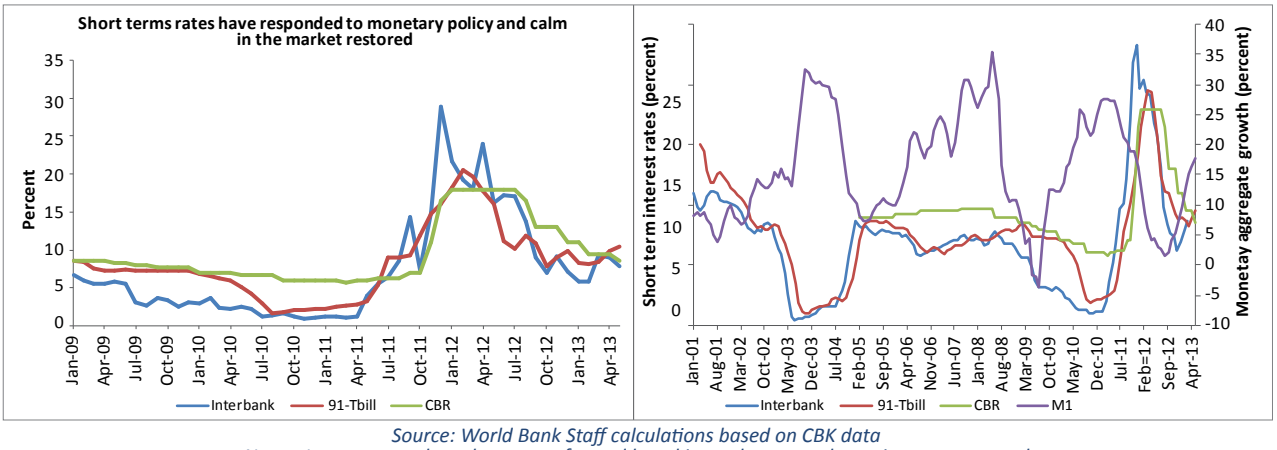
Figure 1.15: Monetary aggregates started increasing in response to policy easing in the second half of 2012



Source: World Bank Staff calculations based on CBK data
Notes: Interest rates have been transformed by taking a three month moving average used

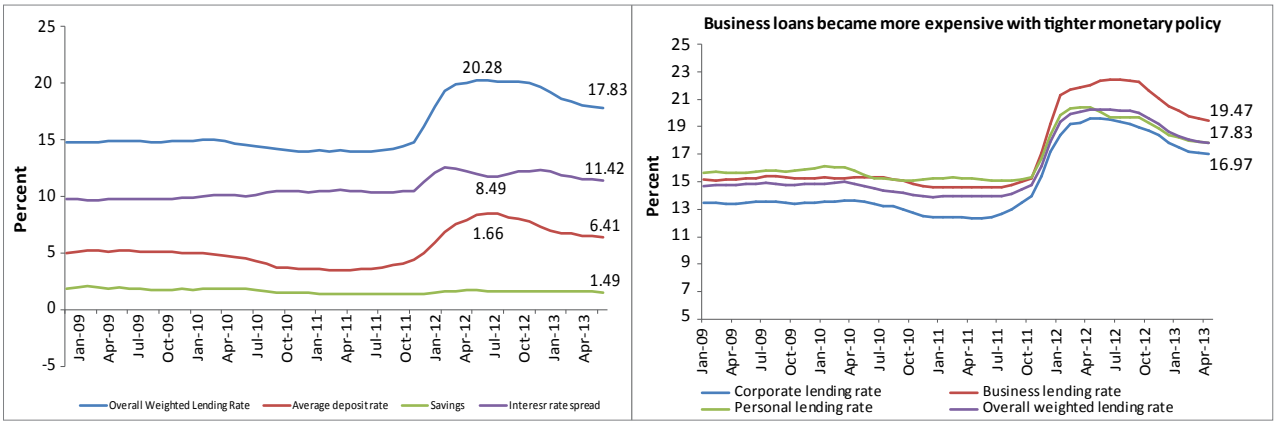
The money market rates have also reacted to the monetary easing. Short term money market interest rates have declined in response to CBK's eased monetary policy. By April 2013, in response to the 9.5 percentage points reduction in the CBR, the 91 day Treasury bill and the interbank rates had declined by 21 and 10.2 percentage points, respectively from their peak of 28.9 percent

Figure 1.16: Short term rates have responded to monetary policy which seems effective



Source: World Bank Staff calculations based on CBK data
Notes: Interest rates have been transformed by taking a three month moving average used

Figure 1.17: Long term rates have remained high but are declining with monetary easing



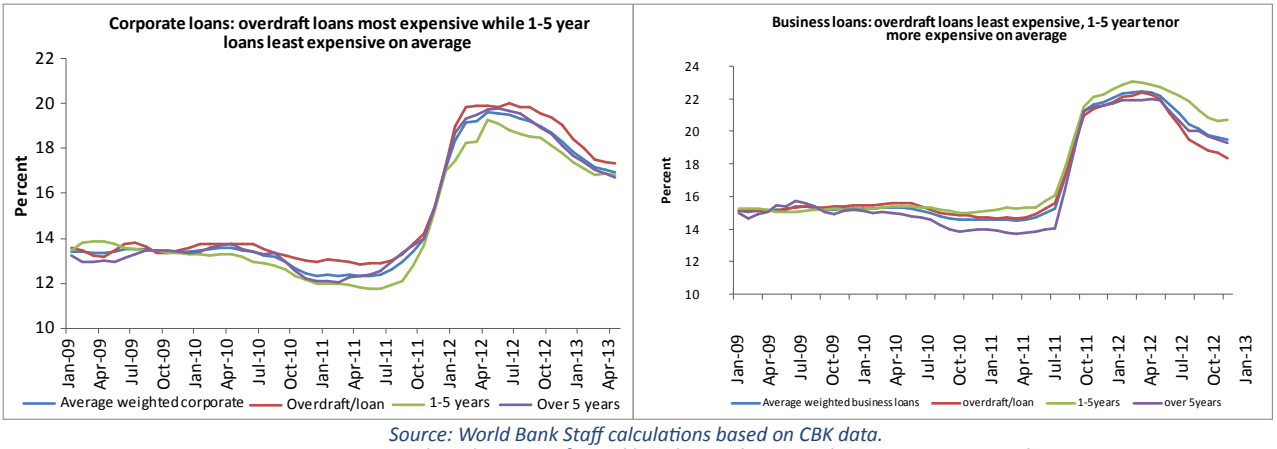
Source: World Bank Staff calculations based on CBK data.
Notes: Interest rates have been transformed by taking a three month moving average used

(November 2011) and 20.56 percent (January 2012)(see figure 1.16). In addition, unlike what happened during the monetary policy tightening period when the interbank rates rose above the Treasury bill rates, Treasury bill rates are now above interbank rates.

Long term interest rates are falling, but at a much slower rate. While commercial banks were quick to increase their lending rates as CBK tightened monetary policy, they have not reacted with similar vigor in reducing their lending rates to their customers during the monetary easing. The average weighted lending rates have only declined by 243 basis points in response to 950 basis points reduction in the CBR. Overall, the weighted lending rates declined from a peak of 20.3 percent in June 2012 to 17.9 percent in April2013 (see Figure 1.17). Average rates paid on three month term deposits also declined from 8.25 percent in July 2012 to 6.4 percent in April2013. Savings rates remained unchanged (see Figure 1.17).[7] As a result, interest rate spread (lending minus deposit rate) remained high at 11.5 percent, compared to the pre-tight monetary policy level of 10.3 percent.

Business loans bore the brunt of tight monetary policy. Commercial banks are pricing business loans more expensively than personal/household loans, while corporate loans are priced less expensively. Before the tight monetary policy begun in the last quarter of 2011, commercial banks priced personal/household loans more expensively than business and corporate loans.

Figure 1.18: Commercial banks pricing behavior of loans seems to vary across categories of borrowers

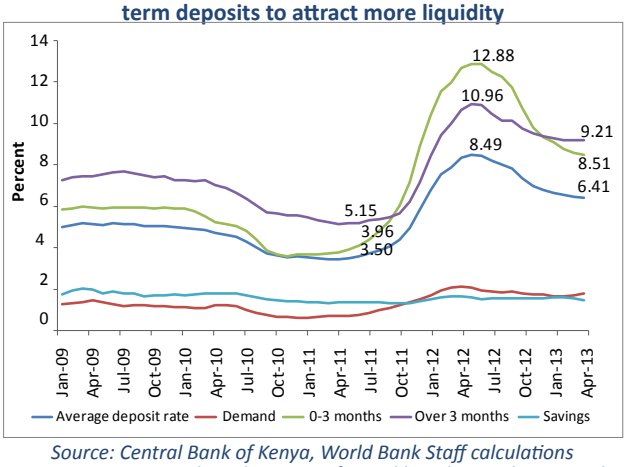


Source: World Bank Staff calculations based on CBK data.
Notes: Interest rates have been transformed by taking a three month moving average used

[7] *Savings deposits are non-term.*

However, this changed with the onset of tight monetary policy conditions (see Figure 1.18). By April 2013, average lending rates on business loans were priced at 250 basis points above corporate loans, 162 basis points above personal loans. This signals the risk by which banks viewed businesses in Kenya during an economic downturn and the election period. Another interesting observation is the pricing of loans based on tenor.[8] While banks tended to price corporate overdrafts loans more expensively compared to 1-5 years tenor, the opposite was true with business loans, where overdrafts were priced more cheaply compared with loans of 1-5 years tenor.

Figure 1.19: Commercial banks offered high deposit rates for term deposits to attract more liquidity



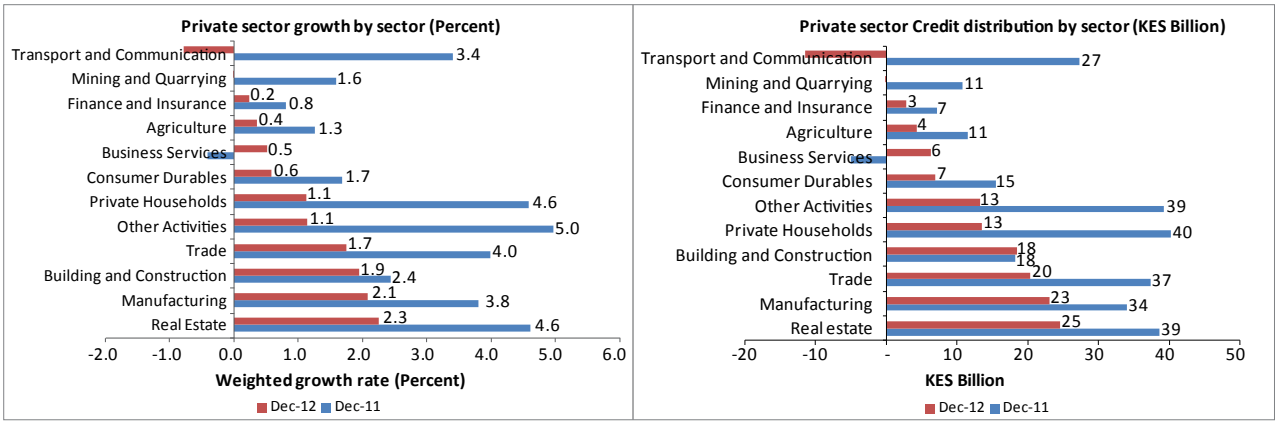
Source: Central Bank of Kenya, World Bank Staff calculations
Notes: Interest rates have been transformed by taking a three month moving average used

Commercial banks offered high deposit rates to counteract CBK's measures.

Term deposits increased significantly as commercial banks competed for deposits to meet statutory liquidity requirements when CBK tightened its lending conditions. Average deposit rates for all commercial banks increased by 500 basis points from 3.50 percent in May 2011 to a peak of 8.49 percent in May 2012, before falling to 6.41 percent in April 2013. This significant increase was driven by 0-3 month term deposits category, which increased by almost 900 basis points from 3.96 percent to 12.87 percent, before falling to 8.51 percent in the same period. At the same time, term deposits greater than 3 months increased by 560 basis points from 5.17 percent to 10.96 percent, before falling to 9.21 percent.

The private sector suffered a massive credit squeeze in 2012. Because of tight monetary policy during the first half of 2012, credit to the private sector dropped by KES 153.2 billion (a 56 percent drop) as commercial banks only disbursed KES 121.1 billion in 2012, compared to KES 274.3 billion in 2011. The growth of the credit to the private sector declined from 30.9 percent in 2011, to 10.4 percent in 2012. There was a significant cutback across all sectors of the economy except building and construction, which received KES 0.2 billion more credit in 2012 compared to 2011. In terms of the amount of credit, transport and communication suffered a KES 39 billion cutback in credit in 2012, when compared to 2011, private households (KES 26.8 billion), trade (KES 17 billion)

Figure 1.20: Tight monetary policy constrained credit to all sectors of the economy



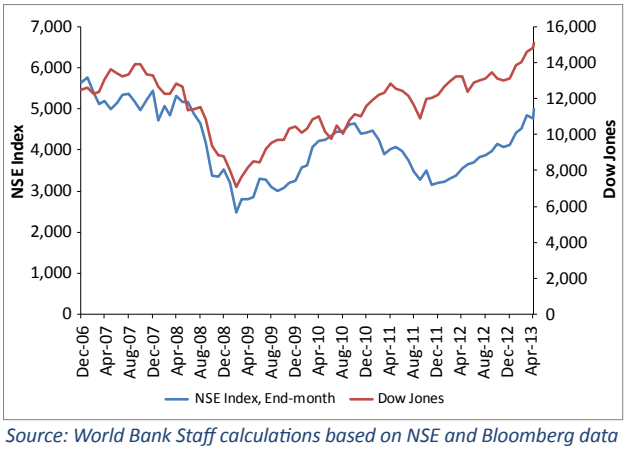
Source: World Bank Staff calculations based on CBK data

[8] *Tenor refers to the length of the loan period.*

and real estate (KES 14 billion). The top four credit recipients of in 2012 were real estate (20 percent), manufacturing (19 percent), trade (17 percent), and building and construction (15 percent). This was a slight change from 2011, when the top four top credit recipients were private households (14.7 percent), real estate (14.1 percent), trade (13.6 percent) and manufacturing (12.4 percent).

However, the rate of private sector credit growth has been picking up gradually, as bank lending conditions eased slowly in 2013. In the first four months of 2013, commercial banks have loaned out KES 42.3 billion, compared to KES 38.1 billion in 2012 (11 percent increase). Majority of the loans have been to private households (33.9 percent), business loans (33.8 percent) and domestic trade (15.3 percent). Credit and activity are propelling each other. Credit expansion has continued at an elevated pace, and credit-to-GDP ratios have continued to move up. However, private sector credit remains sluggish, compared to pre-crisis level. If the current CBK's monetary policy stance of monetary easing continues, it is expected to translate slowly into more dynamic bank lending.

Figure 1.21: Kenya's equities are recovering strongly



Source: World Bank Staff calculations based on NSE and Bloomberg data

The banking sector remained healthy in 2012, despite an environment of tight monetary policy. Aggregate balance sheets grew by 15 percent in 2012. The banking sector's total assets grew from 2.0 trillion (66.3 percent of GDP) in December 2011, to 2.3 trillion (67.7 percent of GDP) in December 2012. The main components of the banking sector's assets comprised of loans and advances (55.6 percent), government securities (17.7 percent) and placements (6.2 percent). Despite prevailing high interest rates, the quality of banking assets remained resilient. The stock of gross non-performing loans (NPLs) increased by 16.9 percent, from KES 53 billion in 2011, to KES 62 billion in 2012. As a result, the quality of assets deteriorated marginally. Asset quality measured as a proportion of net NPLs to gross loans deteriorated from 1.2 percent to 1.7 percent, while the ratio of gross NPLs to gross loans increased from 4.4 percent to 4.7 percent over the same period.[9] A significant portion (67 percent) of the NPLs was in personal household category (33.2 percent), trade (22.1 percent) and real estate (11.6 percent).

There has been a broad market rally at the NSE indicating a reacceleration in activity. The equities market is booming with equity prices rising strongly. The NSE equity index is up 44 percent in the twelve month period through March 2013, driven by strong performances across all sectors of the market. Kenya's equities have continued to follow the global equity markets into higher territory in 2013. In the first 5 months of 2013, the NSE has increased by 873 points (21.2 percent), while the Dow Jones Industrial Average increased by 2011 points (15.3 percent).

1.4 The External Sector poses challenges and risks to Kenya's growth prospects

Kenya's "external growth engine" remains stifled signaling stagnation or loss in competitiveness. Kenya's exports as share of GDP have remained constant since 2005 (at around 23-24 percent) while imports have ballooned from 32 percent in 2005, to 40 percent of GDP in 2012. The exports to imports ratio has declined. For every US$ 100 worth of imports, exports could pay US$ 77 of that in 2005. However, this has reduced to US$ 58. Appreciation in the real exchange rate is

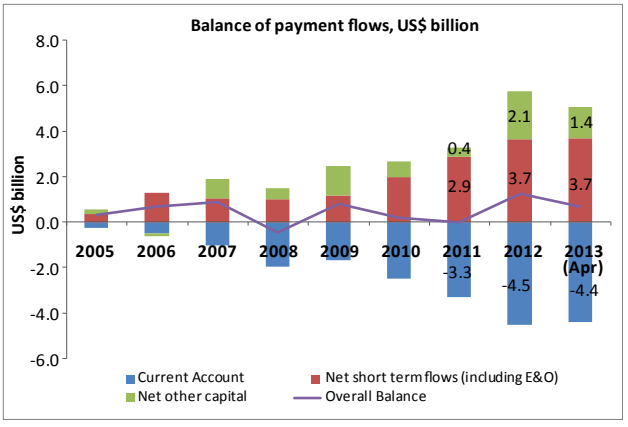
an important contributor to the export stagnation. The shilling has appreciated by 33 percent, or 3 percent per annum, in real terms since 2003.[10] Though the nominal exchange rate depreciated during this period, Kenya had higher inflation than its major trading partners, which in turn led to real appreciation, i.e. loss in competitiveness.

The current account continued to deteriorate in 2012. The current account deficit widened from US$ 3.3 billion (9.7 percent of GDP) in 2011, to US$ 4.5 billion in 2012 (11.1 percent of GDP). This reflected the combination of subdued export demand from Kenya's trading partners in Europe, and strong import demand fueled by the growth in capital imports.

Kenya's current account has deteriorated sharply as exports have stagnated, while imports increased. The share of Kenya's exports in GDP has remained constant since 2005, while the share of Kenya's imports has increased. Specifically, exports marginally declined from 24.3 percent in 2005, to 23.1 percent of GDP in 2012, while at the same time imports as share of GDP increased from 32 percent to 40 percent. Though a significant portion of the increase of imports can be attributed to the oil bill and increased imports of machinery, transport goods and other intermediate goods, the appreciation in the real exchange (discussed below) has contributed to the problem. More recently, the deterioration in the current account reflected an increase in non-oil imports by 13.8 percent to US$ 12.2b in 2012, from US$ 10.7 in 2011. Crude oil imports were not a major factor driving the current account deficit in 2012, as the oil bill remained the same as in 2011 at US$ 4.1 billion. Capital imports were a major factor, increasing by 29 percent from US$ 3.7billion to US$ 4.9 billion.

The overall balance of payments returned to surplus in 2012. The overall balance moved from a small deficit in 2011 to a large surplus in 2012, on the back of strong net short term flows and project loans (including defense loans). The overall balance of payments improved from a deficit of US$ 0.04 billion (0.1 percent) in 2011 to a surplus of US$ 1.4 b (3.0 percent of GDP) in 2012, mainly the result of an increase in project loans from US$ 0.6 b to US$ 1.4 billion. The basic balance (current account balance plus net direct investment)[11] remained negative, implying a continued reliance on potentially volatile portfolio investment, which signals that Kenya continues to remain vulnerable to external shocks (see Figure 1.22).

Figure 1.22: A wider current account deficit is being financed by short term flows



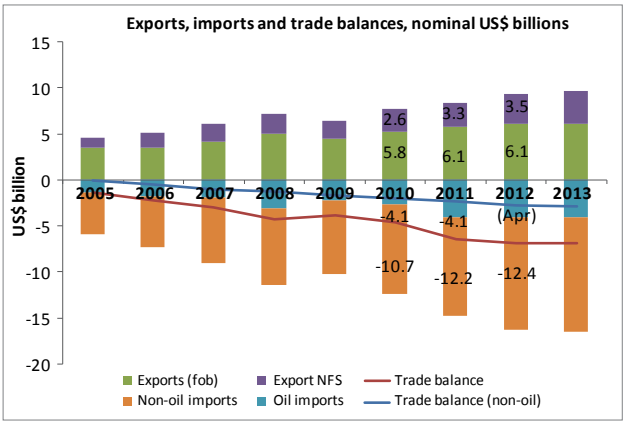
Source: World Bank Staff calculations based on CBK data

The balance of trade deteriorated further in 2012, reflecting strong capital import demand coupled with weak commodity exports. The non-oil trade balance deteriorated slightly to US$ -2.8b (6.91 percent of GDP) in 2012, from US$ -2.4b (6.89 percent of GDP) in 2011, while the deficit in the balance of trade including oil increased to US$ 6.9b (16.9 percent of GDP), from US$ 6.4b (18.8 percent of GDP) in the same period (see Figure 1.23). Turning to a more detailed view of recent trade dynamics, in 2012 the merchandise account deficit increased from US$ 9b (26.8 percent of GDP) in 2011, to US$ 10.4b (25.1 percent of GDP) in 2012. Total imports growth moderated from a growth of 19.5 percent in 2011, to 10.0 percent in 2012, to reach US$ 16.3b (40.3 percent of GDP). Capital goods imports grew by 29 percent from

[10] *Nominal exchange rate is the amount of Kenyan shillings that can purchase a unit of a given foreign currency (e.g. a US dollar). A decrease in this variable is termed nominal appreciation of the currency while an increase is termed nominal depreciation of the currency. Real exchange rates are nominal exchange rate that has been adjusted for the difference in inflation between Kenya and its trading partners.*

US$ 3.7b to US$ 4.9b, while imports of crude oil remained flat in 2012 at US$ 4.08b, same as in 2011. Exports of goods grew by 5.5 percent to reach US$ 6.2b (15.1 percent), from US$ 5.8b (17.3 percent of GDP) in the same period. This underperformance of exports is explained by poor performance in Kenya's main export crops. Tea and horticulture grew by only 4 percent and 2 percent respectively in 2012. Strong performance in the transportation account and other government services saw non-factor services grow 27 by percent in 2012, from US$ 2.6billion to US$ 3.2 billion. Overall exports of goods and services for 2012 increased by 12.2 percent to reach US$ 9.4b (23.2 percent of GDP), up from US$ 8.4b (24.9 percent of GDP), in nominal USD terms.

Figure 1.23: Non-oil imports mainly capital imports increased significantly in 2012 while oil imports remained flat

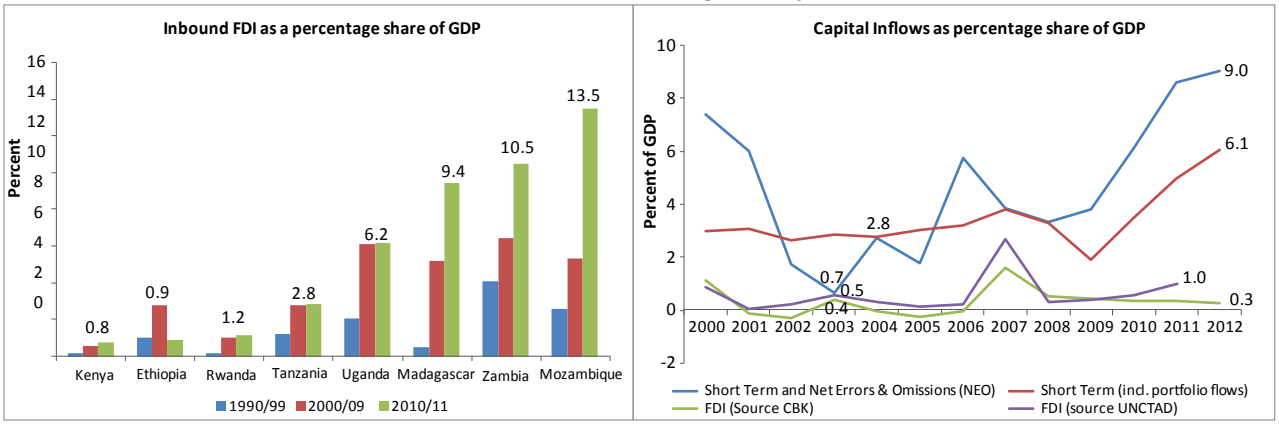


Source: World Bank Staff calculations based on CBK data

Despite its potential, Kenya is still not attracting adequate long term capital inflows to power its growth. Kenya receives less long term capital inflows than any other country in the EAC region. According to CBK balance of payment data, official medium and long terms flows, which are mainly project loans (including defense loans), increased from US$ 527 million in 2010, to US$ 612 million in 2011, and then to US$ 1,449 million in 2012. However, foreign direct investment (FDI) remained subdued, as Kenya received only US$ 177 million (2010), US$ 140 million (2011) and US$ 164 million (2012) according to CBK data. UNCTAD data on the other hand shows that Kenya received US$ 178.1 million (2010) and US$ 335 million (2011) in FDI. Kenya's performance in attracting foreign investment remains limited compared to its peers. The FDI Kenya attracted was only equivalent to 0.8 percent of its GDP in 2010-11, compared to Rwanda (1.2 percent of GDP), Tanzania (2.8 percent of GDP), and Uganda (6.2 percent of GDP) in the same period (see Figure 1.24). However, following the recent peaceful elections, and given the improvements in the governance framework since the new Constitution was adopted in 2010, FDI to Kenya is expected to increase in the future.

Kenya has not been an attractive destination of FDI. A variety of factors explain low FDI in Kenya (i) infrastructure bottlenecks both in energy and roads have been a major constraint on FDI. For Kenya

Figure 1.24: FDI inflows into Kenya remains low compared to its peers in the region while Short term flows have increased significantly



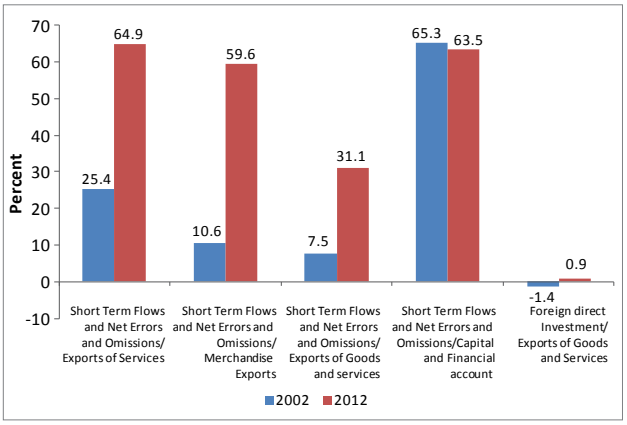
Source: World Bank Staff calculations based on CBK and UNCTAD data

[11] *Even if we defined basic balance as current account deficit plus non short term capital, it still remains negative, further demonstrating Kenya's vulnerability.*

to be an attractive destination for FDI, it requires infrastructure to facilitate the production activities and sale of goods and services. Good infrastructure lowers the transaction costs, which enable investors to earn returns on their investments, as their enterprises are able to generate profits. This constraint has been recognized by the government as a larger proportion of Kenya's budget is now allocated to roads and energy sector. (ii) Kenya's labor productivity has been falling in the recent past, while at the same time, labour costs have been rising fast compared to their productivity. (iii) The regulatory environment in Kenya has been hostile to FDI and impeded it. Excessive regulations have hindered entrepreneurial activity, as firms spend more time and resources complying with rules and regulations. The long delays in resolving disputes in the judiciary and other cumbersome compliance items, have discouraged FDI. In addition, the regulations that require foreign firms to enter into mandatory joint ventures partnerships (30 percent share) with locals in order to invest in Kenya, makes it a less favorable investment destination.

Short term flows continue to dominate Kenya's balance of payments, and expose the economy's vulnerability to sudden reversals. Short term flows including errors and omissions increased from US$ 2 billion (6.1 percent of GDP) in 2010 to US$ 4.3 billion (9 percent of GDP) in 2012. Excluding the errors and omissions, short terms flows increased from US$ 1.1 billion (3.5 percent of GDP) to US$ 2.4 billion (5.8 percent of GDP) in the same period. The critical importance of short term flows in financing the current account is detected when its contribution to the capital and financial account is analyzed (see Figure 1.25). Short term flows (including errors and omissions) constitute 63.5 percent of net capital and financial account. This was a significant decline from 87.9 percent in 2011, which is accounted for by US$ 1.2 billion in the project loans (including defense loans) that were recorded in 2012. Portfolio inflows are mostly for investment in the equities and bond markets, where returns have been very high since the onset of global financial crisis in 2008. Strong net portfolio investment inflows were in line with a solid domestic government bond and stock market performance, which occurred at a time when the global risk appetite was improving, and interest rates in advanced and emerging markets were low.

Figure 1.25: Short term flows has become a significant factor in the balance of payment



Source: World Bank Staff calculations based on CBK data

Kenya remains exposed to a reduction in shorter-term capital flows in the event of heightened uncertainty on global financial markets. The current account deficit is expected to widen further, as the economy expands, after the general elections. Moreover, imports of heavy machinery and transportation equipment, which are important for infrastructure projects and oil and gas exploration, are expected to grow in 2013. Kenya runs a risk, if it continues to depend on short term flows that uncertainties in global financial markets could undermine its ability to finance the current account deficit. Kenya would benefit from increased long term flows and FDI, to substitute for some of the short term flows that are more vulnerable to uncertainties in the global capital markets.

The Central Bank of Kenya has built a large enough buffer to cushion the economy in the event of external shock. The CBK increased its holding of international reserves by US$ 1.5 billion (36 percent) in 2012, from US$ 4.2b in 2011 to

US$ 5.7b. The import cover increased from 3.7in December 2011 to 4.3 in 2012, which is above the statutory requirement of 4 months.

Kenya's structure of exports and imports has not changed in the last 5 years. Machinery and transport equipment constitute the largest share of imports accounting for about 30 percent, while oil imports take a 25 percent share. Variations in oil imports are driven by price fluctuations. Imports of machinery and transport equipment tend to expand the economy's productive capacity, and are beneficial to Kenya's long term growth (see Table 1.2).

Exports remained weak in 2012. Weak external demand for Kenya's exports was as a result of subdued global demand, and lower commodity prices. Tea remains the major contributor to merchandise exports earnings, bringing in about 20 percent of total earnings, followed by horticulture and manufactured goods, which each contributed about 11 percent in 2012. While tea earnings have increased from 17 percent in 2007 to 20 percent in 2012, export earnings have declined for horticulture from 15 percent in 2007 to 11 percent in 2012, in the face of subdued demand in Europe. The largest destination of Kenya's exports is Africa, where 48 percent of its exports go with 26 percent

Table 1.2: Kenya's top exports and imports by broad functional category

Selected Exports												
	2007	2008	2009	2010	2011	2012	2007	2008	2009	2010	2011	2012
Coffee (%)	4	3	4	4	4	4	0.6	0.5	0.7	0.6	0.7	0.7
Tea (%)	17	18	20	22	20	20	2.5	3.0	2.9	3.6	3.4	3.0
Horticulture (%)	15	15	15	14	12	11	2.2	2.5	2.3	2.3	2.0	1.7
Manufactured Goods (%)	12	12	12	12	13	11	0.6	0.4	0.3	0.3	0.4	0.2
Selected Imports (%)												
As a share of Total imports							**As a share of GDP**					
Oil (%)	21	27	21	22	28	25	7.0	10.0	7.2	8.3	12.1	10.1
Chemicals (%)	13	13	13	13	13	13	4.2	4.7	4.3	5.0	5.8	5.1
Manufactured Goods (%)	16	14	14	14	15	14	5.3	5.2	4.6	5.5	6.7	5.7
Machinery & Transport Equipment (%)	31	27	30	31	25	29	10.3	10.1	10.0	11.8	11.0	11.7
Selected Exports (%)												
	As a share of Total Exports						**As a share of GDP**					
	2007	2008	2009	2010	2011	2012	2007	2008	2009	2010	2011	2012
Coffee	4.03	3.07	4.45	3.99	3.82	4.39	0.61	0.51	0.66	0.65	0.66	0.66
Tea	16.76	18.30	19.69	22.17	19.86	19.57	2.54	3.03	2.92	3.60	3.43	2.97
Horticulture	14.70	15.12	15.29	13.88	11.67	11.34	2.23	2.51	2.26	2.25	2.02	1.72
Manufactured Goods	12.42	12.38	11.62	11.63	12.55	11.43	0.59	0.38	0.31	0.28	0.35	0.20
Selected Imports (%)												
	As a share of Total imports						**As a share of GDP**					
Oil	21.17	26.55	21.29	21.56	27.55	25.05	7.05	10.02	7.17	8.30	12.14	10.09
Chemicals	12.74	12.58	12.86	12.93	13.15	12.74	4.24	4.75	4.33	4.98	5.79	5.13
Manufactured Goods	15.83	13.83	13.70	14.31	15.19	14.13	5.27	5.22	4.61	5.51	6.69	5.69
Machinery & Transport Equipment	30.87	26.65	29.77	30.72	24.88	29.15	10.28	10.05	10.02	11.83	10.96	11.74

Source: World Bank Staff calculations based on CBK data

Table 1.3: Selected Kenya's Trading Partners

	Top 10 Exports Destination			Top 10 Origin of Imports (country of origin		
		US$ (Million)	Percent of Total Exports		US$ (Million)	Percent of Total Exports
1.	Uganda	67,450	13.0	India	195,230	14.0
2.	Tanzania	46,036	8.9	China	167,206	12.2
3.	UK	40,630	7.8	UAE	149,879	10.9
4.	Netherlands	31,056	6.0	Saudi Arabia	66,841	4.9
5.	UAE	28,608	5.5	USA	65,966	4.8
6.	USA	26,405	5.1	Japan	63,135	4.6
7.	Pakistan	23,889	4.6	South Africa	61,954	4.5
8.	Egypt	21,464	4.1	Indonesia	55,241	4.0
	Rwanda	16,151	3.1	UK	43,849	3.2
9.	Germany	9,771	1.9	Germany	41,474	3.0
	Total	**517,847**	**60.1**		**1,374,587**	**66.3**
1.	Africa	250,589	48.4	Asia	856,525	62.3
2.	Europe	125,195	24.2	Middle East	284,117	20.7
3.	Asia	105,460	20.4	Far East	572,408	41.6
4.	Middle east	42,065	8.1	Europe	249,769	18.2
5.	Far East	63,395	12.2	Africa	140,755	10.2
6.	EAC	134,946	26.1	EAC	30,857	2.2
7.	COMESA	175,732	33.9	COMESA	61,572	4.5

Source: KNBS, Economic Survey 2013

going to East African Community. The EU is Kenya's second main trading partner and accounts for 24 percent of it's exports, of which 7.8 percent goes to the UK. As such, even though the economic situation in Europe affects Kenya's exports, more than three quarters of its trading partners have not seen an economic crisis similar to what has been happening in Europe in the past few years.

The exchange rate stabilized in 2012. The Kenya shilling in December 2012 traded at KES 85.99 against the US$ (compared with KES 86.66 in December 2011). This represented a 0.8 percent nominal appreciation against the US$. Taking a long term perspective, between January 2003 and December 2012, the shilling has depreciated by 11.8 percent, 10.5 percent and 39.8 percent, respectively against the US$, the Sterling Pound and the Euro. As such, the average annual rate of depreciation was 1.2 percent, 1.1 percent and 4 percent per annum, respectively in the period. The rate of depreciation has been much lower when compared to Kenya's inflation rate during the period, which averaged 9.6 percent per annum in the last 10 years. Between December 2012 and April 2013, the shilling had appreciated in nominal terms by 2.1, 7.2 and 2.8 percent against the US Dollar, the Sterling Pound and the Euro mainly on

[14] *Nominal exchange rate can be defined as the amount of Kenya shillings that can purchase a unit of a given foreign currency. A decrease in this variable is termed nominal appreciation of the currency while an increase is termed nominal depreciation of the currency. Real exchange rates are nominal exchange rate that has been adjusted for the different rates of inflation between Kenya shillings and a foreign currency. In practice, changes of the real exchange rate rather than its absolute level are important. An increase in the real exchange rate is termed depreciation while a decrease is depreciation. The importance stems from the fact that it can be used as an indicator of competitiveness in the foreign trade of a country.*

[15] *Long-run equilibrium real exchange rate is the real rate that, for given values of "economic fundamentals" (openness, productivity differentials, terms of trade, public expenditure, direct foreign investment, international interest rates, etc.) is compatible with simultaneous achievement of internal and external equilibrium. For methods to estimate long-run real equilibrium exchange rate, see Hinkle and others 1999.*

>> Box 1.3: Could the deprecation of the Kenyan shilling be beneficial to Kenya's economy? Evidence from the literature

Recent studies on Kenya have shown that import price elasticity of demand is greater than unity. This implies that import demand in Kenya is fairly elastic. In other words, as relative prices fall import demand will increase by a greater than proportional amount.

Aggregate price elasticity of demand estimates for Kenya[13]

	Jones (2003)	Tokarick (2010)	Kee et al (2008)	Faini (1988)	Senhadji (1977)	Bruce/Ndii (1994)
Aggregate Import price Elasticity	-1.148	-1.33	-1.14	-1.48		-1.45

Even though Kenya's aggregate price elasticity of demand indicates that imports would respond to the shillings depreciation, there is a very wide disparity across sectors as depicted in Table 2. From the studies by Jones (2003), 10 percent depreciation of the shilling would lead to 28.2 percent reduction in rubber and hinds, 24 percent in Footwear and headgear, 20 percent in precision instruments etc. However, capital goods, chemicals and vehicles and transport would fall less than proportionately

Import price elasticity of demand for Kenya sectors

	Sector	Sector Elasticity		Sector	Sector Elasticity
1.	Rubber and Hides	-2.82	9.	Mineral Products	-1.32
2.	Footwear and Headgear etc	-2.42	10.	stones, Pearls Glass etc	-1.29
3.	Precision Instruments	-2.01	11.	Beverages and Tobacco	-0.99
4.	Base metals	-1.93	12.	Miscellaneous Manufactures	-0.95
5.	Textiles and Garments	-1.76	13.	Vehicles and Transport Equipment	-0.88
6.	Live animals	-1.58	14.	Arms and Munitions	-0.63
7.	Wood and Paper Products	-1.54	15.	Chemicals	-0.53
8.	Vegetable products	-1.51	16.	Machinery and Electrical Equipment	0.22

Source: Jones C. (2003)

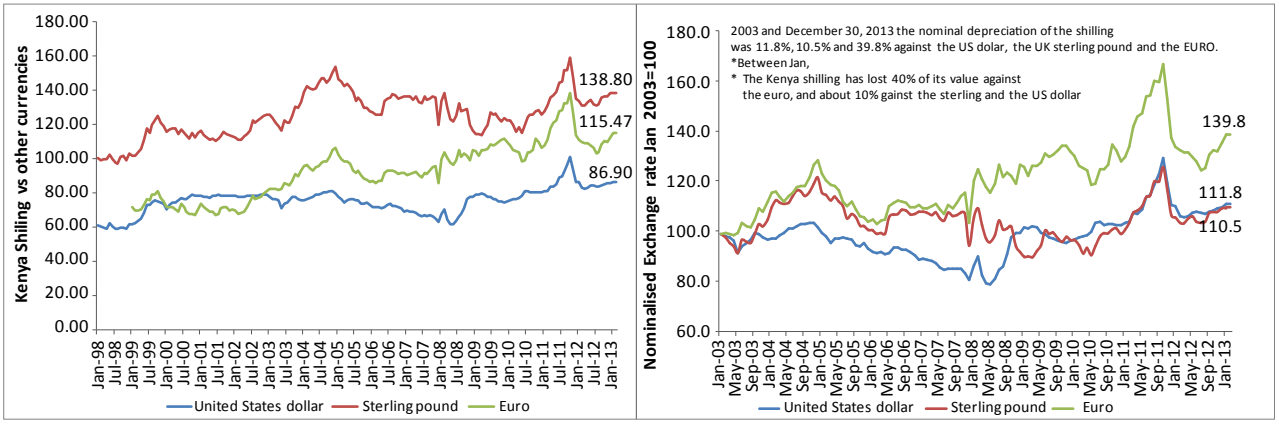
The response of exports to depreciation would be weak in the short run. According to recent studies Kenya's export supply elasticities are in the range of 0.28-0.60 in the short run and 0.33 -0.88 in the long run (see Broda et al (2008) and Tovarick (2010). If these elastcitites are correct, then a 10 percent depreciation will elicit less than proportionate export supply response.

Lastly, using import demand and export supply elasticities from various studies, Tovarick (2010) calculated Kenya's trade balance elaticities to range from 0.46 in domestic currency and 0.56 in foreign currency. According to this study, a 10 percent depreciation of the shilling will improve the trade balance by 4.6 percent in domestic currency terms or 5.6 percent in foreign currency terms.

Source: World Bank

[13] *Kee, H. L. Nicita A., and Olarreaga (2008): Import Demand Elastcities and Trade distortions" Review of Economics and Statistics Vol 90, No4, pp 666-682 Senhadji, Semlali 1997: Time series of Structural Import demand Equations- A cross country Analysis, IMF Working Paper WP/97/132 Jones C (2003): Aggregate and Sector Import Price Elastcities for a sample of African Countries' CREDIT Research Paper No 08/03 Tokarick S (2010): A Method for Calculating Export Supply and Import Demand Elasticities, IMF Working Paper WP/10/108.*

Fig 1.26: The exchange rate stabilized in 2012 but has depreciated at the rate of 1-4 percent per year in nominal terms in the last 10 years against the major currencies



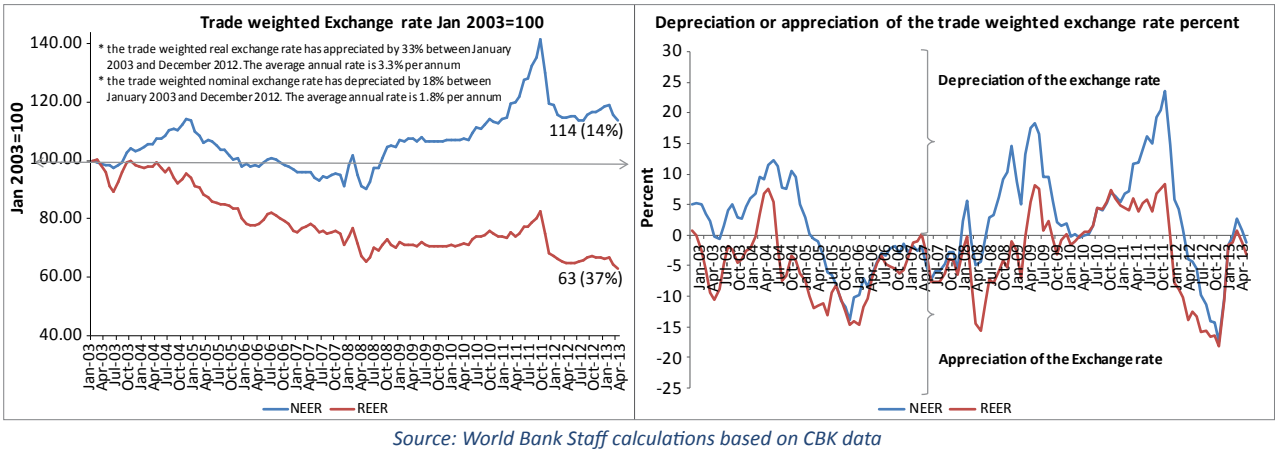
Source: World Bank Staff calculations based on CBK data

account of peaceful transition of power which had reduced political risk.

On the other hand, the persistently higher inflation *vis-à-vis* its trading partners, points to an appreciation in the real exchange rate, i.e. erosion in Kenya's competitiveness. The evolution of the real exchange rate over the last decade, shows a trend of real appreciation. Between January 2003 and April 2013, the Kenya shilling appreciated by 37 percent in real terms, cumulatively representing an annual appreciation of about three percent.[12] [13] Hence, despite the nominal depreciation of the shilling, Kenya's inflation was higher than in partner countries, which, in turn, implies that the competitiveness of Kenya's export products eroded relative to the domestically produced products in those countries.

The high inflation in 2011 caused a big real appreciation of the shilling. The real effective exchange rate (REER) appreciated by 7.8 percent in 2011, and by 14.9 percent between the end of September and the end of December 2011. Up to 2011, the REER had been relatively stable for about 4 years and appeared to be in line with economic fundamentals. IMF's Article IV report of January which looked at data up to the end of Q3 of 2011 found "no significant evidence of exchange rate misalignment". This assessment was made using three model approaches: the macroeconomic balance, the external sustainability, and the equilibrium real exchange rate assessment. However, between the end of September 2011 (latest data used in the Article IV) and January 2013, the REER appreciated by 21.5 percent, which points to weakened export competitiveness.

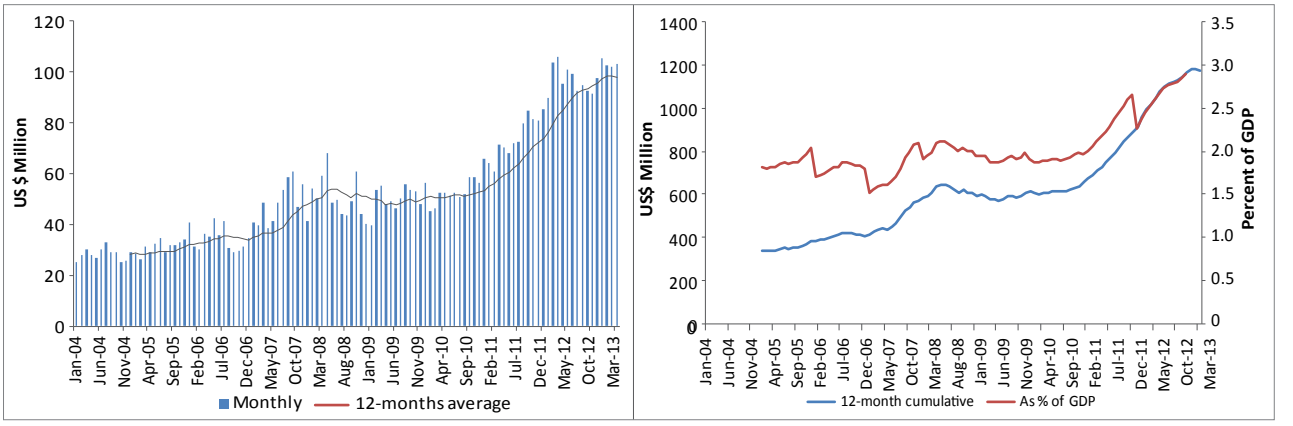
Figure 1.27: Kenya competitiveness continues to be eroded



Source: World Bank Staff calculations based on CBK data

Kenya is experiencing a boom in remittances, surpassing US$ 1 billion for the first time in 2012. Remittances increased from US $ 642 million (2.0 percent of GDP) in 2010 to US$ 891 million (2.65 percent of GDP) in 2011, to US$ 1.2 million (2.9 percent of GDP) in 2012. Monthly average inflows have increased by 82 percent in just 2 years to US$ 97.6 million in 2012, from US$ 54 million in 2010 (see Figure 1.28). North America is the main source of the remittances (48 percent) followed by Europe (28 percent) and the rest of the world (24 percent). The recent increase in remittances is explained both by better data collection methods employed by the CBK, and by the ease by which the diaspora can now send remittances to Kenya via commercial banks for investment purposes.

Figure 1.28: Remittances have risen sharply in the last few years



World Bank Staff calculations based on CBK data

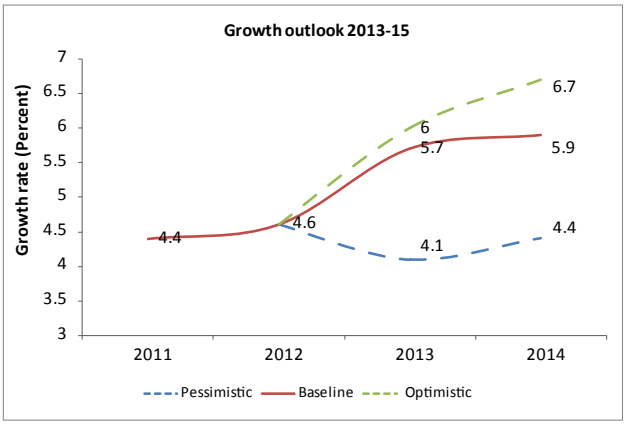
2. Growth Outlook for 2013-2014

2.1 Growth prospects

Kenya's economic prospects have improved following the peaceful elections in March 2013, and subsequent transfer of power. The World Bank forecasts growth to reach 5.7 percent in 2013 and 6 percent in 2014. This will be the highest growth since 2007, when the economy grew by 7 percent. Aggregate demand fueled by strong consumption and investment growth will power the economy forward. Growth in the first half of 2013 was subdued due to election jitters, when activity stalled by a wait-and-see attitude to new investment. Starting in the second half of 2013, growth will gradually accelerate, as demand firms up and overall economic activity picks up steam. The baseline scenario is one of a recovery in credit flows, to the economy supporting an investment led recovery. Government is assumed to maintain a prudent fiscal stance, and hence, seek to consolidate fiscal policy in the outer years of the forecast. Expenditures will still expand, but not like in the pre-election year. Exports are assumed to grow in line with the strengthening of the economies of Kenya's trading partners. And imports are dependent on the strength of domestic demand, particularly for capital goods. The World Bank forecasts accelerated growth in the second half of 2013, driven by private sector net lending and strong performance in the booming agricultural sector. Kenya's growth outlook for 2013 closely mirrors projected SSA average growth of 4.9 percent (5.6 percent for oil importing countries), but continues to be lower than other EAC member states, which are estimated to grow at 6.1 percent in 2013.

In a high case scenario, Kenya's GDP growth is projected to reach 6.1 percent in 2013. Under this scenario, investment outturns are much stronger than in the baseline, due to stronger than expected inflows of foreign direct investment, and ongoing peace dividends. Macros stability is sustained, with agriculture harvests being favorable, thereby supporting household incomes. Much of the increased investments is also used for the purchase of imported equipment, thus leading to a stronger than expected growth in imports.

Figure 2.1:A pickup in growth in 2013-14



Source: World Bank staff calculations

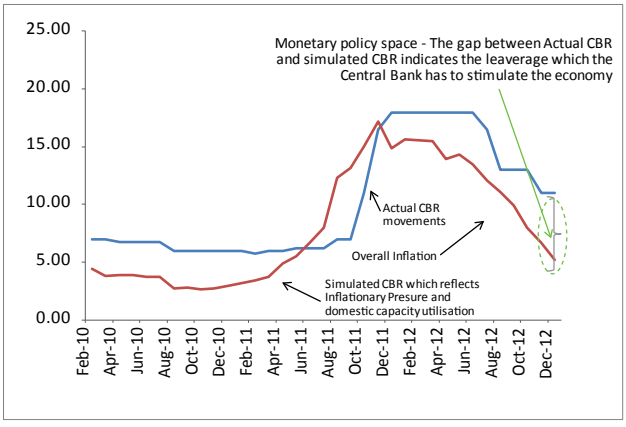
Table 2.1: Macroeconomic Indicators 2008-2014

	2009	2010	2011	2012	2013**	2014**	2015**
GDP	2.7	5.8	4.4	4.6	5.7	5.9	5.5
Private Consumption	5.0	7.2	3.0	5.5	2.9	3.1	2.8
Government Consumption	3.8	6.3	5.2	9.3	4.6	3.7	3.0
Gross Fixed Investment	2.8	7.7	12.6	11.5	12.1	15.0	13.2
Exports, GNFS	-9.3	17.4	6.6	4.7	5.4	6.4	6.7
Imports, GNFS	2.8	6.1	15.6	12.5	5.8	8.0	7.7

Source: World Bank Staff calculations
** - Forecasts

In the low case scenario, GDP growth could remain at below potential as macroeconomic instability induced by the realization of risks in Kenya's current account deficits (fast depreciating shilling), as well as overheating from excess liquidity (high inflation), both of which combine to reduce investment activity and consumer spending. Government and export activities are assumed to be less affected, however, imports are also reduced.

Figure 2.2: Monetary policy space is available to support growth



Source: World Bank Staff calculations based on CBK data

With inflation no longer being a significant threat, the Central Bank's softer monetary policy stance has stimulated aggregate demand and growth. To stimulate economic activity, the Central Bank has been easing the monetary policy since the second half of 2012, by lowering the CBR to 8.5 percent from 18 percent by May 2013. Commercial banks have started to ease their rates, with the average lending trending downwards. The impact of CBK's action is already evident, as credit growth has been increasing since November 2012, and is expected to accelerate in the second and third quarter as of 2013, as borrowers respond to lower lending rates. Within 6 months leading to April 2013, credit grew by 132 percent with commercial banks having lent KES 74 billion compared to 32 billion in the same period in 2012. Most of the credit went to private households (22 percent), business activity (19 percent), domestic trade (18 percent), and manufacturing (18 percent).

A combination of accommodative monetary stanceand rapid credit growth will spur consumption and private investment in 2013. Domestic demand growth may be higher than projected, supported by strong capital inflows and eased financing conditions. With economic activity and capital inflows accelerating, lenders are expected to ease credit conditions, further driving up aggregate demand. The World Bank expects a sharp pick up in private consumption during the second half of 2013, driven by sharp increase in credit and increased gross investment,as investors rush to implement plans which have been on hold waiting for the new government to be in place. Domestic demand will continue to power Kenya's GDP growth, with public infrastructure investment playing a leading role. The drag on growth from net exports will ease, as global economic conditions improve. Inflationary pressures should remain in check, and Kenya can expect to receive continued inflows of short term capital into its fixed income securities and equities market. Prices in the equities market have increased significantly in the first quarter of 2013, and should this continue, it will inspire consumption as a result of the increasing wealth effect. In addition, with the discovery of oil and gas reserves, Kenya will attract higher FDI flows to finance exploration in 2013, and these flows will continue into the medium term.

Macroeconomic policies are expected to remain generally accommodative to support growth. As the supply side constraints in agriculture ease due to adequate rainfall, the government will try to balance fighting inflation and supporting growth. Even though inflationary pressure has moderated with core inflation subdued, inflation is expected to edge upwards as private demand picks up. Inflation could move above the 5 percent medium term target in the second half of 2013, without necessarily triggering a CBR hike, provided medium-term inflation expectations remain well anchored. This may help bring down lending rates. With monetary policy space available, the deleterious effects of an easy monetary policy

triggering high inflation in the near term are reduced. In addition, fiscal consolidation would reduce the pressure on the external account and mitigate the impact of the appreciation of the real exchange rates. Moreover, the shift of spending from urban towards rural counties envisaged under the devolution processmay contribute to economic growth, as the multiplier effects of additional spending are expected to be greater in rural areas.

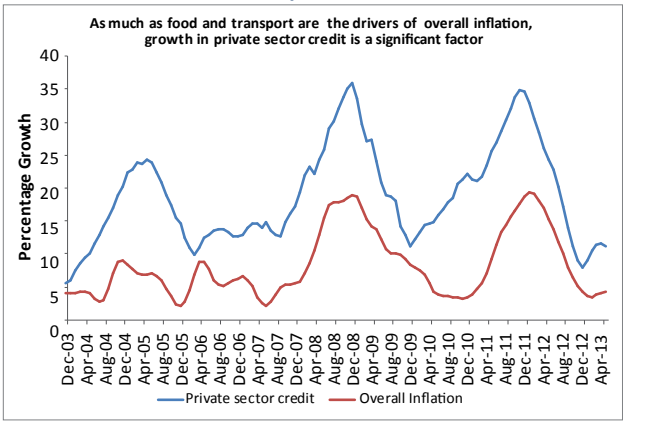
2.2 Risks to outlook

Kenya's short-term risk picture improved remarkably at the end of first quarter, following the successful elections and the peaceful transition of power. The main risks to the growth outlook for Kenya stem from: (i) continued high current account deficit; (ii) inflationary risks associated with monetary easing to stimulate growth and increases in electricity prices; (iii) poor implementation of the budget affecting service delivery; (iv) security threats from terrorists; and, (iv) fiscal risks associated with the devolution process and demands for higher salaries of public officials, could fuel inflation further.

The high current account deficit continues to pose a risk and vulnerability to Kenya's macroeconomic stability. Kenya's large and persistent current account deficit of over 10 percent of GDP in the last three years, raises a major concern for Kenya's sustained economic growth. The short term flows which Kenya relies on to finance the deficit could become volatile, triggering a disorderly adjustment. Moreover, the current account deficit is bound to stay high, driven by high capital imports and high investment demand. In addition, the weak and subdued demand for Kenya's exports in its traditional European markets will remain a drag on Kenya's current account, as euro zone battles recession.

Inflationary risk associated with monetary easing to stimulate growth needs to be taken seriously. The easing of monetary policy will trigger significant demand for private sector credit, as lending and economic activity propel each other forward. In addition, further easing of credit conditions will reaccelerate economic activity. The provision of interest free loans to youth and women, as pledged by the new administration during the election period, if implemented without careful targeting, could pose problems for the monetary authorities. The advantages of credit growth to power economic activity should be assessed against the risks of generating inflationary pressures. As figure 2.3 shows, private sector growth and inflation are strongly correlated. As highlighted in previous edition of the Kenya Economic Update, the key lesson learned through the 2011 crisis, is the need for policymakers to react fast to anchor market expectations and prioritize the fight to reign in on inflation, as a necessary condition to assure sustained growth. As such, gradualism in monetary policy easing is a more preferred approach.

Figure 2.3: A close relationship between Inflation and credit to private sector



Source: World Bank Staff calculations based on CBK and KNBS data

Demands for more public spending pose a fiscal risk. There are several demands to increase public spending. First the demand to hire over 100,000 additional teachers, despite studies indicating a high rate of class absenteeism of up to 36 percent poses a fiscal risk for Kenya. The national teachers union has also called for mass promotion of its members along with hardship allowances, which are at variance with notional government budget allocations. Secondly, demands by elected representatives at national and county levels

to be paid salaries at rates way above those recommended by the Salaries and Remunerations Commission (SRC) will significantly drive up the wage bill. Thirdly, there are still unresolved issues associated with devolution, which have fiscal implications and need to be sorted out without threatening the public sector wage bill, including: (i) the integration of local authorities' staff with civil servants whose national functions have been decentralized to the counties; and, (ii) emerging demands among public servants for higher wages.

Other risks are also present. Security threats from Al Shaabab and the Mombasa Republican Council (MRC) are hurting the tourism industry and investment in the coastal region, and parts of Nairobi. The activities of these insurgent groups have led to tourist cancelations and might deter investors from investing in Mombasa, Kenya's second largest city. Secondly, the proposed increase of over 100 percent in electricity tariff planned to take effect in 2013, will increase the cost of doing business in Kenya for manufacturing industries. Electricity costs in Kenya are already high, when compared to Kenya's competitors in this sector. A huge increase in electricity tariff will hurt business for those in the export sector.

2.3 Important priorities for the near and medium term

The key challenge for the medium term remains boosting productivity and regaining competitiveness. To maintain high growth rates, Kenya needs to continue investing more in infrastructure and human capital, improve the business and regulatory environment, and diversify exports. Strong import growth, lackluster export growth, and an appreciating real effective exchange rate, are driving the growing current account deficit. The challenge for Kenya is to engineer policies to boost productivity growth and foster job creation, i.e. reinvigorate both engines of the economy. The best way to achieve this is to maintain macroeconomic stability, to develop a business environment that promotes investment and job creation, and to increase the stock of physical and human capital.

Developments in exchange rate suggest that Kenya's real effective exchange rates are far from levels consistent with medium-term fundamentals. Kenya's real exchange rate has appreciated strongly in the last decade, and this has been accompanied by the deterioration of thecurrent account balance. For any exchange rate regime to remain stable and competitive, real exchange rates require a supportive policy environment, which would include prudent macroeconomic policies and a strong financial sector.

Kenya's policy makers have to confront the challenge of managing the surge in short term capital flows and the associated vulnerabilities to a sudden reversal of the inflows. In recent years Kenya's economy has benefited from large short term flows attracted by the open capital account, one of the most vibrant bond and fixed income securities markets in Africa, as well as the underlying strength and potential of the domestic economy. However, strong capital inflows have contributed to the appreciation of the real exchange rate.

> "Since domestic savings are low, attracting FDI would supplement domestic savings in financing Kenya's growth agenda"

Foreign Direct Investment is key to Kenya's development agenda. Since domestic savings are low, attracting FDI would supplement domestic savings in financing Kenya's growth agenda. Kenya should aggressively seek more productivity enhancing FDI to diversify its economy and develop its private sector, encouraging technology transfer to sharpen its competitive edge in the external market. Kenya needs strong judicial institutions to resolve conflicts, enforce contract disputes, and ensure a level playing field for investors. Political

>> Box 2.1: Higher savings for faster growth

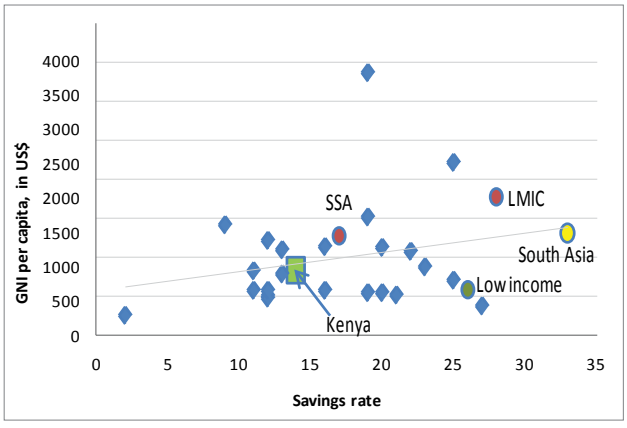
The economic literature finds that domestic savings are crucial a component for high and sustainable growth in open developing economies. Economic developments of the past few decades confirm the theoretical findings. The Growth Report (2009), which analyzes the factors behind the 13 most successful economies in the post-World War II period, illustrates the importance of high investment for achieving rapid growth. The common feature of these "success stories" is that they had relatively high saving rates at the beginning and during their "high growth episode". High savings rates are particularly common in East Asia -the fastest growing region of the world. The average savings rate in East Asia during the 2000s was 30 percent of GDP, compared to the global average of about 19 percent. Sub-Saharan Africa (SSA) is the poorest region of the world and also has the lowest-though rapidly increasing-rate of saving. SSA's average savings rate has gone from 10 percent of GDP in the 1990s to 14 percent of GDP during the 2000s, and by 2011 it reached 17 percent of GDP.

Kenya's savings rate has not followed the same trend as the rest of SSA. The savings rate has been lingering around 13-14 percent of GDP over the last five years, and is much lower than the average for low income countries (26 percent of GDP). In contrast, neighboring Uganda and Tanzania have already passed the 20 percent mark even though their GNI per capita is less than $550 compared to Kenya's $820.

Kenya has succeeded to attain the same investment rate as SSA (17 percent of GDP) with lower rate of savings, partly owing to higher inflows of foreign savings. Nevertheless, it would be difficult to reach the needed investment rate to meet the Vision 2030's development goal by relying solely on foreign savings. Uganda and even more so Tanzania have achieved remarkable investment rates, and high savings rates are a big contributor to this success.

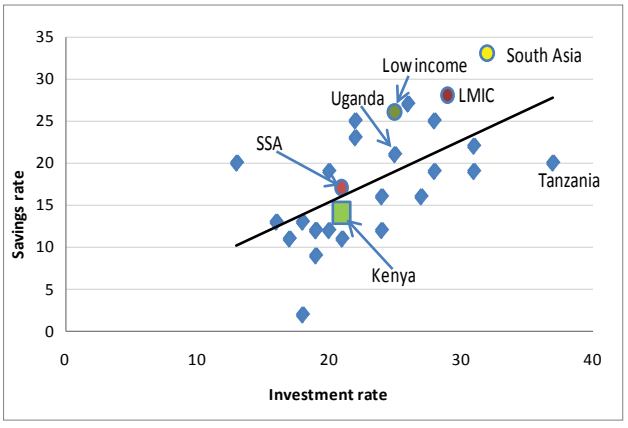
Increasing Kenya's savings rate will not by itself lead to the desired 10 percent annual GDP growth rate. Higher foreign investment is necessary in order to bring superior technologies and know-how into the country. More importantly, unless Kenya's economy realizes progress in productivity –which is currently constrained by numerous factors such as poor infrastructure and weak governance- the desired economic development will not be achieved even with the most ambitious savings efforts.

Figure 2.4: Savings and GNI per capita (2011)



Source: World Bank

Figure 2.5: Savings and investment, as at GDP (2011)



Source: World Bank

Source: World Bank

stability is also an important factor in attracting FDI, and in providing longer term investment horizons.

Increasing investment will also need to rely on higher domestic savings. While FDI is beneficial and should be promoted, achieving the investment rate needed for sustainable rapid growth will require higher propensity to save (see Box 2.1). Savings in Kenya are low compared to other countries in the region, and far from the levels of fast-growing countries (in particular in East Asia).

The ultimate objective of Kenya's development strategy is to make it more inclusive. The new administration promises to make growth more inclusive. This can only be done through reforms to promote economic diversification and job creation, tackling infrastructure gaps, and enhancing the human capital and productivity of the poor. Again, Kenya's policy agenda includes economic rebalancing, strengthening private investment, improving tax and spending policies, and addressing rapid demographic shifts. Kenya should also undertake coordinated and collective action to deepen regional trade integration.

Kenya's policy agenda includes economic rebalancing, strengthening private investment, improving tax and spending policies, and addressing rapid demographic shifts

Kenya's medium term plan must address the issues of economic growth, equity and macroeconomic stability and sustainability. As the economy has not generated enough modern jobs for the burgeoning youth, and as poverty levels are still at high levels, significant proportion of Kenyans with limited employability are being squeezed into vulnerable, insecure, low-paying jobs, mostly in the informal sector or subsistence agriculture. The situation is even worse among women, youth, as well as other groups that have one or more characteristics that become the ground for discrimination. Shrinking the informal sector requires both positive and normative actions, by improving their productivity, and implementing better labor standards. Both policies and goals on addressing inequality must be part of the MTP II agenda for the next 5 years. The agenda should focus not only on growth, but it should recognize the importance of growth for employment creation, and improved well-being. As such, a broader objective including inclusive growth and goals and targets on employment may be appropriate (see also UNDP/ILO Report May 2012).

Special Focus: Poverty

3. Poverty

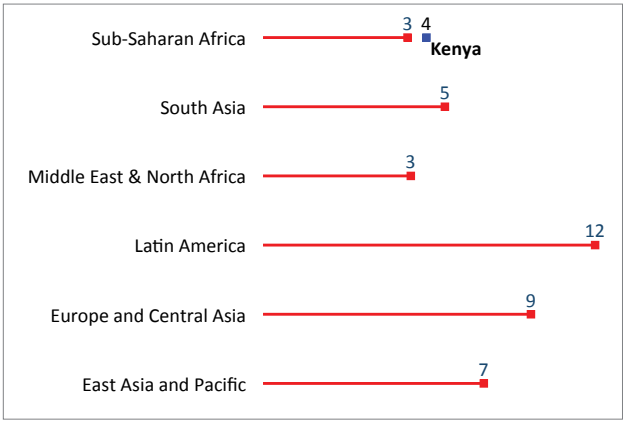
With strong economic growth, a peaceful political transition, a new constitution and a rapidly growing and educated labor force, Kenya has growing potential to tackle poverty. In 2005, close to 17 million Kenyans (47 percent of the population) were estimated to be living in poverty. As there has not been another nationally representative household budget survey since 2005 that enables poverty measurement, it is not known exactly how poverty has changed in the past 8 years. However, rapid economic growth is driving poverty reduction across the region and projections using national accounts data suggests that Kenya's poverty rate is in the range of 34 and 42 percent. Broader measures of welfare point to a Kenya that is increasingly healthy, more educated and more connected, but a large proportion of Kenyans still live without access to clean water, good sanitation facilities and electricity. What can the government do to accelerate poverty reduction? By sustaining growth through sound fiscal and monetary policy; encouraging manufactured exports and improving the business environment so that more productive jobs for low and middle skilled workers are created; supporting smallholder farmers by connecting them to productive assets and markets; strengthening and expanding targeted cash transfer programs, and ensuring basic services are more accessible and responsive to everyone regardless of their location, wealth, ethnicity or gender. Lastly, a routine system of poverty monitoring with household budget surveys as a foundation is needed to understand where, how and why poverty is changing, and to inform Kenya's policy efforts in the fight against poverty.

3.1 Poverty in Kenya

At a time of major social and economic transitions, the conditions for attaining better living standards are increasingly within reach for a majority of Kenyans. In the past twenty years, Kenya's economy has gone from shrinking to growing at nearly 5 percent per year; jobs, once predominantly in farming, are now predominantly in non-farm self-employment and wage work; families are smaller and more likely to settle in towns and cities; and people have more education and skills than ever before. Behind each of these transitions are each Kenyan's quest for opportunity, and a desire for a better life for themselves and their children.

Despite these major social shifts, we know little about how poverty has changed. Efforts to measure poverty and welfare in Kenya have been sporadic and inconsistent. In the 30 years spanning 1980 to 2010, Kenya conducted four surveys that provided a basis to measure poverty—an average of one survey every 8 years. In Latin America, surveys that enable poverty monitoring are conducted once every 3 years, and in East Asia once every 4 years (Figure 3.1). Countries that devote resources to tracking social outcomes are in a better position to learn about the impact of their policy choices and make incremental improvements to policies over time.

Figure 3.1: Kenya needs to ramp up poverty monitoring
Poverty surveys by region between 1980-2010 (average)



Source: World Bank

The latest reliable poverty estimates are almost a decade old. The 2005 Kenya Integrated Household Budget Survey (KIHBS) was the last nationally representative survey conducted by the Government of Kenya to measure poverty.

Without more frequent surveys, there has been a missed opportunity to understand whether the economic gains that have been achieved in the past decade, have generated opportunities widely for Kenyans and pathways out of poverty for the poor.

Poverty and well-being are often understood in terms of income. Today's most widely used measure of poverty is the number of people living on less than 1.25 dollars a day—the extreme poor. The Millennium Development Goals adopted this measure for its target of reducing by half the rate of poverty between 1990 and 2015, and the World Bank recently endorsed the goal of reducing the percentage of extreme poor to 3 percent by 2030. Kenya's own measure of poverty is based on the cost of purchasing a basket of food items which provides just enough calories (2,250 kilocalories) to meet daily requirements and an allowance for basic non-food amenities (Box 3.1).

Survey data from 2005 indicates that the scale of consumption poverty in Kenya is staggering, and is concentrated in rural areas. Based on Kenya's national poverty line, close to half of the population (close to 17 million Kenyans) was poor in 2005 and the vast majority of the poor lived in rural areas. Poor households are also more likely to depend on income and consumption from crops and livestock, as a source of livelihood (Table 3.1).

Poor people are more likely to have low education levels and be part of larger families. Primary and secondary school completion rates are the lowest amongst the poorest individuals. In 2009, the average size of households among the poorest 20 percent of households was 5.2 compared, to a national average of 4.3, and an average of 3.5 among the wealthiest households.

Day to day hardship accompanies the condition of poverty. Among the poorest Kenyans, 99 out of 100 live without electricity and without a flush toilet, 80 out of 100 share a living space with two or more people, and 64 out of 100 do not have access to an improved source of water.

Table 3.1 : Looking back - patterns of poverty in 2005

	Kenya Overall		Nairobi		Other Urban		Rural	
	Mean	95% CI	Mean	95% CI	Mean	95% CI	Mean	95% CI
Fraction of the population	100	--	7.5	--	19.6	--	68.3	--
Population in 2005	35.6	--	2.7	--	7.0	--	24.3	--
Fraction of the population below the national poverty line (%)1	46.7	44.6–48.6	22	14.4 - 29.6	42.5	37.9 - 47.1	49.7	47.6 - 51.9
Number of poor below the national poverty line (thousands)	16,630		589		2,961		12,094	
Fraction of population below $1.25 per day poverty line (%)2	43.3	41.1 - 45.5	5.8	2.8 - 8.7	14.3	11.3 - 17.2	51.4	49.2 - 53.6
Number of poor below $1.25 per day poverty line (thousands)	15,419		155		996		12,508	
Poverty headcount by occupational sector of household head:	54.7	52.4 - 56.9	7	-5.8 - 19.7	53.4	41.9 - 64.9	54.9	52.6 - 57.2
Industry	42	37.3 - 46.7	24.6	14 - 35.2	50.8	43.5 - 58	46	40 - 52.1
Services	32.4	29.5 - 35.4	21.6	13.1 - 30.1	39.1	33.7 - 44.4	32.4	28.8 - 36
Share of employment by sector (%)3:	57.1	54.7 - 59.6	3.3	1 - 5.6	7.5	5.8 - 9.3	69.1	67.1 - 71.1
Industry	8.8	7.8 - 9.9	23.4	18.3 - 28.5	17.7	15 - 20.4	6.7	5.7 - 7.7
Services	34.1	32 - 36.1	73.3	68.1 - 78.6	74.8	71.7 - 77.9	24.2	22.5 - 25.9
Total	100	--	100	--	100	--	100	--
Gini coefficient	0.516	--	0.581	--	0.410	--	0.383	--

Source: World Bank analysis of 2005 Kenya Integrated Household Budget Survey

>> Box 3.1: Kenya's poverty line

In 2005, the cost of basic food and non-food needs per month for one adult was established at KES 1,562 for rural areas and KES 2,913 for urban areas. Throughout this report, the poverty rate or headcount refers to people living in households with per adult equivalent expenditures below these amounts. Adjusting for increases in prices since 2005 using the Consumer Price Index (CPI), the approximate value of the rural poverty line in 2012 was KES 2,900 per month for rural areas and KES 5,400 per month for urban areas.

Kenya's poverty lines expressed in 2005 international dollars – the unit of measure used by the global 1.25 "dollar per day" measure of poverty—were approximately 1.57 dollars per day per person for rural areas, and 2.9 dollars per day per person for urban areas. Expressed in Kenyan shillings, the 1.25 poverty line in 2005 was approximately KES 1,246 per day. Using this benchmark, Kenya's 1.25 dollar a day poverty rate in 2005 was 43.3 percent overall.

Source: World Bank

Poverty rates are highest in the arid and semi-arid regions in the north and north east. Areas with very little annual rainfall, and thus, low agricultural potential have acute poverty (Figure 3.2). These regions have also been historically neglected, reflecting Kenya's unbalanced geographical development. In 2005, poverty rates in arid regions (78 percent) were nearly double the poverty rates in medium and high potential agricultural areas (with poverty rates averaging 41 percent).

Due to patterns of population density, the largest numbers of poor are concentrated in areas where land is most fertile. Medium to high potential agricultural areas only make up 20 percent of all land, yet are home to 80 percent of the population. As a result, the largest numbers of poor are found around the shores of Lake Victoria in the west, the central highlands around Nairobi and east of Mt. Kenya and the coast near Mombasa (Figure 3.3). With rapid and concentrated population growth in these areas, the pressure over productive land resources will continue to grow.

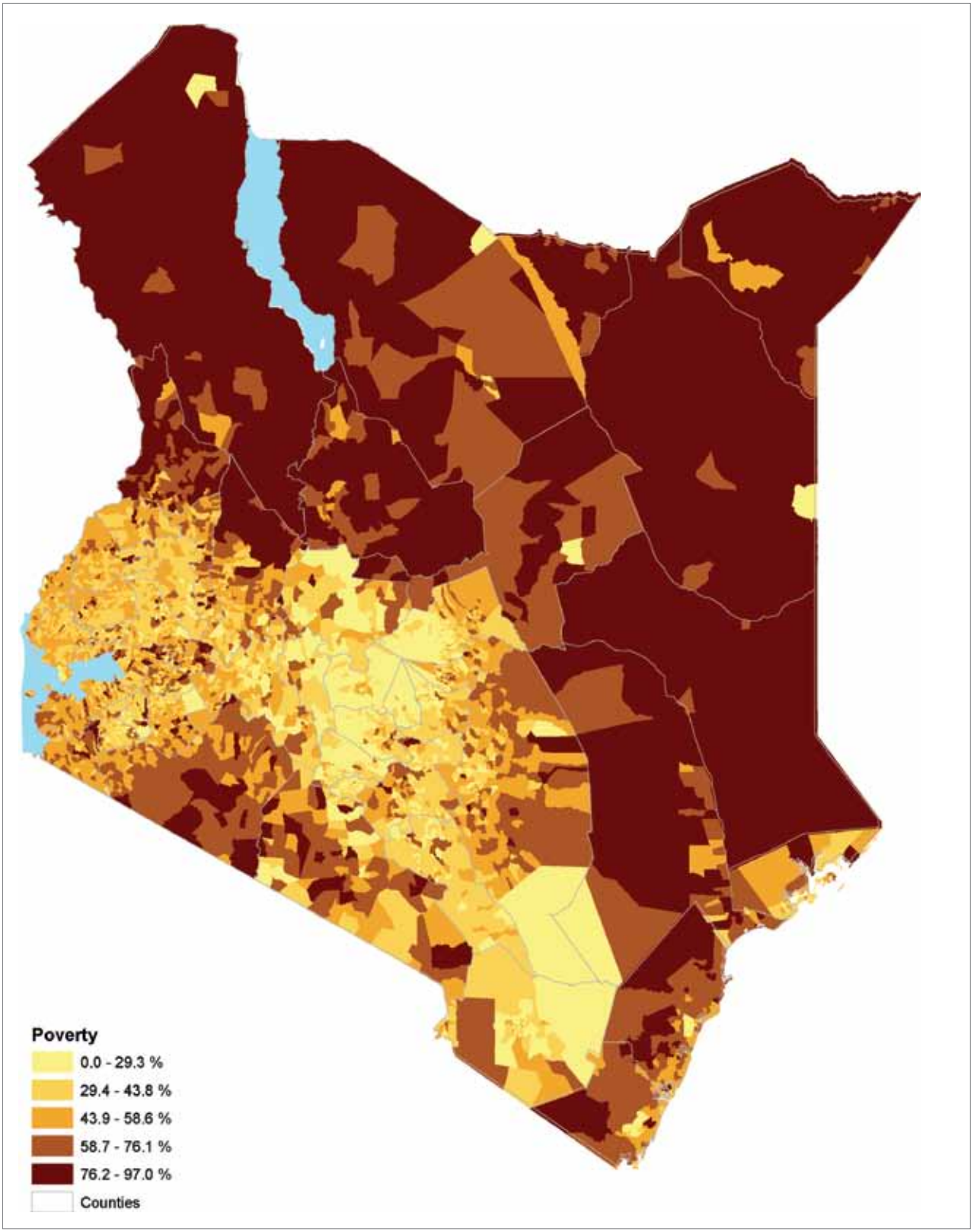
Inequality in Kenya is high, especially among households in urban areas. In 2005, the average per adult equivalent expenditures among the bottom ten percent of households was KES 466 and KES 1,110 in rural and urban areas—more than ten times smaller than the average expenditures among the top ten percent of households (KES 5,741 and KES 22,823 in rural and urban areas, respectively).

Low income or material deprivation alone does not constitute the full experience of poverty. Global consultations with the poor reveal the overwhelming anxiety, grief, hunger, stress and low self-confidence associated with poverty. These emotions are linked to lack of security, power, poor health, discrimination and unstable work. In recognizing that income is not the only thing people care about, broader measures of poverty that attempt to capture a more complete picture of well-being have emerged.

Broad indices of well-being indicate improving living conditions for Kenyans. The Multi Dimensional Poverty Index (MPI) developed by the Oxford Poverty and Human Development Initiative, combines ten deprivations (each with a specific weight) in the categories of health, education and living standards into one overall index. According to this measure, a household is poor if it experiences at least a third of all possible weighted deprivations. Using Demographic and Health Survey (DHS) data, the percent of poor people according to the MPI declined from 60.1 to 51.2 percent between 2003 and 2008 (Alkire & Roche, 2013). Another measure, the Human Development Index (HDI) developed by the United Nations Development Programme combines life expectancy, mean years of schooling and Gross National Income (GNI) per capita in a single index. In 2012 Kenya's HDI was 0.519, ranking it 145 out of 187 countries with comparable data. Since 1990 (when Kenya's HDI was at 0.463) the HDI has improved at a rate of 0.5 percent annually (UNDP, 2013).

Figure 3.2: The North and north-eastern, arid and semi-arid regions are the poorest regions in Kenya

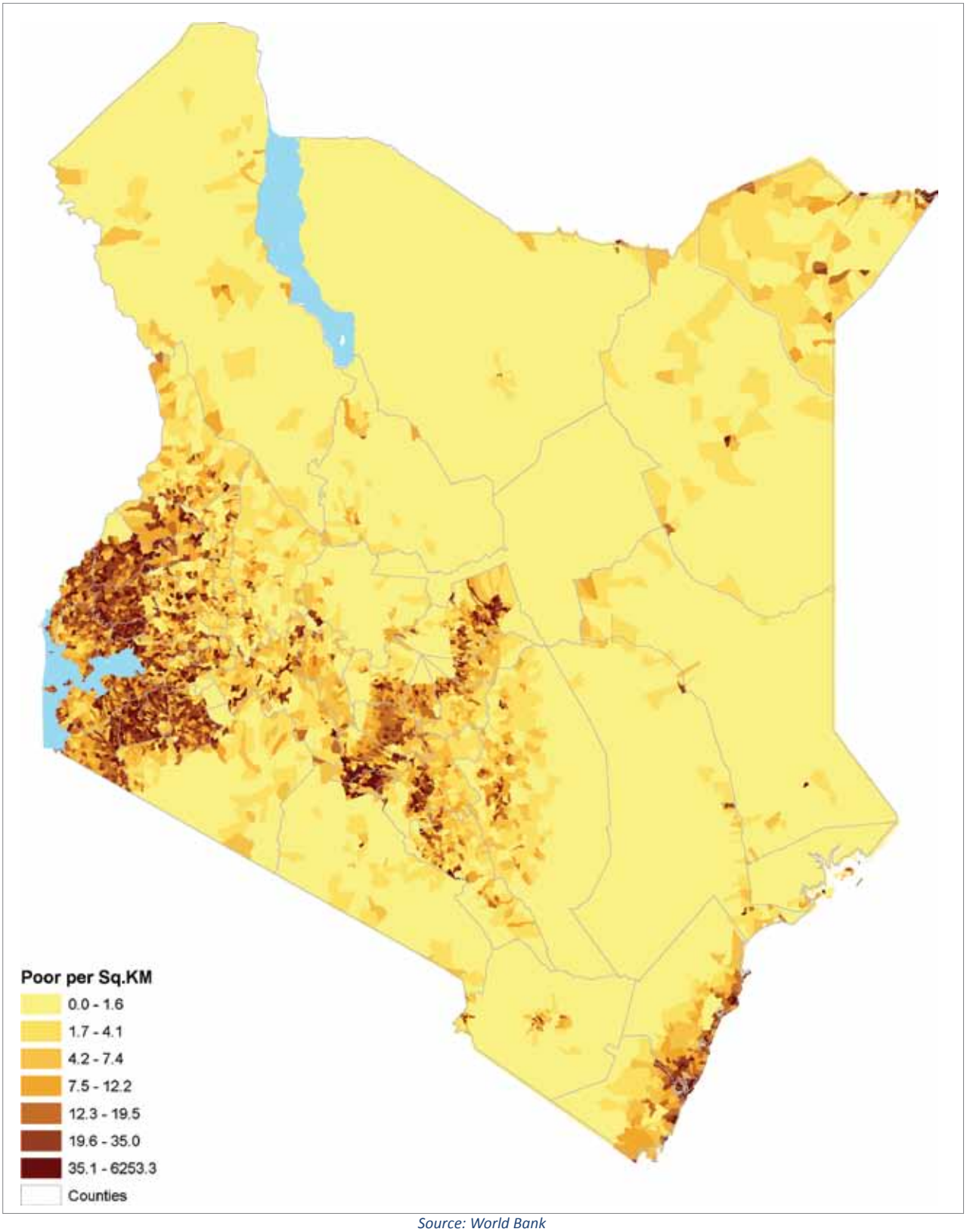
Poverty estimates at the sub-location level, 2009



Source: World Bank

Figure 3.3: The poor are concentrated where land is most fertile

Number of poor per square kilometer by sub-location, 2009



Source: World Bank

Kenyans primarily equate poverty with an inability to meet basic human needs and a lack of cash income. The 2003 Afrobarometer asked Kenyans what they think about poverty. "Lack of food" and "Lack of money" were the most common responses along with lack of shelter and clothing. Poverty was also frequently associated with not having productive assets such as land or livestock; not having key opportunities such as an education or a job; and being physically handicapped (Figure 3.4).

Among a range of poverty-related experiences, Kenyans most frequently report having lived without earning cash income. In 2011, almost three in four adult Kenyans said they went without a cash income, "many times", "several times" or "always" during the year. The next most common experiences of deprivation (reported by one in three adult Kenyans) were not having enough food to eat, going without medical care or treatment, and not having enough clean water for the home.

The proportion of Kenyans describing their living conditions as very bad or fairly bad doubled from 36 to 72 percent between 2003 and 2011. While responses to an opinion-poll should not be interpreted as evidence that welfare in Kenya is worsening, it is worth noting that Kenyans increasingly think of and perceive their living conditions in more negative terms. Understanding what is driving these perceptions could yield important insights about what Kenyans value the most, when thinking of their own living standards.

Many Kenyans expect the government to reduce the gap between the rich and the poor, and to ensure that people have access to basic necessities. Inequality in Kenya is fairly high, and about one in five Kenyans think that an essential part of democracy involves a government that works to reduce inequality in society, and provide support to help families meet basic food, shelter and clothing needs.

Figure 3.4: Kenyans associate poverty with lack of food and money

Frequency of words in response to "What do you associate with poverty?"

Source: World Bank

Kenya can do more with the resources it has to reduce hardship and improve well-being. Among countries with comparable GDP per capita, Kenya is an average performer with respect to available measures of well-being, and is far from the frontier of what is possible. For example, while Nepal and Rwanda have lower income per capita compared to Kenya, their newborns are 30 percent more likely to survive to the age of five. In Ghana, another country with a similar income level, the percentage of people experiencing multiple deprivations is 30 percent lower than in Kenya (Figure 3.5).

3.2 How has income-poverty changed?

Poverty rates in sub-Saharan Africa are falling. Using all available data, the World Bank estimates that the percentage of people living on less than $1.25 per day in sub-Saharan Africa fell from 56.5 to 48.5 percent between 1990 and 2010, at a rate of about 0.8 percent per year. The majority of this decline occurred during the 2000s, fueled by GDP growth which averaged 5 percent per year. Given population growth, poverty rates have not declined fast enough to reduce the number of poor in the region, which increased from 290 to 413 million between 1990 and 2010 (Figure 3.4).

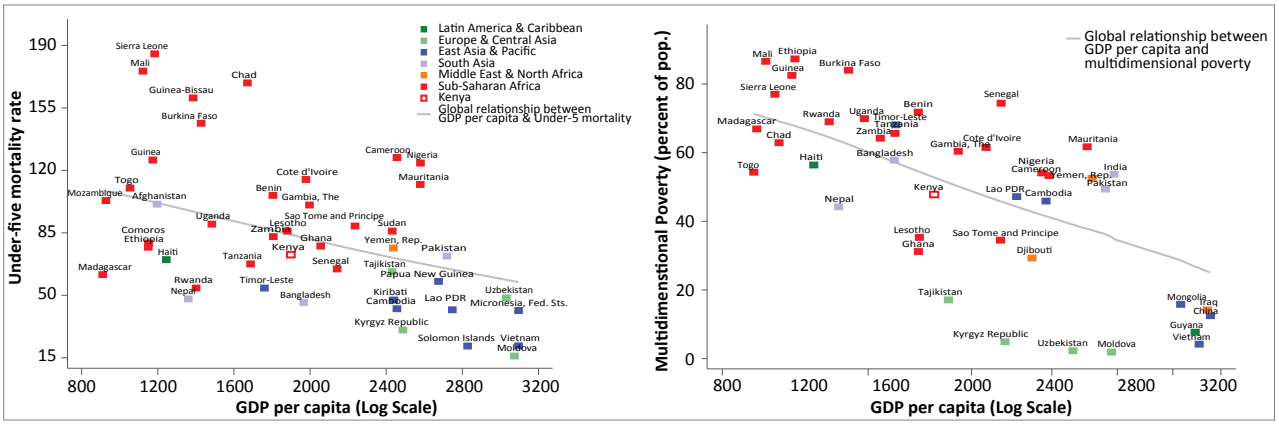
Experience from the region suggests that poverty reduction can occur at a very fast pace. Among countries with available data, Uganda, Rwanda and South Africa reduced poverty at over 2 percent per year over a period of between 5 and 7 years in the 2000s (Figure 3.4). In Uganda, poverty rates fell from 39 percent to 25 percent between 2002 and 2009. Rwanda, another one of Kenya's close neighbors, also made major gains against poverty; the drivers of this success are explored in more detail in Box 3.2.

In Kenya, how poverty has changed is not clear because of the lack of regular household budget surveys. It is not known with certainty how poverty has changed since 2005, and until a new household budget survey is conducted, the poverty level will not be known.

This section presents results from two methods to estimate the likely trajectory of income poverty in the past 20 years. It should be noted up front that these methods, used by the World Bank and other institutions in settings where survey estimates of poverty are not available, rely on strong assumptions and produce estimates that are used only to get a first order approximation of changes, not specific poverty levels. The first approach models the trajectory of consumption per capita, both forwards and backwards in time from 2005 by applying observed growth rates in GDP per capita from national accounts data to household consumption from KIHBS data. The second approach uses information on characteristics of households to predict consumption and poverty

Figure 3.5: Kenya's welfare indicators in an international perspective

Purchasing Power Parity GDP per capita vs. Under-five mortality and Multidimensional Poverty



Source: World Bank

>> Box 3.2. A small country with big declines in poverty
The role agricultural production and off-farm income in poverty reduction in Rwanda

Between 2001 and 2011 Rwanda's poverty head count fell from 59 to 45 percent, a major success for the country in the fight against poverty. During this time, Rwanda posted average annual GDP growth of over 8 percent, translating into real improvements for households which now enjoy real consumption levels that are thirty percent higher than they were in 2001.

More crop per acre, more cash per crop
More than 70 percent of Rwandans depend on agriculture for income, and it is the single most important source of income for the poor. It is no surprise then that increased agricultural production was a major driver of consumption gains and poverty reduction. In the past decade, agricultural production doubled at the household level, as did the share of households selling surplus harvests on the market. Behind these developments were increased investments in agricultural inputs, land consolidation and infrastructure. Specific public programs such as the Crop Intensification Program (CIP) and the Land Husbandry, Water Harvesting and Hillside (LWH) irrigation supported production gains, as did dramatically increased fertilizer use made possible through Government subsidized fertilizer imports.

Don't put all of your eggs in one basket
Rwandan households have increasingly taken up non-farm activities such as wage jobs and small businesses in addition to farming. In 2001 less than 30 percent of households had a non-farming activity, by 2011, the share of households with livelihood activities off the farm shot up to 70 percent. Interestingly, families did not abandon farming; they added income activities both as primary and secondary occupations. This has helped households to reduce the risk of bad weather that accompanies rain fed farming and provided a more regular source of cash income which boosted consumption.

Source: Rwanda Economic Update 2013(World Bank, 2013)

in surveys that do not measure consumption directly. Annex 1 describes the methodology for both of these approaches in more detail.

Assuming growth rates in GDP per worker closely follow the growth of household consumption, it is likely that poverty has declined in Kenya since 2005, but the degree of decline depends on whether inequality has risen or fallen. Between 2005 and 2011, per-worker income (adjusted for inflation) increased at approximately 2.2 percent per year on average. In a setting where this growth translates to increased consumption of 2.2 percent per year for all income levels, inequality would not change and poverty would fall. However, if growth disproportionately benefitted the already wealthy or middle class, income inequality would increase and poverty would fall at a slower rate (and possibly even increase).

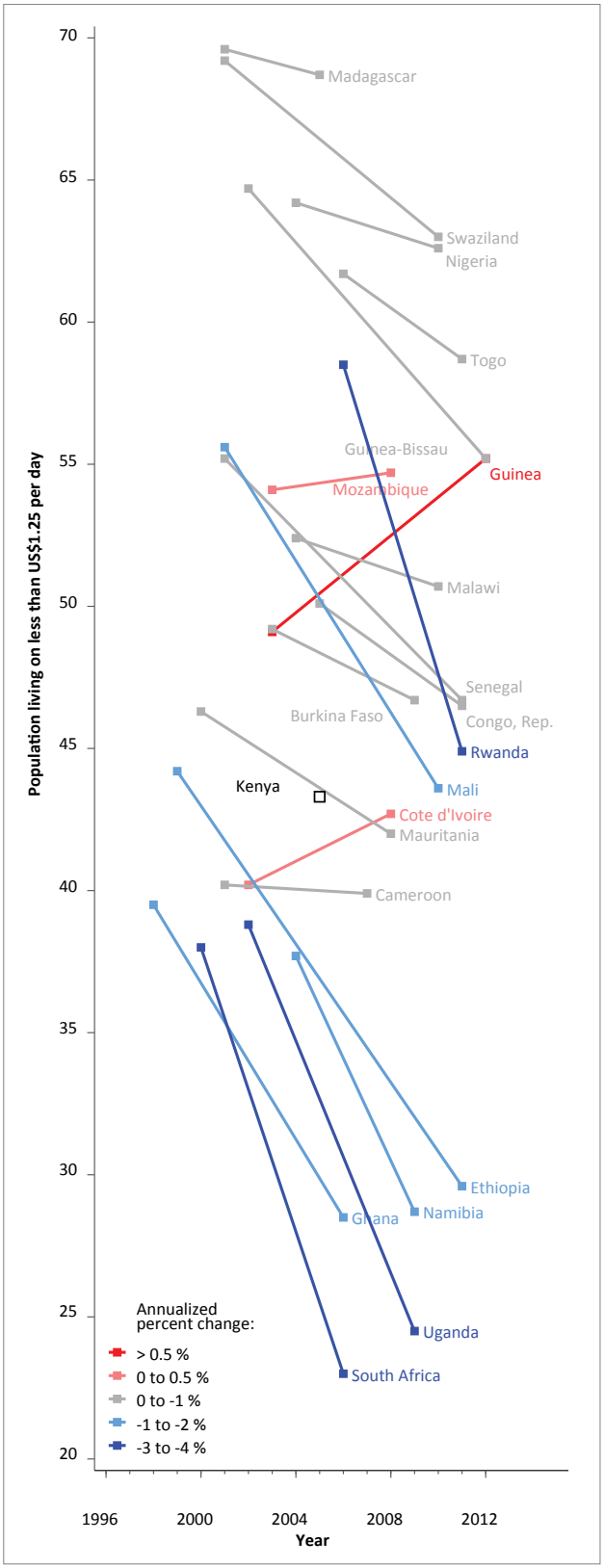
Among growing economies, inequality tends to fall as often as it rises. A study of the relationship between growth and inequality over time within countries, found that historically, economic growth is distribution-neutral on average (Ravallion, 2004).

Among countries in sub-Saharan Africa with available data, inequality fell by 0.5 percent per year on average between 1990 and 2010. The fastest rise in inequality (measured by the Gini coefficient described in Box 3.3) in the region during this period was over five percent per year in the Seychelles, and the fastest decline was 4.2 percent per year in Malawi (the Gini fell from 50 to 38 between 1998 and 2004).

Given that Kenya's economic growth is driven by domestic consumption and services, rather than extractive industries; it is likely that the benefits from growth have been spread broadly across income groups. In contrast to countries where vast oil or mineral endowments have driven growth such as in Nigeria, Equatorial Guinea or Angola, Kenya's economic growth in the past ten years has not relied on commodity exports. The historical experience with commodity driven growth is that it benefits the few at the expense of the many.

Figure 3.6: A decade of poverty reduction in Sub-Saharan Africa

US$1.25 dollar a day poverty in the 2000s



Source: World Bank

Kenya's pattern of growth gives more plausibility to scenarios of moderate, rather than extreme changes in inequality. However, given entrenched inequality between population groups defined by ethnicity and geography, the slow overall rate of increase in agricultural productivity and the urban nature of much of Kenya's growth (Nairobi and Mombasa alone account for about 40 percent of the country's wage earnings) it is difficult to say whether inequality has increased or fallen.

In scenarios of moderately changing inequality (from a decline in the Gini coefficient of 1 percent per year, to an increase of 1 percent per year), national accounts based projections suggest that poverty declined from 47 percent in 2005 to somewhere in the range of 34 and 42 percent in 2011. In rural areas, this scenario predicts that poverty fell from 50 to between 38 and 46 percent, and in urban areas from 34 to between 22 and 28 percent (Figure 3.7). (Annex 2 illustrates the impact of inequality on the distribution of consumption).

While growth is a necessary condition for poverty reduction, growth alone may not lower poverty. Even though Kenya sustained growth in real income per capita between 2005 and 2011, a 2 percent per year increase in income inequality over this period would have erased the poverty reduction that would have otherwise accompanied that growth (Figure 3.8).

These simulations show that reducing inequality accelerates the poverty-reducing effect of economic growth. For each percentage point that inequality falls, the poverty rate falls by an additional 1.7 percentage points for Kenya's observed trajectory of income growth.

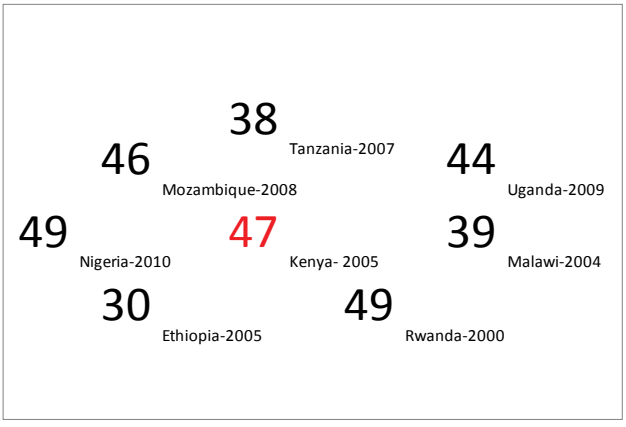
Data on the characteristics of households such as the quality of housing, the education of parents and the size of the family provides an indirect way to measure income poverty. As many nationally representative surveys collect in depth data on household characteristics, this information can

>> Box 3.3: Know your Gini!
Kenya's inequality and how it is measured

One measure of inequality is the Gini coefficient. The Gini gauges how far the distribution of income in a population is from a scenario where all income is shared equally. In a perfectly equal society each household has the same income so that both the "bottom" and "top" ten percent of the population both earn 10 percent of all income. In this imaginary society, the Gini is equal to 0. In a very unequal society, the "bottom" ten percent of households earn a much smaller share of all income relative to the "top" ten percent of households. The maximum possible Gini for a country is 100 which would be a case where one person owns very close to 100 percent of all income. In 2005, Kenya's Gini coefficient was 47—markedly higher than its neighbors to the north and south (Ethiopia and Tanzania) but near the average of 45 for the region as a whole (Figure 3.7).

Source: Rwanda Economic Update 2013 (World Bank, 2013)

Figure 3.7: The Gini-coefficient in Kenya and the region



Source: World Bank

be used to estimate consumption, even if it is not measured directly in the survey. This is achieved by estimating a consumption model using a survey that does measure consumption, and applying the model to surveys or census data without consumption data (Table 3.2)

A consumption model estimated households in Nairobi, other urban and rural areas, and applied to seven surveys spanning 20 years suggests that overall poverty declined by just over 1 percent per year between 1989 and 2009, with the most rapid poverty reduction occurring in Nairobi. This modeling technique predicts that poverty rates fell from 53 percent in 1989, to just over 42 percent in 2009. For Nairobi, predicted poverty fell from 30 percent in 1989, to 13 percent in 2009, for other urban areas from 44 to 37 percent, and for rural areas from 56 to 47.6 percent. Figure 3.8 displays the poverty estimate obtained from each available survey as well as the average rate of change implied by these estimates.

3.3 How have broader measures of welfare changed?

The availability of census data and other surveys provide an opportunity to assess how non-income measures of welfare have changed in Kenya. Since 1989,Censuses have been conducted every 10 years, and the Demographic and Health Surveys every 5 years. Combined, they

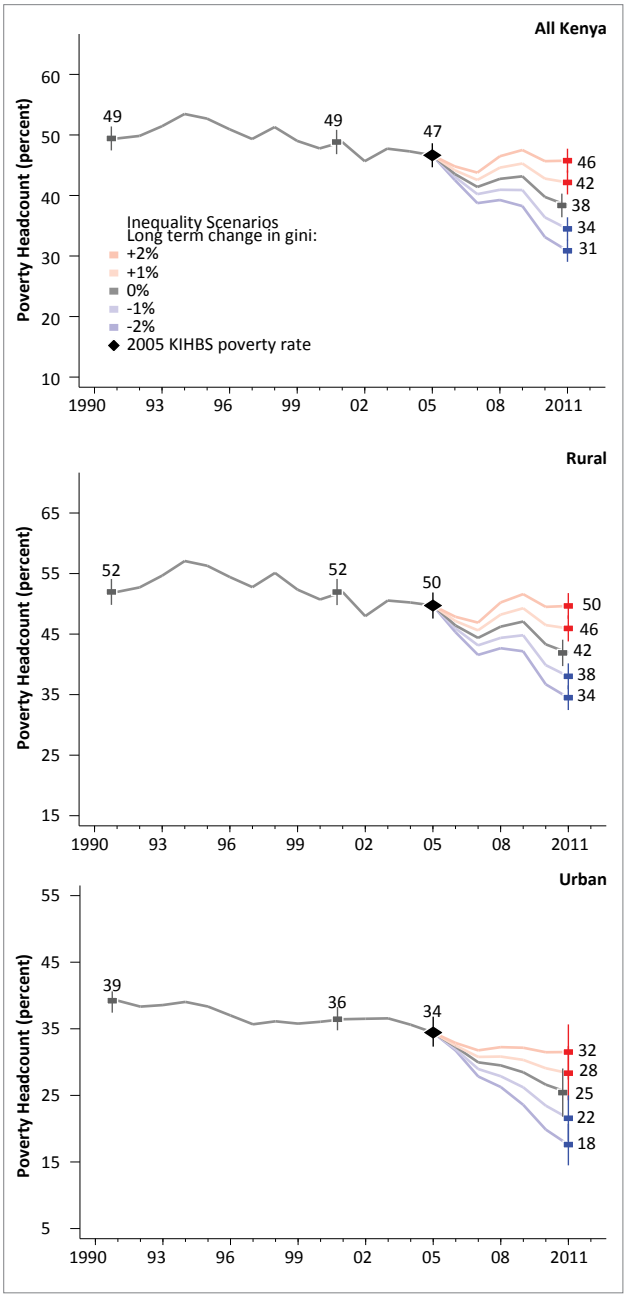
Table 3.2: Data sources with information on household welfare

Data Source	Survey Year	Sampled Households	Household members
Census	2009	868,160	3,793,282
DHS	2008	9,057	38,515
KIHBS	2005	13,212	66,725
DHS	2003	8,561	37,612
Census	1999	314,976	1,394,965
DHS	1998	8,380	37,705
DHS	1993	7,950	38,865
Census	1989	217,632	1,066,869

Source: KIHBS = Kenya Integrated Household Budget Survey / DHS = Demographic and Health Survey / WMS = Welfare Monitoring Survey

Figure 3.8: Did strong growth drive poverty rates down? Depends how you think inequality has changed

National accounts based projections of headcount poverty in Kenya, 1990- 2011



Source: World Bank

capture data on educational attainment, child and maternal health, housing conditions, ownership of consumer durables and access to electricity among others.

Assessment of a range of indicators points to a Kenya that is, on average, increasingly healthy and more educated, enjoying better living conditions and an expanded set of consumption opportunities. At the same time, a large fraction of the population continues to live with sub-standard access to water, sanitation and energy, and for many, circumstances given by the sheer luck of one's birth, such as ethnicity, the wealth of the family and area of residence play an outsize role in determining access to basic opportunities (Box 3.5).

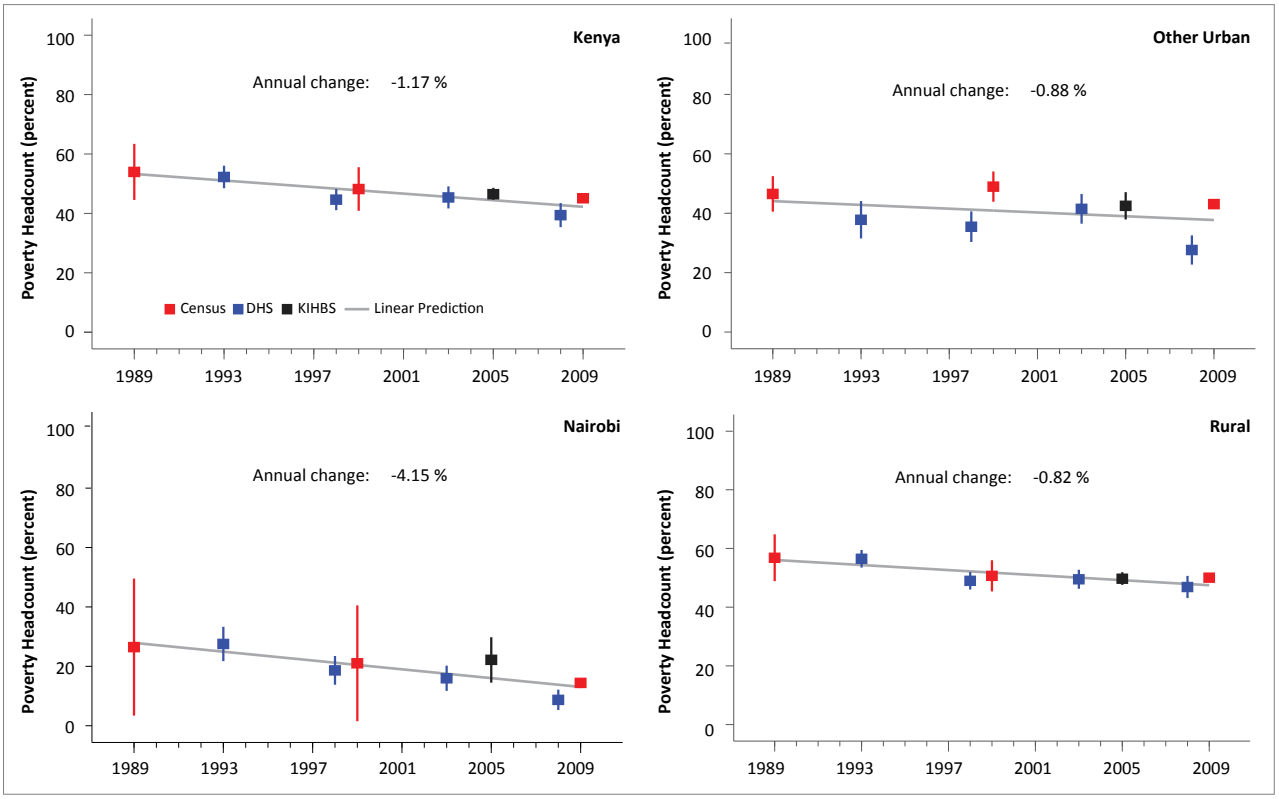
The past decade has been a major success for children's health in Kenya. While under-five mortality rose in the early 1990s to a high of 116 deaths per 1000 live births in 1999, in the 2000s under-five mortality fell by over 4 percent per year to reach 76 by the end of the decade, this was one of the fastest rates of decline in the region. A study of the drivers of infant mortality credits the scale-up of insecticide treated bed nets as a major contributor to this decline (Demombynes, 2012).

Stagnant nutritional outcomes for children, however, point to the need for renewed focus on improving food security and behaviors around child care and feeding. Between 2003 and 2008, the percentage of children who were stunted an underweight remained at 35 and 16 percent, respectively.

Educational attainment in Kenya has steadily increased. Among new entrants to the labor market (defined as individuals between the ages of 25 and 35) the percentage without any formal education fell from above 20 percent in 1989, to less than 15 percent in 2009. Overall the average number of years of formal education among 25 to 35 year olds has increased from 6 to 8 years between 1989 and 2009. The education gap between women and men fell from 2.5 years in 1989 (7.3 years for mean and 4.9 years for women) to 0.7 years in 2009 (8.5 years for mean and 7.8 years for women).

Inequality in educational attainment between heads of households has declined significantly. Between 1989 and 2009, the Gini coefficient for educational attainment of the household head measured in years, fell from 0.54 to 0.38 at a rate of

Figure 3.9: More evidence that poverty has declined
Consumption model predictions of poverty in Kenya, 1990- 2011



Source: World Bank analysis of Kenya microdata
Notes: 95 percent confidence intervals are shown as vertical lines.

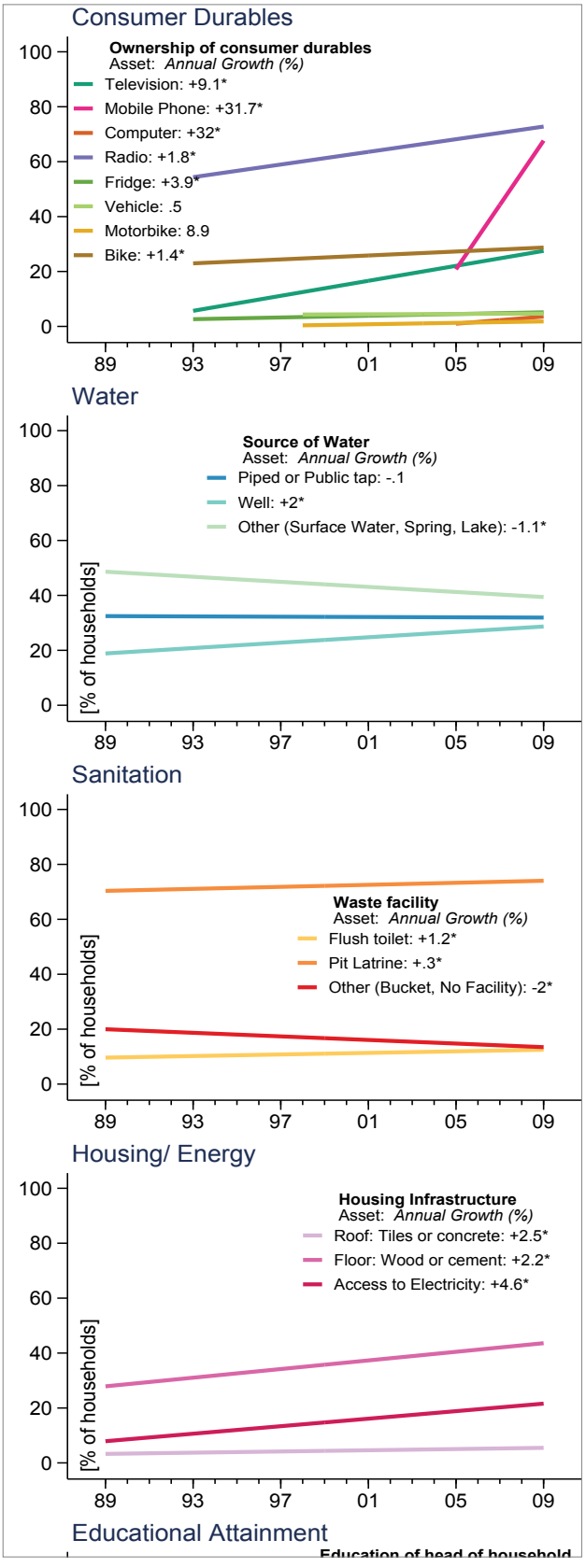
2 percent per year. This trend suggests the success of government efforts to expand the coverage of basic education. The percentage of household heads without any formal education declined by 3.6 percent per year between 1989 and 2009, and at the high end, secondary and post-secondary education is increasingly common: the share of household heads with post-secondary education increased by 11 percent per year between 1989 and 2009 (Figure 3.9).

Early signs of an emerging urban-based middle class are suggested by the increasing rates of ownership of "middle tier" consumer durables and housing quality indicators. Between 1989 and 2009, ownership of televisions grew by 9 percent per year (1 in 3 households owned a TV in 2009), and refrigerators by 4 percent per year. The share of households with high quality materials for the roof and floor increased by over 2 percent per year in Nairobi, and access to electricity by about 3 percent per year in urban areas.

A mobile revolution swept Kenya this past decade, and is creating a platform for delivering a host of services to the masses. Between 2005 and 2009, mobile phone ownership increased by over 30 percent per year on average, both in urban and rural areas. In 2009, almost two thirds of all households owned a mobile phone and it has surely reached a wider share of the population since then, as prices continue to decline. According to Afrobarometer data from 2011, over 80 percent of adults owned their own phones, with an additional 10 percent using a phone owned by someone else in the household.

Mobile money has become a fixture of the lives of Kenyans, including the poor. Launched in 2007, M-Pesa—the globally known mobile money platform has extended a basic form of financial access to the population, including a way to transfer money, make payments and store money safely. Recently, a mobile savings product called M-Kesho was launched which provides interest earning accounts on small deposits.

Figure 3.10: The evolution of household characteristics



Source: World Bank

For the poor, mobile money represents a more efficient way to receive financial support and to save. 10 percent of individuals in the poorest wealth quintile are registered with M-Pesa and tend to receive more money in remittances than they spend. Six percent of individuals in the poorest quintile also report saving on M-Pesa, and while it does not offer interest, it provides a secure storage mechanism and a potential commitment device to encourage saving. Evidence also suggests that registration to M-Pesa increases the likelihood of savings by 32 percent (Demombynes & Thegeya, 2012).

Owned by one in four households in 2009, bicycles remain the most common form of private transportation. In Nairobi, ownership of cars and trucks are more common than bikes, but ownership of a car or truck has not grown over time, remaining at about 15 percent of households. Households in rural areas increasingly owned bicycles. Ownership of motorbikes has grown at over 7 percent per year in other urban and rural areas albeit from a low base (motorbike ownership was between 3 percent in other urban areas and 2 percent in rural areas in 2009).

Access to improved water is evident in the modest rate of decline of reliance on surface water and other unprotected sources of water towards wells. However the overall figures mask the dynamic of declining access to piped or public tap water in the second tier urban areas outside Nairobi, where household access to piped water fell by 2.3 percentage points per year between 1989 and 2009, and there is even some evidence of increasing rates of reliance on unprotected water in urban areas outside of the capital (Figure A1 in Annex 3).

The fact that top tier water and sanitation indicators (such as access to piped water and a flush toilet) have declined in urban areas outside of Nairobi, suggests that smaller towns and cities have not been able to keep up with the rapid rate of urbanization. Between 1989 and 2009, the urban population outside Nairobi grew from 2.2

>> Box 3.4: Mais Iguais ("More Equal" in Portuguese)
How did one of the most unequal countries in the world become more equal?

Inequality has been a persistent feature of Latin America, but beginning in the 2000s, inequality unambiguously declined across the region from an average Gini coefficient of 0.53 in the late 1990s to 0.497 in 2010. The reduction in inequality accounted for 50 percent of the observed decline in poverty during this period.

Brazil is widely associated with inequality and it has topped the charts for having at times that highest rate of inequality in the world. But things started to change in the early 2000s: between 1998 and 2009, the Gini coefficient declined by 5.4 percentage points per year reaching 0.537 in 2009. The rate of income growth among the bottom 10 percent of earners (7 percent per year) outpaced the income growth of the top 10 percent of earners (1 percent per year) by a factor of seven.

More equal wage earnings across skill levels
Researchers found that real increases in labor income per working adult and a moderate decline in its inequality accounted for about half of the decline in overall income inequality. The reduction in inequality in labor income was driven by a narrowing of the gap between the earnings of skilled versus low or unskilled workers. Policies that expanded access to basic education broadly increased the pool of basic skills in the labor market. With a higher supply of workers with basic skills and relatively fewer unskilled or low skill workers the premium on skills declined, making wage earnings more equal across the board. The decline in labor earnings inequality was also due to falling wage differences between similar workers in large versus small cities, urban versus rural areas and between primary versus other sectors.

More progressive government transfers
The contribution of government transfers also played a big role in equalizing incomes. Since 2001, government programs – especially cash transfer programs – worked to broaden coverage of participants. BolsaFamilia- Brazil's conditional cash transfer program – increased coverage rapidly reaching 17 percent of households in 2007 from 7 percent in 2001. The equalizing effects of both targeted cash transfer programs and contributory social security had about as large an effect as more equal labor incomes in reducing overall income inequality.

Source: Pez-calva, and Ortiz-Juarez, 2012

to 8.9 million people at a rate of 7.3 percent per year. By comparison, over this period, Nairobi's population grew by an average of 4.5 percent per year from about 1.2 to 3.1 million, while the rural population grew by an average of 1.9 percent per year from 17.9 to 26.2 million.

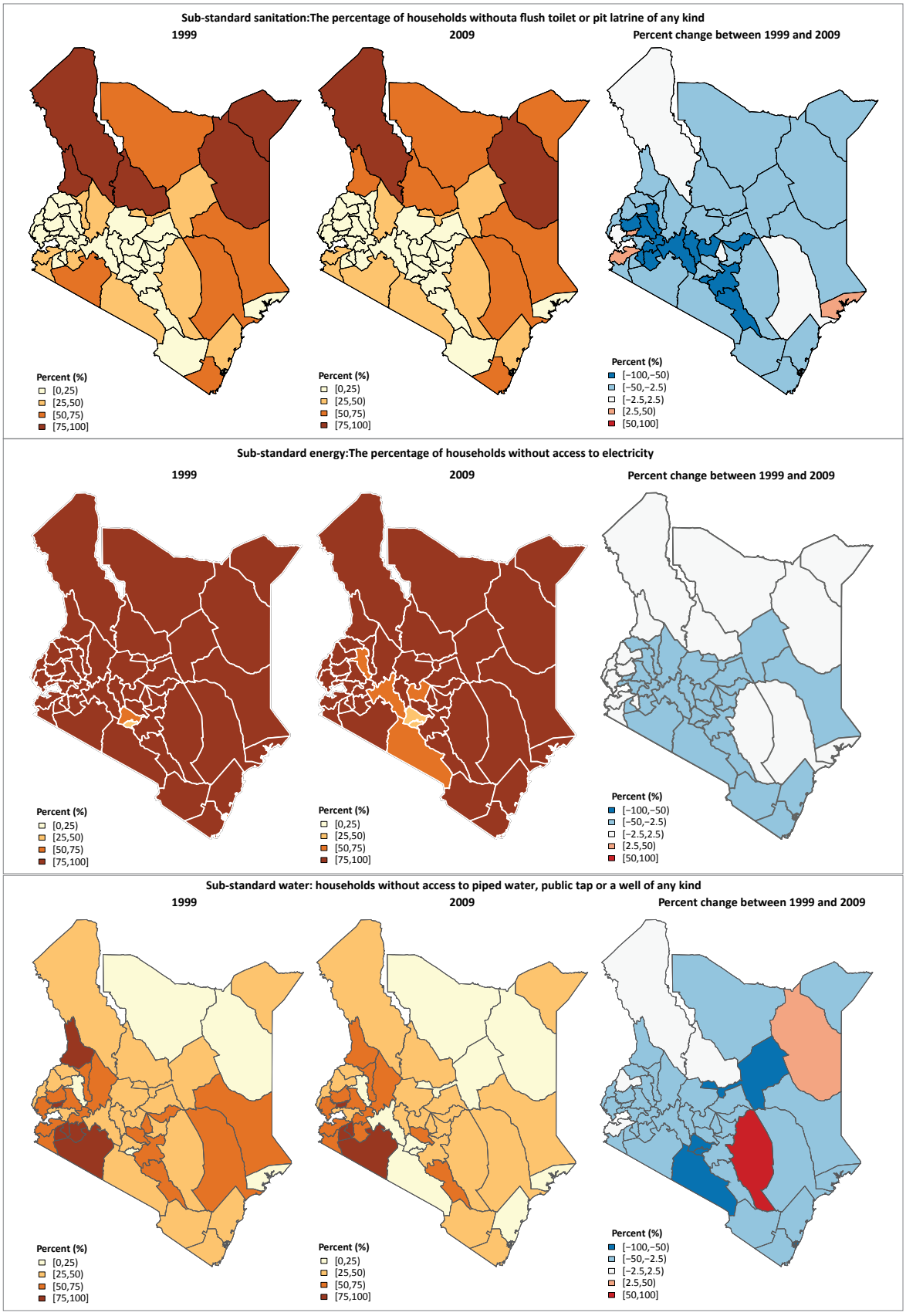
Key indicators of hardship have declined over time across Kenya, but the number of households facing day to day hardship remains very large (Figure 3.10). Between 1989 and 2009, the share of households without any type of infrastructure that enables access to water fell from 50 percent to 38 percent. These gains were distributed across most geographic regions, with the exception of two counties: Kitui and Wajir where water-related hardship increased from 32.4 to 48 percent in Kitui and from 10.6 to 14.3 percent in Wajir. Even though households in the more remotely populated north and northeast are poorer, they are more likely to have access to wells as a source of water, compared to less poor households in western Kenya because rainfall, natural rivers, streams and lakes are not as common a feature of the region's ecology.

The share of households without any waste infrastructure (except possibly a bucket) declined from 21 percent in 1989 to 13.8 percent in 2009. These improvements were widespread geographically, with the fastest reduction in sanitation hardship occurring in Nyamira, Bomet and Makueni counties, where the share of households without any waste facility fell by over 70 percent. Counties where sanitation hardship increased over this period were Homa Bay and Vihiga in the western part of Kenya and Lamu on the coast.

While household access to electricity increased in Kenya between 1999 and 1989, the improvements were more concentrated in the counties around

Figure 3.11: The geographic distribution of hardship in Kenya

The percentage of households with sub-standard access to Water, Sanitation and Energy, by county, 1999 and 2009



Source: World Bank

>> Box 3.5: Give them a chance
How opportunities for children depend on their circumstances

An important dimension of inequality relates to opportunities that are available to children, where "opportunities" are defined in terms of access to education, health and household infrastructure facilities like water and sanitation. The Human Opportunity Index (HOI) is a measure that quantifies the extent to which existing opportunities for children in the country are equitably distributed across children by "circumstances" into which children are born. These circumstances include gender, economic status, geographic location and household characteristics.

There is a growing consensus that equality of opportunity is desirable in that it levels the playing field so that everybody has the potential to achieve the outcomes they choose.There are two reasons why equality of opportunity is relevant for policymakers. The first is that people view as unfair opportunities that are accessed by circumstances rather than effort. The second reason is that inequality can be economically inefficient.

In school but without safe water
Children in Kenya have high equality of opportunities in education, but low equality of opportunities in health and household services (including adequate water, flooring, sanitation and electricity). Kenya's HOI for school attendance is amongst the highest in Sub-Saharan Africa, but HOI levels for household services- such as water and sanitation - which are amongst the lowest in the sub-Saharan Africa.

Geographic location of households, family wealth and ethnicity shape life chances
Wealth, ethnicity and location of residence are circumstances that drive inequality of opportunities for children. Household wealth and ethnicity are the most important circumstances influencing differential access to opportunities in education and health; the geographic location of the households and household wealth are the most important circumstances contributing to inequality of household services such as electricity and water.

Source: World Bank

Nairobi. After Nairobi (where about one in four households do not have access to electricity), the greatest improvement in energy-access was in Kiambu, Mombasa, Kajiado and Nakuru. One in three counties, mostly in the north, north east and far west of the country, did not experience a meaningful change in electricity access The hardship associated with not having electricity in the home is still very widespread, over 75 percent of households in 40 out of 47 counties in 2009 did not have any access to electricity.

3.4 Making public spending work for the poor

With the implementation of Kenya's new constitution, the next decade provides a tremendous opportunity for Kenya to use its public resources to reduce poverty. Kenya's new constitution represents an opportunity for policy makers and the citizens who elect them into office, to restructure and pressure public agencies to deliver services more efficiently and effectively. This section focuses on the sectors where government action can have the largest impact on poverty reduction.

The government can alleviate poverty by focusing public spending and reform efforts on sectors that increase the human capital of the poor, and that allow the poor to access information and markets. Making access to basic, but effective health and education services easy, affordable and without risks, builds human capital and enables people to seize more productive economic opportunities – whether it is through diversification of employment into other industries or migration to areas where opportunities are available. Similarly, investing in information networks and infrastructure that connects high density rural areas to Kenya's urban economic hubs will enable larger numbers of the poor to access markets for their products and labor and thereby increases income opportunities.

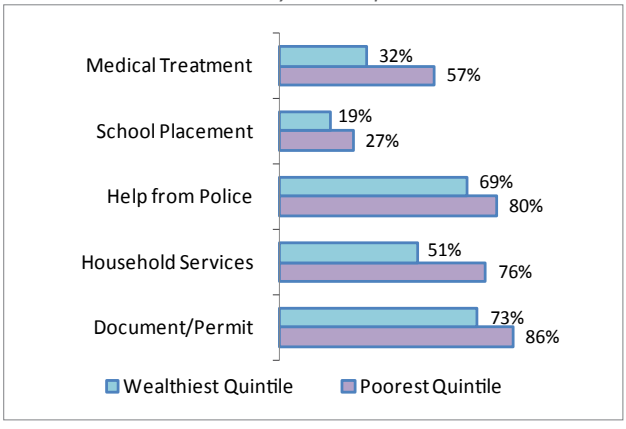
Targeted interventions that improve productivity gains in agriculture will help to reduce poverty. The agriculture sector employs the largest share of poor households in Kenya, and therefore investments that can improve the productivity of smallholder farms, such as fertilizer, improved seed varieties, access to markets and introduction of higher value added activities, carry great potential to reduce poverty.

Better governance and accountability in institutions that deliver public services is crucial to ensure that services reach the poor. As exemplified by high teacher absenteeism in Kenya's schools (Figure 3.14), current governance and accountability structures are inadequate and undermine the effectiveness of public spending. Policies that maximize incentives and effort within public service delivery agencies will translate into benefits for poor households. However, public accountability also requires informed and engaged citizens who can hold leaders and bureaucracies responsible for failures, so transparency and openness are also crucial.

The poorest Kenyans report having most difficulties in obtaining key public services, especially documents and permits, household services such as electricity and help from the police when needed (Figure 3.11). Problems with placing a child in primary school are much less frequently reported, which likely reflects the benefits of the Government's efforts to expand access through the free primary education program. Large numbers of Kenyans also report having to pay bribes to obtain public services (Figure 3.12). Compared to Tanzania and Uganda, Kenya has the highest rate of bribe payments to obtain household services, documents or permits, and avoiding problems with the police. Bribe payments to obtain medical treatment are also common.

Figure 3.12: Getting services can be difficult, especially for the poorest

Percent of Kenyans reporting difficulty obtaining public services by wealth quintile



Source: 2008 Afrobarometer

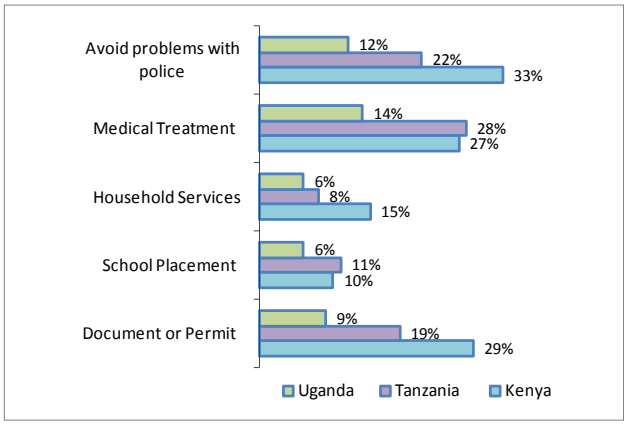
Education

As of 2011, Kenya's public expenditure on education was 20 percent of total government expenditure, and 7.2 percent of GDP. Education expenditure increased by 42 percent in real terms between 2004 and 2011 (Government of Kenya, 2013). Comparatively, the average public expenditure on education in sub-Saharan Africa was much lower—at 3.8 percent of GDP. Of the total, the largest share of public spending goes to teachers' salaries: primary school teachers alone account for 57 percent of total government spending on education.

While there has been considerable improvement in the level of resources in public schools, learning outcomes remain low, especially among the poorest students. Results from a recent effort to track service delivery indicators in Kenya revealed that Kenya is doing well relative to other countries in the region, in providing key education inputs: in 2012, on average, there were 31 students per classroom, 33 students per teacher and 3 students per textbook. However, less than one in three public school students in standard 4 could read a standard 3 level short story. Testing done by Uwezo found that students from poor households scored between 20 and 40 percent lower on basic literacy and numeracy exams, than students from non-poor households. While resources in schools have improved, the poorest Kenyans perceive that

Figure 3.13: *Nilihonga* ("I paid a bribe" in Swahili)

Percent of citizens reporting having to pay a bribe to obtain services, Kenya, Tanzania and Uganda



Source: 2005 Afrobarometer

problems with public schools most commonly have to do with inadequate facilities, overcrowding, lack of textbooks and teacher absenteeism (Figure 3.13).

Improving education outcomes will require exploring ways to make better use of educational inputs. One major source of inefficiency is teacher absenteeism. A service delivery indicator study conducted by the World Bank in 2012 found that an average of 45 percent of teachers were not teaching during an unannounced visit to schools. The majority of these absences were cases in which the teachers were not in class, even though they were present in school (Figure 3.14) and head teachers were more likely to be absent than other teachers. These findings suggest very weak monitoring and accountability at the school level.

Information campaigns to increase active participation by parents in their children's education are one possible vehicle to improve governance and accountability within schools. Greater involvement by parents might assist in lowering teacher absenteeism rates, allowing better monitoring of teacher quality, and increasing the likelihood that disbursed funds are spent efficiently.

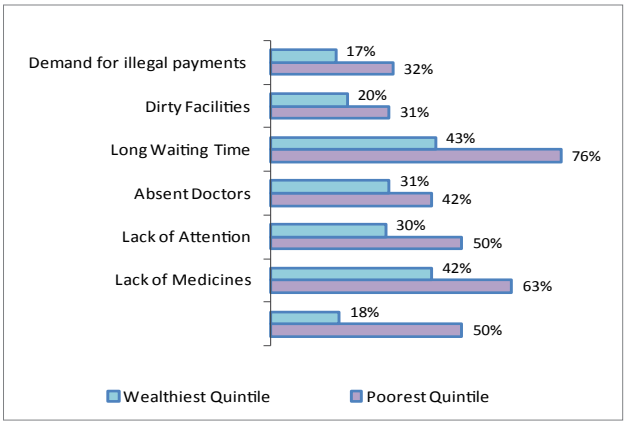
An opportunity exists to leverage information technology for improved governance within schools, and for greater access to information at a lower cost. The Ministry of Education has already made effective use of the telecommunications infrastructure, by disseminating national exam test scores through mobile phone networks. Given the high levels of mobile phone access by Kenyan households and the relatively low cost of electronic information dissemination, deploying information technology innovations within the education sector for both student learning and monitoring outputs and outcomes, should be explored.

With the increasing demand for secondary school education as a result of free day secondary education, it is increasingly important to address barriers to secondary attendance for poor households. Currently, students from poor households are less likely than those from wealthier households to complete secondary or tertiary education, so policies that remove barriers to secondary education for the poor will help to boost completion rates. Evidence suggests that scholarship programs targeted at poor households can decrease the attendance gap in secondary schooling (Demery and Gaddis, 2009).

Health

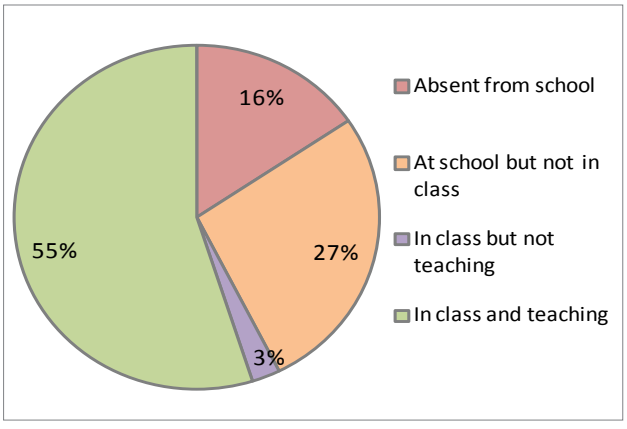
Death and disability caused by the risks associated with poverty contribute heavily to Kenya's overall burden of disease. Findings from the recent

Figure 3.14: Poor facilities and overcrowding are the most common problems associated with schools
Percent of Kenyans reporting various problems with public schools, by wealth quintile



Source: 2008 Afrobarometer

Figure 3.15: Teacher absenteeism: At school but not teaching
Percentage of teachers by attendance status during unannounced visit



Source: Kenya PETS++ 2012

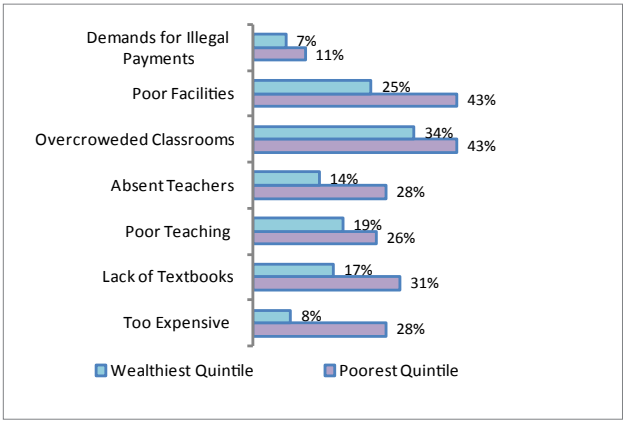
Global Burden of Disease study indicate that 20 percent of Kenya's burden of disease (measured in Disability Adjusted Life Years—the years of life lost due to early death and living with disability) can be attributed to the following risks: childhood underweight; household air pollution; suboptimal breastfeeding; iron, vitamin A and Zinc deficiency; sanitation and unimproved water. These risks in turn result from the day to day hardship that poverty brings such as food insecurity and the lack of nutrition in diets, insufficient access to information about the benefits of low cost healthy behaviors (such as exclusive breastfeeding and good continued feeding practices) and sub-standard housing infrastructure. These findings suggest that many of the upstream causes of early death and disability in Kenya can be addressed in large measure by one core prevention: alleviating poverty.

As of 2010, Kenya's total expenditure on health was 5.4 percent of GDP, below the SSA average of 6.5 percent. Health expenditure as a share of GDP and as a share of total government spending (now at 7.8 percent) has been increasing over time. Approximately 56 percent of Kenya's total public spending on health is provided by development partners (Kenya Public Expenditure Review, 2010)—which more than doubled in the past decade.

Wide variation in per capita government spending and health personnel between counties indicates wide disparities in the ability of public agencies at the local level to provide adequate health care. For example, Isiolo county spends KES 1,800 per person on health, while Mandera spends less than KES 200. Uasin Gishu has upwards of 250 health personnel per 100,000 people while Kilifi has less than 40 (Government of Kenya, 2013).

Problems with care at health facilities are more frequently reported among the poorest Kenyans. When asked about problems with health facilities, the poorest Kenyans most commonly reported about long waits, lack of medicines, lack of attention and high cost of services (Figure 3.15). These responses reflect the challenge of ensuring that people in rural areas have access to adequate facilities, and trained and motivated health workers.

Figure 3.16: Long waits and lack of medicines are the most common problems associated with health facilities
Percent of Kenyans reporting various problems with health facilities by wealth quintile



Source: 2011 Afrobarometer

Expenditure targeted at upgrading facilities and drug distribution networks at the health centre and dispensary level is likely to have a great direct impact on health care amongst the poor. Health centres and dispensaries are the major source of primary level care for poor groups in rural areas of Kenya. Historically, a high proportion of the funds intended for districts have failed to reach them. As of 2007, only 67 percent of allocations to districts were received, and receipt of funds was often delayed (Public Expenditure Tracking Survey, 2007). Further, the majority of these funds were spent at the district level, leaving peripheral facilities with very limited operating funds. With the new constitution, the responsibility of primary health care, including the financing and management of health facilities will fall on county governments.

The Government of Kenya has established the Health Sector Services Fund (HSSF) to disburse operational funds directly to health centres and dispensaries, in an effort to improve service delivery and accountability. The HSSF was established in recognition of the fact that inadequate access to resources is a contributor

to poor facility performance. HSSF resources are channeled directly to each designated facility's bank account, and managed by a local health facility committee (HFC). The phased implementation of the HSSF began in October 2010. While HFC members have the potential to improve accountability, many have not received any training in their roles or in facility management. Additionally, there is confusion over HFC roles, with facility staff and HFC members expressing different opinions (Opwora et al., 2011). The potential of the HSSF to improve facility performance by directly channeling funds and involving communities in fund management and prioritization is promising. This promise, however, is conditional on how it is implemented and shaped in the context of devolution, where currently, the future management of the fund is uncertain, and more confusion between key stakeholders may arise.

Demand-side voucher schemes to allow the poor in need of specialized medical care to claim medical benefits, and subsidization of transport costs from rural areas to national referral hospitals will help to reduce disparities in access to specialized healthcare. Funding to pay for emergency referral transport is low, and disproportionately excludes poor individuals from receiving specialized treatment. National referral hospitals are concentrated in urban areas, and the highest concentration of medical specialists is found in Nairobi. Poor individuals in need of specialized treatment, thus need to travel to the closest referral hospital with adequate facilities.

Incentive programs and policies to recruit and retain health workers in rural and remote areas can help to lower the gap in health care provision between urban and rural areas. Health workers tend to prefer working in urban areas, resulting in an undersupply of workers in rural and remote areas. There is evidence that a mix of strategies can help to attract trained health staff to these areas. For example, locating professional schools and residency programs outside of capitals or having certain clinical rotations in rural areas, can increase the likelihood that graduates choose to practice in rural areas. In addition, financial incentives (such as hardship allowances, grants for housing or paid vacations) can offset opportunity costs of working in rural areas. Improving the working conditions of rural health facilities (such as providing safe working environments, supportive supervision and mentoring) can also encourage staff to take opportunities outside of urban centers (WHO, 2010).

Infrastructure

Kenya's utilities are largely inefficient; they are characterized by high production costs, volatile supply and losses in distribution. Access to electricity and water is largely dependent on rainfall cycles. Within the power sector, 57 percent of total power supply is generated through hydro power. Kenya Power and Lighting Corporation (KPLC) reports transmission and distribution losses of 18 percent, compared to a best practice of 10 percent, and captures only 85 percent of potential revenues (Kenya Public Expenditure Review, 2010). These losses are an indication of poor maintenance and rehabilitation of the network. Within the water sector, water utilities are capturing less than 60 percent of the revenues they need to operate effectively, largely a result of underpricing and high non-payment rates (Kenya Public Expenditure Review, 2010).

Policies to increase the water storage capacity of utilities will lower susceptibility to Kenya's rainfall cycles. Within the water sector, investment to exploit water harvesting during heavy rainfall cycles, for example through artificial dams, will result in lower vulnerability during periods of drought. Within the electricity sector, diversification of power sources to geothermal and wind power will lower dependency on hydro power and lower the incidence of rationing during dry seasons. The government has embarked on an ambitious plan to increase power supply within Kenya.

Government subsidies to lower or eliminate electricity connection costs for poor households may increase uptake of electricity connections amongst poor households. Within slum areas, KPLC already charges a reduced connection fee of KES 1,000, which is highly subsidized over the regular connection fee of KES 35,000 (Kenya Public Expenditure Review, 2010). However, the fee remains restrictive for the poorest households.

Improved governance and accountability systems within utilities can set the foundation for improved service delivery. Poor governance remains an issue for service delivery within the water and electricity sectors. Historically, these sectors have been characterized by high rates of unaccounted losses, poor revenue collection rates, low levels of maintenance and mismanagement. Improving performance through increased oversight and accountability can help overcome these challenges.

3.5 What will it take to make poverty history?

The dream of a Kenya free of extreme poverty is attainable. Experience from the region shows that achieving rapid reductions in extreme poverty is possible, the challenge for Kenya and other countries in the region is to sustain these gains and to make poverty reduction a national priority.

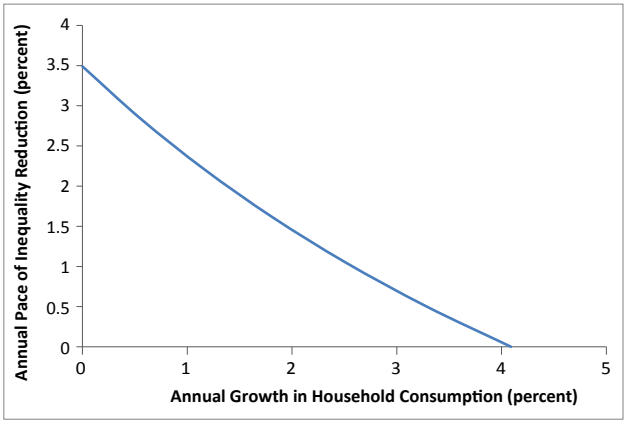
Available evidence suggests that Kenya's progress on poverty reduction between the early 1990s and 2005 was negligible. Consequently, Kenya is unlikely to attain the first Millennium Development Goal (MDG1) of reducing by half the proportion of the population living below 1.25 dollars per day (extreme poverty) between 1990 and 2015. In 2005, 43.4 percent of Kenyans were classified as extreme poor by this international standard. There is however, no reliable estimate for extreme poverty in 1990—the baseline year of MDG1. Using the national accounts based simulation presented in Section 2, and assuming distribution-neutral growth, a ballpark estimate of extreme poverty in 1990 is 45.6 percent.

To achieve the first Millennium Development Goal, poverty headcount would need to drop by 20 percentage points between 2005 (43 percent) and 2015 (estimated target of 23 percent). Broadly speaking, poverty reduction can be achieved through two complimentary channels: growth and redistribution in favor of the poor (reduction in inequality). Figure 3.16 shows the combinations of growth (horizontal axis) and redistribution (vertical axis) that would allow the attainment of MDG1 . In a scenario without redistribution (and as a result no reduction in inequality) household consumption levels would need to grow by 49 percent in real terms between 2005 and 2015 to attain MDG1. This corresponds to annual consumption growth of 4.1 percent (horizontal intercept in Figure 5.1). To put this into perspective, annual growth in per capita GDP in Kenya averaged 1.9 percent between 2005 and 2011. Even in the case of a moderate reduction in inequality (an annual decline in inequality of 0.5 percent-the average for SSA), household consumption levels would need to grow at more than 3 percent per year to attain the MDG poverty target by 2015. In a case of no growth in household consumption whatsoever, the Gini coefficient would have to drop from 0.47 in 2005 to 0.33 in 2015, an annual decline of 3.5 percent .

Shaping the post-2015 agenda, the Development Committee of the World Bank Group recently endorsed the goal of eradicating extreme poverty

Figure 3.17: Reaching the first Millennium Development Goal is unlikely

Combinations of growth and inequality reduction necessary to attain MDG1between 2005 and 2015



Source: World Bank

>> Box 3.6: Turbocharging Poverty Reduction: The Case of Rwanda
How changes in inequality hamper or boost poverty reduction

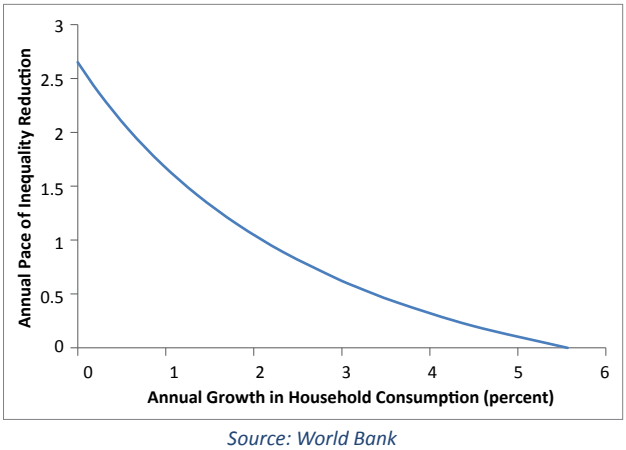
The importance of inequality dynamics in boosting or complicating poverty reduction is nicely illustrated by Rwanda's experience over the past decade. Between 2001 and 2006, household consumption in Rwanda grew at a solid pace of 2 percent per year, resulting in a real consumption gain of over 10 percent. However, poverty dropped by only two percentage points (59 percent in 2001 and 57 percent in 2006).

The disappointing performance in terms of poverty reduction during this period is explained by rising inequality: If inequality had remained constant, poverty would have fallen by more than 5 percentage points instead of the 2 points actually observed. In the subsequent five years (2006-2011), household consumption in Rwanda grew at 3 percent per annum, and the incidence of poverty fell by 12 percentage points. Although strong, growth in household consumption accounted for "only" 8.5 percentage points of the reduction in poverty. The decrease in inequality added another 3.5 percentage points-more than the total poverty reduction in the preceding period.

Source: World Bank

within a generation globally. This goal has been specified as reducing the proportion of people living on less than $1.25 per day to no more than 3 percent by 2030. In Kenya, this entails reducing poverty by 40 percentage points between 2005 and 2030. What will it take for Kenya to achieve this goal? Figure 3.17 shows the possible combinations of growth and redistribution necessary by to attain the target. In the absence of redistribution, household consumption will need to increase almost four-fold between 2005 and 2030, requiring an annual consumption growth of 5.6 percent. With an average decline in inequality of 0.5 percent per year, consumption will still need to grow by 3.2 percent per annum to attain the target, a daunting task given Kenya's modest performance during the past decades.

Figure 3.18: What Will it Take for Kenya to Reduce Extreme Poverty to 3 Percent by 2030?
Combination of growth and inequality reduction necessary to reduce extreme poverty to 3 percent by 2030



Source: World Bank

Despite the large reduction in poverty needed to eliminate extreme poverty, it is not beyond reach. For instance, a reduction in inequality of 1 percent per year coupled with an annual consumption growth rate of 2.1 percent would suffice to hit the target (Figure 3.17). With annual growth of 2.5 percent, inequality will need to decline at 0.8 percent per year to achieve the goal. If inequality could be reduced by 1.5 percent per year, a modest consumption growth rate of 1.2 percent per annum would be enough to hit the target.

These simulations highlight the important mediating role played by inequality dynamics in poverty reduction (see Box 3.6). It is clear that in the absence of redistribution, it will be hard for Kenya to attain growth rates that are sufficiently high, to make significant dents in poverty and reach the 2030 target. The scope for rapid poverty reduction will crucially depend on the extent to which the Government can bring down inequality levels by adopting policies that are more likely to result in pro-poor growth, ensuring good basic services are available everywhere and designing effective social protection mechanisms (Box 3.7).

3.6 Poverty reduction: the way forward

The analyses presented in this report suggest the following areas as possible elements of a poverty-reduction agenda:

>> Box 3.7: Strengthening Social Protection in Kenya
Why cash transfers not food aid should become the backbone of social assistance for the poor in Kenya

Kenya's commitment to social protection is encoded in the constitution and in the National Social Protection Policy (NSPP) of 2012. Social protection programs in Kenya fall under three categories: social security, social health insurance and social assistance (or safety nets). As a majority of the people who benefit from social security (pensions) and health insurance are formal sector workers, social assistance programs are most relevant for the poor and vulnerable.

Emergency food aid dominates social assistance

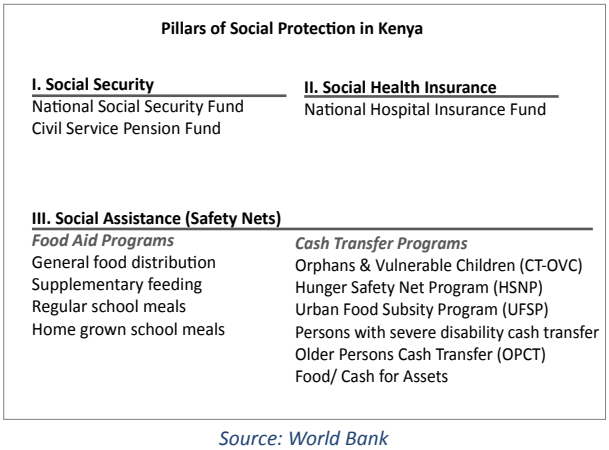
The most common type of social assistance programs are food programs—emergency food aid in response to droughts or floods and school feeding programs. These programs jointly absorb over 80 percent of all safety net beneficiaries, and make up over half of all safety net spending. Five social cash transfer programs targeting orphans, the disabled, older persons and the food insecure make up 13 percent of all safety net beneficiaries. Support through emergency food aid, while important, is sporadic, unpredictable and ineffective in reducing chronic poverty. Cash transfers on the other hand provide regular and predictable income support, and have played a key role in reducing poverty and improving health and education outcomes among the poor in many countries around the world (See Box 3.4).

Scale up, harmonize and strengthen cash transfers

While the number of people covered by cash transfer programs has increased since 2005, they only reach about 8 percent of the poor population. Kenya's cash transfer programs are small, fragmented and unable to respond when shocks hit. Improving the effectiveness of these programs will require ramping up government spending on them, improving coordination among implementing agencies, and building capacity for programs to respond to shocks, using early warning systems and contingency funds that can mobilize additional resources when needed. The government is seeking to implement these recommendations through the establishment of the National Safety Net Program.

Source: World Bank

Figure 3.18: Pillars of Social Protection in Kenya



Source: World Bank

(1) Fostering pro-poor economic growth and job creation
(2) Enhancing the productivity of smallholder farms
(3) Using public spending to make key opportunities available to Kenyans of all backgrounds
(4) Strengthening and expanding the cash transfer programs that protect and provide income support to the poor
(5) Investing in a system of routine household budget surveys to monitor poverty and inequality

Poverty reduction needs sustained economic growth, but the nature of that growth also matters. If Kenya's growth and job creation is only concentrated at the high-skills end—for example in industries that hire software engineers or bankers, the poverty reducing effects of growth will be limited. However, if more productive jobs become increasingly available to people with low and medium skills—these jobs will represent pathways out of poverty. To encourage the growth of low and middle skills jobs, especially in manufacturing, the government can work to incentivize exports and improve the investment and business environment more broadly.

Pro-poor growth cannot be achieved without modernizing smallholder farming. Since the majority of Kenya's poor depend on smallholder agriculture for their livelihood, increasing their

productivity through the use of fertilizer, improved seeds and access to markets for agricultural production, will drive poverty reduction in the short to medium term.

Poverty reduction can be complemented with greater equity in Kenyan society and achieved in part through stronger cash transfer programs, and more equitable and effective public spending. Cash transfer programs worldwide have been shown to help reduce poverty and vulnerability, through predictable income support that studies show that households use to improve their consumption, to invest in productive assets and meet their health and education goals. Kenya has a host of cash transfer programs that reach a very small share of the population in need, are fragmented and not able to respond to shocks. Strengthening and expanding these programs with their increased prioritization in the government budget, should be a central pillar of Kenya's poverty reduction strategy (Box 3.7).

Leveling the playing field in access to key opportunities—such as quality education, energy, water and sanitation—has the potential not only to boost growth, but also to reduce inequality. Circumstances such as family wealth, ethnicity or the geographic location of the household play an oversized role in influencing access to opportunities that can enhance the health, education and overall well-being of children in Kenya. These circumstances should not matter and public spending should work to remove their influence, so that every child has the same chance to seize the opportunities being generated in a growing Kenya. This will require focusing financial and human resources in areas that have been historically neglected (such as remote rural and arid areas) and building transparency and accountability to ensure that these resources are used effectively.

A substantial part of inequality in Kenya can be explained by inequality in labor income, which is in turn determined by inequality in access to and quality of education. Ensuring that children from all walks of life have access to quality education will expand the pool of skilled workers, which would have positive effects on poverty reduction, both through a growth effect (skilled workers earn more) and an inequality effect (having a higher supply of skills would drive down the skills premium and reduce inequality).

Kenya's inconsistent record of monitoring poverty and the importance of understanding the nature of changes in growth and inequality, calls for a systematic program of rigorous household data collection. As suggested by the simulations, the effects future growth will have on poverty will largely depend on whether inequality increases or decreases, and the pace of its change. Simply measuring economic growth through national accounts, will not convey useful or reliable information on the evolution of poverty. To convincingly monitor the impact of Government policies on household consumption growth, equity and poverty reduction, comprehensive and comparable household surveys need to be implemented regularly. This will not only determine whether progress is being made, but will also identify areas where policies need to be adapted or stepped up, to maximize their impact on poverty reduction.

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ANNEXES

Annex 1: Macroeconomic environment

	2008	2009	2010	2011	2012
GDP Growth Rates (percent)	**1.5**	**2.7**	**5.8**	**4.4**	**4.6**
Agriculture	-4.3	-2.5	6.3	1.5	3.8
Industry	4.7	2.8	5.4	2.9	4.5
Services	2.7	6.7	3.8	5.2	4.6
Fiscal Framework (percent of GDP)					
Total Revenue	21.8	21.9	23.8	23.8	22.8
Total Expenditure	27.2	27.9	29.7	29.2	28.9
Grants	-0.1	-0.1	-0.1	0.0	0.5
Budget Deficit (incl grants)	-4.3	-5.2	-5.1	-4.3	-5.6
Total Debt	45.6	47.5	49.9	48.5	45.2
External Account (percent of GDP)*					
Exports (fob)	18.7	14.4	16.5	17.1	15.1
Imports (cif)	42.5	32.8	39.1	43.5	40.3
Balance of Trade	-15.7	-12.4	-14.7	-18.9	-17.0
Current Account Balance	-7.3	-5.3	-7.9	-9.8	-11.2
Financial and Capital Account	5.6	7.8	8.4	9.7	14.2
Overall Balance	-1.7	2.5	0.5	-0.1	3.0
Inflation (average)	**16.2**	**10.5**	**4.1**	**14.0**	**9.6**
Exchange Rate (Average KES/$)	**69.2**	**77.4**	**79.2**	**88.8**	**84.5**

Source: KNBS, IMF and CBK
** As at 31 December 2012*

Annex 2: GDP Growth Rates 2008-2012 Kenya SSA EAC

	2008	2009	2010	2011	2012	2008-2012
Kenya	1.5	2.6	5.6	4.5	4.6	3.8
SSA (excluding South Africa)	6.1	4.0	6.1	5.3	5.8	5.5
Uganda	8.7	7.2	5.9	6.7	3.4	6.4
Tanzania	**7.4**	**6.0**	**7.0**	**6.3**	**6.5**	**6.7**
Rwanda	11.2	4.1	7.2	8.6	7.7	7.8

Source: World Bank Global Economic Prospects 2013

Annex 3: Kenya annual GDP

Years	GDP, current prices	GDP, constant prices	GDP/capita, current prices	GDP Growth
	Kshs (Billions)	Kshs (Billions)	U.S. dollars	Percent change
2000	968	965	399	0.6
2001	1026	1011	413	4.7
2002	1039	1014	408	0.3
2003	1142	1042	456	2.8
2004	1274	1090	478	4.6
2006	1623	1229	637	6.3
2007	1834	1315	749	7.0
2008	2108	1357	813	1.5
2009	2367	1394	793	2.7
2010	2554	1475	810	5.8
2011	3049	1540	833	4.4
2012	3440	1610	991	4.6

Source: KNBS

Annex 4: Quartely growth rates (percent)

		AGRICULTURE			INDUSTRY			SERVICES			GDP		
Years	Quarters	Q/Q-1	Q/Q-4	(Q:Q-3)/ (Q-4:Q-7)	Q/Q-1	Q/Q-4	(Q:Q-3)/ (Q-4:Q-7)	Q/Q-1	Q/Q-4	(Q:Q-3)/ (Q-4:Q-7)	Q/Q-1	Q/Q-4	(Q:Q-3)/ (Q-4:Q-7)
2007	1	-15.5	8.7	6.5	-2.2	3.8	4.6	3.5	5.6	5.9	-2.8	7.1	6.6
	2	-9.6	2.0	5.8	5.7	9.3	5.9	2.8	9.3	6.3	0.1	8.3	7.1
	3	24.8	-0.1	4.0	3.2	8.9	6.9	4.7	8.5	6.6	9.1	6.3	6.6
	4	4.7	-0.2	2.3	-0.5	6.2	7.1	-2.0	9.1	8.1	0.1	6.4	7.0
2008	1	-19.7	-5.2	-0.9	-5.3	2.8	6.8	-3.1	2.3	7.2	-7.5	1.1	5.5
	2	-4.6	0.1	-1.3	9.2	6.2	6.0	3.4	2.9	5.6	1.2	2.2	4.0
	3	18.1	-5.2	-2.7	3.4	6.4	5.4	5.7	3.8	4.5	9.5	2.6	3.1
	4	4.0	-5.9	-4.3	-3.5	3.2	4.7	-4.1	1.7	2.7	-2.1	0.2	1.5
2009	1	-16.0	-1.5	-3.4	-1.4	7.5	5.8	5.1	10.3	4.6	-2.1	6.2	2.7
	2	-6.9	-3.9	-4.3	3.6	1.9	4.7	-2.6	3.8	4.9	-2.9	1.9	2.7
	3	18.9	-3.3	-3.8	0.1	-1.3	2.7	8.3	6.4	5.5	9.5	1.9	2.5
	4	6.2	-1.3	-2.5	1.4	3.7	2.8	-4.1	6.3	6.7	-2.8	1.2	2.7
2010	1	-9.9	5.9	-0.8	-0.7	4.4	2.1	-0.9	0.2	4.1	-1.9	1.4	1.6
	2	-9.2	3.3	0.8	4.2	5.0	2.9	2.7	5.7	4.6	1.5	6.1	2.6
	3	25.0	8.6	4.0	2.2	7.2	5.1	8.8	6.1	4.6	10.7	7.2	4.0
	4	4.6	7.0	6.3	-0.8	4.8	5.4	-6.6	3.3	3.8	-1.8	8.3	5.8
2011	1	-15.6	0.2	4.9	-0.6	5.0	5.5	1.5	5.8	5.2	-5.0	4.8	6.6
	2	-5.7	4.0	5.1	1.9	2.7	4.9	1.3	4.4	4.9	0.3	3.5	6.0
	3	20.5	0.3	2.9	0.5	1.0	3.3	9.6	5.2	4.7	11.2	4.0	5.1
	4	6.4	2.0	1.5	1.3	3.1	2.9	-6.5	5.3	5.2	-0.7	5.2	4.4
2012	1	-15.6	2.1	2.0	-0.5	3.2	2.5	0.6	4.5	4.9	-6.1	4.0	4.2
	2	-5.7	2.1	1.6	1.3	2.6	2.5	1.4	4.5	4.9	0.6	4.4	4.4
	3	24.9	5.8	3.1	1.3	3.4	3.1	9.3	4.3	4.6	11.4	4.5	4.5
	4	5.3	4.7	3.8	6.3	8.5	4.5	-5.7	5.2	4.6	0.0	5.3	4.6

Source: World Bank Calculations based on KNBS data.

Agriculture = Agriculture and forestry + Fishing Industry = Mining and quarrying + Manufacturing + Electricity ans water + Construction

Servics = Wholesale and retail trade + Hotels and restaurants + Transport and communication + Financial intermediation + Real estate, renting and business services + Public administration + Education + Other services + FISIM

Annex 5: Inflation

Year	Month	Overall Inflation	Food Inflation	Energy Inflation	Core Inflation
2011	January	5.4	8.6	5.7	1.4
	February	6.5	9.8	7.8	1.8
	March	9.2	15.1	9.6	2.5
	April	12.1	19.1	12.7	3.6
	May	13.0	20.1	14.4	4.0
	June	14.5	22.5	15.5	4.8
	July	15.5	24.0	16.2	5.6
	August	16.7	23.9	16.8	8.5
	September	17.3	24.4	17.6	9.1
	October	18.9	26.2	19.2	10.4
	November	19.7	26.2	20.6	11.8
	December	18.9	25.0	19.7	11.6
2012	January	18.3	24.6	17.3	12.1
	February	16.7	22.1	14.8	12.1
	March	15.6	20.3	13.0	12.0
	April	13.1	16.2	11.1	11.0
	May	12.2	14.6	10.0	11.3
	June	10.1	10.5	9.0	10.7
	July	7.7	6.6	7.4	9.7
	August	6.1	3.6	6.7	9.0
	September	5.3	2.9	6.0	8.3
	October	4.1	1.4	5.0	7.0
	November	3.3	1.7	3.1	5.5
	December	3.2	1.7	2.8	5.5
2013	January	3.7	2.4	3.9	5.2
	February	4.5	4.0	4.6	4.9
	March	4.1	2.9	5.3	4.8
	April	4.1	3.6	4.3	4.6
	May	4.1	4.3	3.5	4.1

Source: World Bank Calculations based on KNBS data

Annex 6: Tea production and exports

Year	Month	Production	Price	Exports	Exports value
		MT	Ksh/Kg	MT	Ksh Million
2011	January	35,999	256	31,110	7,871
	February	26,711	251	28,814	7,223
	March	22,459	243	35,852	8,890
	April	31,482	241	32,084	7,900
	May	32,856	245	31,898	7,825
	June	28,955	264	34,957	7,825
	July	26,343	283	33,629	8,907
	August	24,471	294	32,693	9,266
	September	30,493	292	26,430	9,333
	October	39,926	291	29,422	7,686
	November	36,825	269	33,353	8,855
	December	41,393	251	35,187	9,334
2012	January	36,205	250	35,382	9,145
	February	18,412	245	37,656	9,123
	March	17,859	251	31,280	9,415
	April	18,118	256	26,816	7,804
	May	37,383	264	25,060	6,445
	June	30,197	279	29,148	7,770
	July	24,306	288	28,054	7,813
	August	31,920	288	30,996	8,798
	September	33,549	280	30,689	8,771
	October	40,235	272	33,167	9,448
	November	39,977	277	38,681	10,840
	December	41,401	281	30,067	8,463
2013	January	45,390	284	40,190	11,383
	February	38,503	271	34,585	10,071
	March	33,368	241	32,534	8,619
	April	45,390	284		

Source: KNBS

Annex 7: Coffee production and exports

Year	Month	Production	Price	Exports	Exports value
		MT	Ksh/Kg	MT	Ksh Million
2011	January	3,774	682	3,067	1,282
	February	3,851	640	3,261	1,671
	March	3,639	587	4,204	2,155
	April	2,298	474	4,254	2,294
	May	0	0	3,878	1,963
	June	1,136	596	2,677	1,322
	July	3,305	592	2,857	1,749
	August	4,558	582	3,096	1,955
	September	2,904	593	3,317	2,161
	October	1,388	543	3,298	2,134
	November	1,331	541	1,990	1,173
	December	1,800	603	1,672	940
2012	January	4,770	544	3,094	1,454
	February	6,505	369	3,668	1,937
	March	3,317	389	5,069	2,550
	April	4,801	342	4,625	2,369
	May	5,472	303	4,924	2,275
	June	3,884	258	4,887	2,098
	July	3,086	298	5,727	2,397
	August	3,948	277	4,484	1,712
	September	4,474	265	4,421	1,596
	October	2,924	263	4,482	1,690
	November	1,794	272	4,110	1,453
	December	1,075	308	2,223	740
2013	January	3,938	344	2,790	1,062
	February	4,825	320	3,955	1,429
	March	4,074	327	3,179	1,188
	April	6,038	279		

Source: KNBS

Annex 8: Horticulture exports

Year	Month	Exports	Exports value
		MT	Ksh. Million
2011	January	16,231	7,470
	February	17,531	7,368
	March	21,287	7,548
	April	23,448	7,159
	May	21,839	8,315
	June	17,730	6,836
	July	15,420	5,531
	August	16,128	6,582
	September	15,658	6,745
	October	17,553	9,508
	November	17,277	6,647
	December	16,145	8,915
2012	January	14,974	8,721
	February	16,053	6,726
	March	18,967	6,515
	April	17,408	6,317
	May	17,027	6,013
	June	15,271	6,227
	July	17,349	7,813
	August	15,869	5,825
	September	16,506	7,567
	October	19,708	11,368
	November	18,347	7,742
	December	18,250	9,036
2013	January	18,398	9,071
	February	21,576	9,198
	March	19,814	7,061
	April	19,790	5,228

Source: KNBS

Annex 9: Local electricity generation by source (Million KWh)

Year	Month	Hydro	Geo-thermal	Thermal	Total
2011	January	296	119	188	603
	February	246	105	200	551
	March	259	126	225	610
	April	237	120	224	582
	May	264	124	222	610
	June	268	118	200	586
	July	263	122	226	611
	August	254	125	234	614
	September	249	121	224	595
	October	253	122	225	601
	November	263	115	208	587
	December	331	125	156	613
2012	January	330	129	169	627
	February	332	125	159	616
	March	293	134	194	620
	April	273	124	175	572
	May	323	132	159	615
	June	342	129	147	618
	July	358	119	168	646
	August	348	122	176	645
	September	358	119	168	646
	October	360	129	166	654
	November	372	121	159	652
	December	369	130	148	647
2013	January	377	129	169	675
	February	333	113	160	606
	March	348	135	160	645
	April	345	152	140	637

Source: KNBS

Annex 10: Soft drinks and sugar production

Year	Month	Soft Drinks	Sugar	Galvanized Sheets	Cement
		"000" litres	MT	MT	MT
2011	January	34,446	55,974	22,094	364,432
	February	32,457	52,069	22,386	335,247
	March	36,156	53,842	22,928	355,858
	April	31,162	52,061	20,957	363,035
	May	26,622	49,130	24,744	376,246
	June	28,910	38,818	24,677	365,494
	July	28,478	25,884	24,906	393,149
	August	28,580	26,060	24,659	405,546
	September	29,674	22,815	17,988	407,838
	October	28,540	28,990	16,619	361,941
	November	27,366	32,689	22,104	364,789
	December	38,962	36,729	24,033	384,853
2012	January	34,317	53,852	22,940	350,615
	February	32,009	49,480	19,655	378,453
	March	37,363	52,342	21,507	397,009
	April	29,331	44,914	20,892	360,540
	May	24,359	40,503	22,197	381,026
	June	27,391	45,111	17,180	396,951
	July	22,073	41,607	21,411	398,458
	August	24,458	37,058	23,040	399,873
	September	31,113	32,503	23,268	382,141
	October	32,540	30,123	20,473	421,579
	November	31,497	31,886	21,969	415,866
	December	33,067	34,651	21,283	357,212
2013	January	34,246	49,046	..	387,527
	February	..	50,036	..	377,561
	March	..	43,647	..	373,337
	April	..	..	..	375,237

Source: KNBS

Annex 11: Tourism arrivals

Year	Month	JKIA	MIA	TOTAL
2011	January	79142	35770	114912
	February	69221	31211	100432
	March	71734	26027	97761
	April	66276	10181	76457
	May	74148	5167	79315
	June	72944	6676	79620
	July	131519	12037	143556
	August	113438	23402	136840
	September	85397	17317	102714
	October	88918	18741	107659
	November	89394	19641	109035
	December	94355	21624	115979
2012	January	83450	28134	111584
	February	80405	24636	105041
	March	75668	19965	95633
	April	72023	7531	79554
	May	71287	4830	76117
	June	90972	5934	96906
	July	108136	12671	120807
	August	108869	17771	126640
	September	90153	13312	103465
	October	95911	12942	108853
	November	83122	16135	99257
	December	92365	23290	115655
2013	January	85838	26446	111984
	February	48970	24031	73001
	March	52103	17850	69953

Source: KNBS

Annex 12: New vehicle registration

Year	Month	All body types
2011	January	18805
	February	16190
	March	16497
	April	12560
	May	15115
	June	21546
	July	19128
	August	18797
	September	16802
	October	17202
	November	17640
	December	15559
2012	January	13730
	February	12693
	March	13066
	April	8257
	May	16652
	June	15091
	July	22577
	August	16970
	September	12003
	October	15449
	November	14867
	December	11689
2013	January	20997
	February	16928
	March	17061

Source: KNBS

Annex 13: Exchange rate

Year	Month	USD	UK POUND	EURO
2011	January	81.0	127.7	108.2
	February	81.5	131.5	111.3
	March	84.2	136.1	117.9
	April	83.9	137.1	121.1
	May	85.4	139.5	122.4
	June	89.0	144.4	128.1
	July	89.9	145.0	128.5
	August	92.8	151.9	133.0
	September	96.4	152.1	132.7
	October	101.3	159.4	138.7
	November	93.7	148.2	127.1
	December	86.7	135.1	114.1
2012	January	86.3	133.9	111.4
	February	83.2	131.4	110.1
	March	82.9	131.2	109.6
	April	83.2	133.2	109.6
	May	84.4	134.3	108.0
	June	84.8	132.0	106.5
	July	84.1	131.2	103.5
	August	84.1	132.1	104.2
	September	84.6	136.3	108.8
	October	85.1	136.8	110.3
	November	85.6	136.8	109.9
	December	86.0	138.8	112.8
2013	January	86.9	138.8	115.5
	February	87.4	135.5	116.9
	March	85.8	129.4	111.3
	May	84.1	128.8	109.2

Source: CBK

Annex 14: Interest rates

Year		Short Term			Long term			
		Interbank	91-Tbill	CBR	Average Deposit Rate	Savings	Overall Weighted Lending Rate	Interest rate Spread*
2011	January	1.0	2.0	6.0	3.4	1.3	14.0	10.6
	February	1.0	3.0	5.8	3.4	1.4	13.9	10.5
	March	1.0	3.0	6.0	3.5	1.4	13.9	10.4
	April	4.0	3.0	6.0	3.5	1.4	13.9	10.5
	May	6.0	5.0	6.3	3.6	1.4	13.9	10.3
	June	6.0	9.0	6.3	3.7	1.4	13.9	10.2
	July	9.0	9.0	6.3	3.9	1.4	14.1	10.3
	August	14.0	9.0	7.0	4.1	1.4	14.3	10.3
	September	7.0	12.0	7.0	4.2	1.3	14.8	10.6
	October	15.0	15.0	11.0	4.8	1.3	15.2	10.4
	November	29.0	16.0	16.5	5.7	1.4	18.5	12.7
	December	22.0	18.0	18.0	7.0	1.6	20.0	13.1
2012	January	19.0	21.0	18.0	7.7	1.6	19.5	11.9
	February	18.0	20.0	18.0	8.0	1.7	20.3	12.3
	March	24.0	18.0	18.0	8.0	1.7	20.3	12.3
	April	16.0	16.0	18.0	9.0	1.6	20.2	11.2
	May	17.0	11.0	18.0	8.4	1.6	20.1	11.7
	June	17.0	10.0	18.0	7.9	1.5	20.3	12.4
	July	13.7	12.0	16.5	8.3	1.7	20.2	11.9
	August	9.0	10.9	13.0	7.8	1.6	20.1	12.3
	September	7.0	7.8	13.0	7.4	1.6	19.7	12.3
	October	9.1	9.0	13.0	6.9	1.6	19.0	12.2
	November	7.1	9.8	11.0	6.7	1.6	18.7	12.1
	December	5.8	8.3	11.0	6.8	1.6	18.1	11.3
2013	January	5.9	8.1	9.5	6.5	1.6	18.1	11.6
	February	9.3	8.4	9.5	6.3	1.6	17.8	11.6
	March	8.9	9.9	9.5	6.5	1.4	17.8	11.2
	April	7.9	10.4	8.5	6.4	1.4	17.9	11.5

Source: CBK and World bank
**World Bank computations*

Annex 15: Credit to private sector

Year	Month	Total Private Sector Annual Growth Rates	Agriculture	Manufacturing	Trade	Building & Construction	Transport and Communication	Finance And Insurance	Real Estate	Mining & Quarrying	Private Households	Consumer Durables	Business Services	Other Activities
2011	January	21.04	20.75	30.28	33.52	-1.87	-5.54	-8.24	96.24	-11.97	17.02	15.18	34.38	-7.13
	February	23.30	17.36	27.40	29.46	-2.17	2.27	-19.10	93.56	23.23	21.58	17.81	18.10	18.77
	March	25.70	20.78	26.57	28.84	1.08	-3.03	-22.93	95.12	59.53	20.53	16.88	25.34	35.77
	April	27.28	23.98	26.61	22.08	3.89	2.77	-13.97	96.58	53.71	23.55	50.22	21.02	22.74
	May	27.40	21.41	28.41	29.04	15.14	3.85	-6.45	62.99	45.91	22.03	27.25	13.77	49.25
	June	30.71	27.72	30.55	30.62	27.11	13.62	2.43	44.47	56.05	29.29	30.14	13.58	59.84
	July	32.41	35.85	28.52	39.45	38.69	26.15	26.86	47.17	40.04	27.38	33.53	8.99	41.20
	August	32.70	33.14	29.02	37.52	36.48	29.21	25.82	42.36	45.25	33.76	37.55	4.49	43.86
	September	36.27	37.97	38.60	40.08	55.58	28.52	23.79	37.74	46.62	39.97	38.58	4.35	50.07
	October	35.21	28.84	39.61	37.81	53.37	32.63	24.53	35.72	45.59	39.91	35.84	3.41	48.84
	November	32.50	25.35	28.06	34.70	48.49	46.50	26.01	37.49	77.83	34.68	33.61	-0.71	40.36
	December	30.87	27.58	30.28	24.26	55.67	45.27	31.18	38.99	73.29	32.54	26.66	-5.76	47.42
2012	January	28.04	24.73	24.84	27.37	54.17	40.88	14.15	38.34	93.67	24.44	21.34	-15.39	53.72
	February	26.05	21.08	22.21	26.27	65.23	31.14	22.93	39.43	28.27	17.36	19.23	-0.49	40.17
	March	24.01	16.56	30.52	24.00	54.38	36.32	28.40	36.69	18.02	17.40	19.91	-4.97	23.73
	April	22.61	14.54	29.67	27.38	59.37	24.97	19.26	29.02	37.88	15.67	-7.37	-5.74	47.60
	May	21.76	14.29	26.94	25.40	51.81	28.68	17.87	29.66	10.03	13.04	16.29	0.01	25.01
	June	16.14	10.08	23.40	21.37	49.92	10.31	9.97	27.76	1.76	7.00	14.74	-5.07	16.23
	July	13.46	3.59	19.03	10.48	36.74	-2.91	10.71	26.44	3.34	7.72	13.69	-1.33	26.97
	August	11.92	3.93	14.82	7.80	35.22	-2.71	16.22	26.24	-10.44	8.13	12.47	0.53	21.75
	September	7.72	0.73	7.28	3.19	27.80	-4.27	20.25	24.84	-13.71	5.95	7.97	0.89	8.82
	October	7.12	3.65	3.57	2.79	32.48	-2.58	21.93	22.67	-23.96	5.40	4.52	2.23	10.95
	November	9.07	6.68	10.23	4.82	36.98	-10.32	15.43	21.09	-23.80	7.60	6.66	8.21	15.02
	December	10.42	8.06	15.78	10.63	36.17	-13.26	9.26	17.85	-0.88	8.17	9.35	7.51	10.80
2013	January	11.95	13.33	16.93	8.98	33.64	-11.32	29.93	16.85	5.18	7.34	9.78	23.09	10.01
	February	11.47	7.97	15.15	10.14	22.38	-12.87	-2.61	17.29	8.63	13.99	8.30	24.54	10.31
	March	11.18	11.05	12.64	10.22	23.86	-15.32	-9.49	15.79	4.27	10.96	6.65	23.97	19.56
	April	10.43	4.16	11.61	7.62	17.47	-12.12	-2.40	13.89	-17.74	16.53	8.23	28.27	15.40

Source: CBK

Annex 16: Money aggregate

Year	Growth Rates (yoy)	Broad money supply (M2)	Money (M1)	Money (M0)	Reserve Money
2011	January	21.5	24.3	18.0	16.1
	February	20.5	28.0	17.5	19.7
	March	19.4	29.7	18.5	18.0
	April	18.2	24.3	19.0	20.1
	May	16.6	23.3	17.3	7.9
	June	14.5	21.2	17.4	4.8
	July	14.7	19.6	19.2	11.5
	August	15.2	20.4	19.7	14.8
	September	14.3	16.9	18.2	12.5
	October	14.0	19.6	16.2	8.1
	November	13.8	12.4	16.3	9.5
	December	14.1	7.9	11.4	14.5
2012	January	10.6	5.3	13.0	17.2
	February	11.2	5.7	12.5	10.4
	March	11.5	1.4	13.1	23.2
	April	13.0	6.1	8.1	14.7
	May	12.5	1.7	10.6	13.2
	June	13.1	0.6	6.6	16.7
	July	13.9	2.3	3.6	15.6
	August	15.0	4.1	5.7	8.4
	September	14.3	6.3	5.4	9.7
	October	15.8	5.6	3.8	6.7
	November	18.1	9.3	7.7	14.0
	December	17.2	14.1	7.8	15.1
2013	January	18.2	16.0	11.4	12.2
	February	17.0	15.5	17.5	23.9
	March	15.7	17.8	15.9	11.5
	April	18.5	20.0	13.5	9.5

Source: CBK

Annex 17: Mobile payments

Year	Month	Number of agents	Number of customers	Number of transactions	Value of transactions
			(Millions)	(Millions)	(Billions)
2011	January	33968	16.7	28.2	75.4
	February	34572	16.9	28.5	76.3
	March	36198	17.5	32.7	89.0
	April	37309	17.8	32.4	86.1
	May	38485	17.9	35.3	94.4
	June	42840	18.1	35.8	92.6
	July	43577	18.3	38.0	99.7
	August	44762	18.6	39.3	107.4
	September	46234	18.9	39.2	108.6
	October	47874	19.2	40.6	109.1
	November	49091	19.5	41.2	112.3
	December	50471	19.2	41.7	118.1
2012	January	52315	18.8	40.2	114.1
	February	53685	18.8	41.8	116.7
	March	55726	19.2	45.8	126.1
	April	56717	19.5	44.4	117.4
	May	59057	19.7	48.0	128.4
	June	61313	19.8	47.9	124.0
	July	63165	19.6	49.4	129.3
	August	64439	19.4	49.7	131.4
	September	67301	19.7	48.9	130.7
	October	67301	19.7	48.9	130.7
	November	70972	20.0	51.9	137.7
	December	75226	20.3	53.6	139.0
2013	January	76912	21.1	56.0	150.2
	February	85548	21.4	53.4	142.7
	March	88393	21.8	53.5	141.1
	April	93211	22.3	52.4	134.4

Source: CBK

Annex 18: Nairobi stock exchange (20 share index) and the dow jones (New York)

Year	Month		
2011	January	4464.9	11,892
	February	4240.2	12,226
	March	3887.1	12,320
	April	4029.2	12,811
	May	4078.1	12,570
	June	3968.1	12,414
	July	3738.5	12,143
	August	3465.0	11,614
	September	3284.1	10,913
	October	3507.3	11,955
	November	3155.5	12,046
	December	3205.0	12,218
2012	January	3224.9	12,633
	February	3303.8	12,952
	March	3366.9	13,212
	April	3546.7	13,214
	May	3650.9	12,393
	June	3703.9	12,880
	July	3832.4	13,009
	August	3865.8	13,091
	September	3972.0	13,437
	October	4147.3	13,096
	November	4083.5	13,026
	December	4133.0	13,104
2013	January	4416.6	13,861
	February	4518.6	14,054
	March	4,861	14,579
	April	4,765	14,840
	May	5,007	15,116

Source: NSE, and NYSE

Annex 19: Nominal and real exchange rate

Year	Month	NEER 2003=100	REER 2003=100
2011	January	114	74
	February	115	73
	March	119	76
	April	120	74
	May	122	75
	June	127	77
	July	128	77
	August	133	79
	September	135	80
	October	141	82
	November	130	75
	December	119	68
2012	January	119	67
	February	116	66
	March	115	65
	April	115	65
	May	115	65
	June	115	65
	July	114	65
	August	114	66
	September	116	67
	October	117	67
	November	117	67
	December	117.6	66.7
2013	January	118.6	66.4
	February	119.0	66.6
	March	115.7	64.4
	April	113.6	62.8

Source: CBK

Annex 20: Fiscal position

Year	2004/ 2005	2005/ 2006	2006/ 2007	2007/ 2008	2008/ 2009	2009/ 2010	2010/ 2011	2011/ 2012	2012/ 2013*
Revenue and grants	22.7	21.8	22.5	23.3	22.6	25.1	24.6	23.1	29.0
Total Revenue	21.6	20.5	21.6	22.0	21.8	23.9	24.0	22.8	25.3
Tax Revenue	19.76	18.66	19.72	20.20	20.37	21.92	21.86	21.05	23.05
Income Tax	7.00	7.17	7.24	7.99	8.24	8.82	9.28	9.28	10.16
VAT	5.65	5.02	5.58	5.70	5.67	5.97	6.17	5.59	6.13
Import Duty	1.75	1.35	1.60	1.68	1.62	1.68	1.65	1.58	1.78
Excise Duty	3.28	3.31	3.27	3.15	3.12	3.04	2.89	2.4	2.43
Other Revenues	2.08	1.81	2.03	1.68	1.72	2.41	1.87	1.96	2.54
Appropriation-in-aid	1.79	1.83	1.92	1.82	1.43	1.93	2.09	1.75	2.25
Grants	1.1	1.3	0.9	1.3	0.8	1.3	0.7	0.5	1.5
Expenditure and Net Lending	**22.56**	**25.20**	**24.33**	**27.25**	**26.62**	**29.50**	**29.13**	**28.89**	**33.46**
Recurrent	19.01	20.18	17.80	20.55	19.46	20.77	21.25	19.72	21.26
Wages and Salaries	7.85	7.39	7.38	7.44	6.94	7.02	7.12	6.84	6.92
Interest Payments	2.27	2.72	2.47	2.44	2.33	2.58	2.73	2.78	2.8
Development and Net lending	3.39	4.46	4.66	6.70	7.16	8.73	7.87	9.16	12.07
Deficit (commitment Basis)									
Excluding grants	-1.01	-4.71	-2.70	-5.23	-4.82	-5.65	-5.18	-6.08	-8.17
Including grants	0.10	-3.39	-1.78	-3.93	-4.01	-4.38	-4.50	-5.62	-6.68
Financing	-0.54	2.40	2.10	-0.39	5.23	7.09	4.26	5.23	6.64
Foreign	-0.05	0.08	-0.14	0.32	1.84	0.93	1.02	3	3.82
Domestic Borrowing	-0.50	2.32	2.24	-0.71	3.39	6.16	3.24	2.23	2.83
Public Debt to GDP (Net)	`		**42.6**	**39.5**	**42.2**	**44.9**	**48.3**	**44.6**	**44.6**
External Debt			23.3	22.6	24.2	23.2	25.9	23.4	21.7
Domestic Debt			23.5	21.9	23.3	26.9	27.4	26.0	26.0

Source: Ministry of Finance. Quarterly Economic and Budgetary Review,May 2013
**As at the end of March 2013*

Annex 21: 12-Months Cumulative Balance of Payments In millions of US dollars

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013*
1. Current Account	-492	-595	-293	145	-133	-253	-511	-1034	-1973	-1671	-2512	-3330	-4530	-4426
Balance Of Trade	-1279	-1273	-828	-636	-1007	-1397	-2226	-2996	-4260	-3892	-4642	-6440	-6893	-6847
2. Merchandise Account	-1558	-1614	-1195	-1364	-1906	-2488	-3817	-4936	-6444	-5768	-7169	-9007	-10163	-10367
2.1 Exports (Fob)	1782	1891	2162	2426	2726	3462	3516	4132	5048	4528	5225	5807	6127	6120
Coffee	154	94	84	81	89	128	138	166	155	201	209	222	269	240
Tea	463	435	437	435	456	561	656	693	924	892	1159	1153	1199	1233
Horticulture	209	241	258	351	416	433	509	607	763	692	725	678	695	723
Manufactured Goods	162	175	194	218	292	350	422	513	625	526	608	729	700	675
Other	793	947	1190	1342	1473	1990	1792	2153	2580	2216	2525	3026	3264	3249
2.2 Imports (Cif)	3339	3504	3357	3790	4632	5950	7333	9069	11492	10296	12395	14814	16290	16486
Oil	850	721	607	879	1119	1341	1745	1919	3051	2192	2673	4081	4081	4044
Chemicals	431	479	508	591	746	833	1004	1156	1446	1324	1603	1947	2076	2066
Manufactured Goods	361	437	421	497	687	779	1065	1435	1589	1411	1774	2250	2302	2430
Machinery & Transport Equipment	944	1162	1060	969	1119	1783	2252	2800	3063	3065	3808	3686	4748	4957
Other	753	705	760	854	961	1214	1267	1759	2343	2304	2537	2848	3083	2990
3. Services	1065	1019	902	1509	1773	2234	3306	3902	4470	4097	4657	5676	5633	5941
3.1 Non-Factor Services	279	341	367	728	898	1091	1591	1940	2184	1876	2527	2566	3270	3520
3.2 Income Account	-133	-123	-143	-88	-127	-109	-70	-143	-45	-38	-158	7	-141	-165
3.3 Current Transfers Account	920	801	678	869	1001	1253	1785	2106	2331	2259	2288	3103	2504	2586
of Which Remittances						382	408	574	611	609	642	891	1170	1180
4. Capital & Financial Account	710	967	351	219	250	560	1186	1888	1505	2451	2675	3288	5757	5068
4.1 Capital Account	63	69	81	163	145	188	211	267	294	290	154	235	155	148
4.2 Financial Account	647	898	270	56	105	372	975	1621	1210	2161	2522	3053	5601	4920
4.2.1.1 Official, Medium- & Long-Term				-170	-284	-44	-229	-195	-216	-202	-16	106	466	308
4.2.1.2 Private, Medium- & Long-Term	96	307	257	84	-20	458	38	592	72	44	176	35	-73	-103
4.2.1.2.3 Direct Investment (Fdi)	143	-18	-42	55	-7	-55	-11	438	153	127	106	107	109	110
4.2.1.3 Commercial Banks (Net)	-221	95	-172	104	-122	-202	-156	-5	15	494	61	-213	873	79

Annex 21: 12-Months Cumulative Balance of Payments In millions of US dollars

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013*
4.2.2 Short Term And Net Errors & Omissions (Neo)	942	780	229	97	442	332	1296	1050	1017	1158	1977	2891	3654	3699
Short Term (Incl. Portfolio Flows)	379	396	348	423	443	568	714	1032	995	577	1130	1678	2454	2531
Net Errors And Omissions (Neo)	562	384	-119	-326	-1	-236	582	18	22	581	847	1213	1200	1168
5. Overall Balance	217	372	59	365	117	306	675	854	-469	781	163	-43	1227	642
Memo:														
Gross Reserves	1398	1459	1614	1887	2078	2534	3331	4557	4641	5064	5123	6045	7160	7114
Official	897	1064	1067	1480	1519	1799	2415	3355	2875	3847	4002	4248	5702	5523
Commercial Banks	501	395	547	408	560	735	916	1202	1765	1217	1121	1797	1458	1591
Imports Cover (Calender Year)	2.7	3.0	3.2	4.2	3.4	3.2	3.55	4.00	2.75	4.08	3.55	3.12	3.87	3.69
Import Cover (36 Mths Imports)			3.3	4.4	4.1	3.98	3.89	4.84	3.36	4.08	3.85	3.71	4.31	4.06

Source: CBK
** cumulative 12 months to April 2013*

Annex 22: Growth Outlook

	2012	2013*	2014*	2015*
BASELINE				
GDP	4.6	5.7	5.9	5.5
Private Consumption	2.7	2.9	3.1	2.8
Government Consumption	8.0	4.6	3.7	3.0
Gross Fixed Investment	20.5	12.1	15.0	13.2
Exports, GNFS	5.0	5.4	6.4	6.7
Imports, GNFS	13.0	5.8	8.0	7.7
Output Gap (Percent of Potential GDP)	-0.2	0.6	1.3	1.8
HIGH CASE SCENARIO				
GDP	4.6	6.1	6.7	6.5
Private Consumption	2.7	3.1	3.1	3.1
Government Consumption	8.0	4.6	3.7	3.0
Gross Fixed Investment	20.5	15.0	19.0	18.0
Exports, GNFS	5.0	5.4	6.4	6.7
Imports, GNFS	13.0	7.0	9.0	9.5
Output Gap (Percent of Potential GDP)	-0.2	0.8	2.1	3.1
LOW CASE SCENARIO				
GDP	4.6	4.4	4.4	4.6
Private Consumption	2.7	2.6	2.6	2.7
Government Consumption	8.0	4.6	3.7	3.0
Gross Fixed Investment				20.5
Exports, GNFS	5.0	5.4	6.4	6.7
Imports, GNFS	13.0	5.0	6.0	6.5
Output Gap (Percent of Potential GDP)	-0.2	-0.5	-0.7	-0.5

Source: World Bank Computation

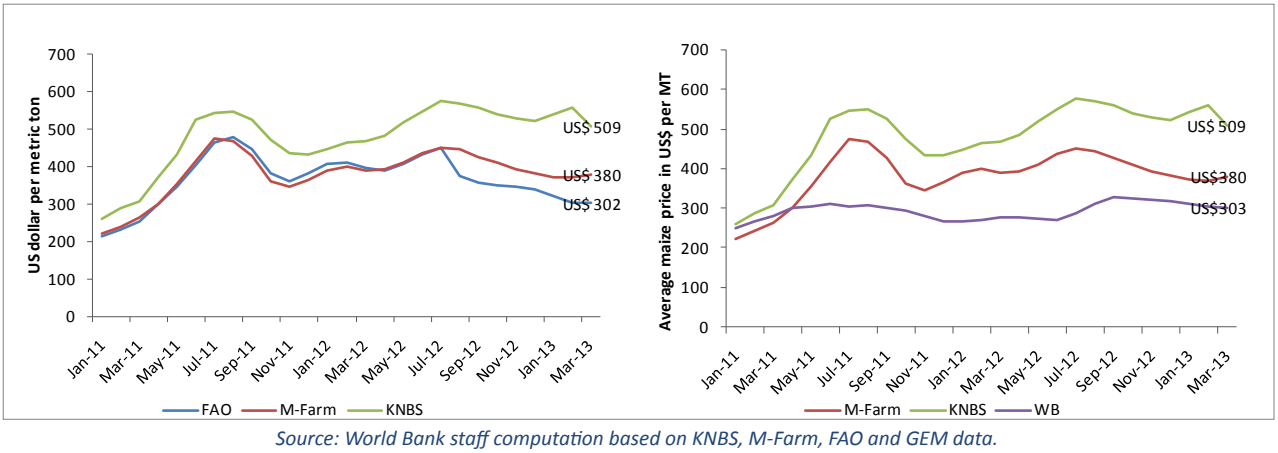
Annex 23: Maize prices in Kenya

Maize is very important in daily Kenyan meal with a per capita consumption level of 77.2 kg per year[1] and at the same time taking a large proportion of lower income groups'expenditure. Increased maize prices would be therefore transmitted to food inflation; affect food security and therefore leading to escalated poverty levels and widened income inequalities. Kenya's prices for maize have been trending above global maize prices, triggered by several factors including the hike of global food prices, and more importantly bad climatic conditions that affected domestic production which accounts for74 per cent of maize domestic supply.[2] However a major challenge would be how high these prices are.

Existing data sources showed irregularities in maize price levels, despite the fact that they all had the same trends. KNBS, FAO and M-Farm maize prices data are compared in Figure 1 below. KNBS prices are monthly retail prices collectedin different markets across the country. FAO and M-Farm's; which are both non-governmental bodies; are at a wholesale basis from major towns of the country including Nakuru, Busia, Nairobi, Mombasa, Kisumu, Eldoret and Kitale. Contrarily to other sources, M-Farm daily data offers an advantage of getting a better estimate of monthly average; and also reduces the probability of having data gaps. For comparison, prices from all sources were normalized to US dollar per metric ton and weighted with counties population shares to reach an overall average. A three months moving average was used to overcome the problem of missing values. All data sources displayed high price in July which shrank in September before picking up again in January. This trend is attributed to maize planting and harvesting seasons.

To some extent these inconsistencies arise as a result of different methodologies used in data collection and distribution costs across markets. FAO and M-Farm maize pricesboth being at a wholesale level are close at an average deviation of US$ 17 per MT for the period since January 2011. However, data gaps are wide between M-Farm and KNBS. The average deviation of M-Farm from KNBS price levels was US$ 80 per MT in Kisumu, US$ 87 in Mombasa, US$ 103 in Nairobi and US$ 118 in Eldoret for the same period. Retail prices of KNBS may reflect distribution cost, profits, and the gap became much higher in 2012 compared to the year 2011.

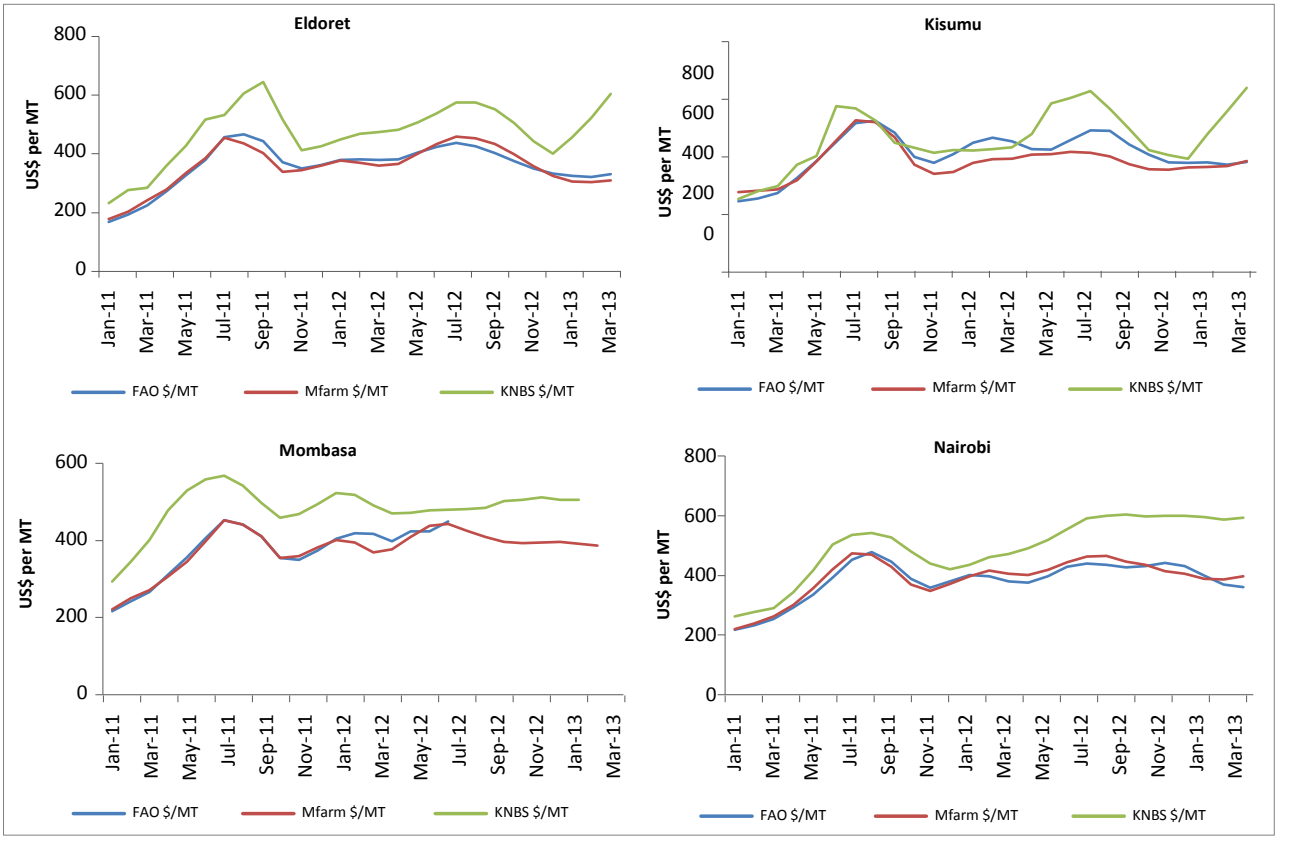
There are wide maize price disparities across data sources, and all lie above global maize prices.



Source: World Bank staff computation based on KNBS, M-Farm, FAO and GEM data.

[1] *FAO Statistics (values for the year 2009) from www.fao.org*
[2] *According to FAO in 2009: total production was 2.4 million MT while supply was 3.2 million MT.*

… with data inconsistencies at a lower level in Kisumu



Source: Computation based on KNBS, M-Farm and FAO data

For the three sources of data, maize is relatively cheaper in Eldoret and Kisumu which are among the largest maize surplus markets compared to Mombasa and Nairobi.

Whereas quality data plays a vital role in offering accurate information which may further be used for analysis and forecasting; where data is wrong or does not exist at all, it would be hard for policy makers not only to provide and predict good development paths but also to evaluate their existing policies' implications.

Domestic maize prices also increased over time due to Kenya National Cereal and Produce Board (NCPB) inefficiency in its intervention in maize market to fix prices for both sale and purchases. Government initiative through NCPB to promote free and fair trade in commodities and their timely accessibility putpressure on maize prices both at wholesale and retail levels. Not only have NCPB purchase prices been above those in other domestic markets but also its sellers have been mainly large-scale farmers.[3]

[3] *Ariga, J et al, 2010. Staple Food Policies in Kenya, a Paper Prepared for the COMESA policy seminar on Variation in Staple Food Prices: Causes, Consequence, and Policy Options. The Comesa-MSU-IFPRI African Agricultural Marketing Project (AAMP). Maputo, Mozambique, 25-26 January 2010.*

Annex 24: Methods

National Accounts based predictions of poverty

The general approach models the trajectory of consumption per capita obtained from household surveys using observed growth rates in GDP per capita from national accounts (Datt, Ramadas, Mensbrugghe, Walker, & Wodon, 2002). The model can accommodate different GDP and population growth rates for specific regions and economic sectors and different scenarios of how the distribution of consumption (inequality) changes over time. In this application, per adult equivalent household consumption is projected both forwards and backwards from the 2005 KIHBS to produce yearly poverty estimates (using the 2005 absolute poverty line) between 1991 and 2011 (Demombynes & Hoogeveen, 2007). The model relies on data from three sources: household consumption from KIHBS, GDP data from national accounts and employment data from the census (Table below).

The base projection calculates per adult equivalent consumption recursively:

Forward projection from 2005 to 2011:

$$c_{i,t} = c_{i,t-1}(1 + g_t^{Si} - n_t^{Si})$$

Backward projection from 2005 to 1991:

$$c_{i,t-1} = \frac{c_{i,t}}{(1 + g_t^{Si} - n_t^{Si})}$$

The survey weights are adjusted similarly to reflect year by year population changes:

Forward projection from 2005 to 2011:

$$w_{i,t} = w_{i,t-1}(1 + n_t^{Si})$$

Backward projection from 2005 to 1991:

$$w_{i,t-1} = \frac{w_{i,t}}{(1 + n_t^{Si})}$$

The assumption of distribution-neutral growth can be relaxed by adjusting consumption for each household within each sector year-by-year:

$$c_{i,t}^{ADJ} = c_{i,t} - \Delta G_t^S(c^{Si} - c_{i,t})$$

Consumption model parameters

Model Parameters	Detail	Data Source and Notes
$c_{i,t}$	Per adult equivalent consumption for samplehousehold i in year t.	2005/06 KIHBS.
$w_{i,t}$	Individual weight for i household in year t.	2005/06 KIHBS.
$s_{i,t}$	Sector of household i in survey year (2005)	2005/06 KIHBS, based on primary occupation of household head.
g_t^{Si}	Real GDP growth rate for sector S of household in year t.	WDI/Kenya National Accounts.
n_t^{Si}	Employment growth rate for sector S of household i in year t.	World Development Indicators: To obtain sector-specific population growth rates, the overall employment: population ratio was used in combination with the share of total employment by sector of occupation obtained from the Census and 2005/06 KIHBS. The average growth rate between known data points was used.
ΔG_t^S	Gini coefficient growth rate in sector S in year t.	

This adjustment is applied after the base projection is completed. If inequality has increased, this procedure redistributes consumption from households with consumption levels below the average for their sector of employment to households above the average for their sector of employment. Note that in a scenario where growth is distribution neutral, the change in the Gini coefficient is zero and no adjustment is made to consumption. The core assumption of this model is the correspondence between growth in consumption per capita measured in the household survey and growth in income per capita measured through national accounts.

Household asset based predictions of poverty

Only a brief exposition of the procedure is outlined here as comprehensive and detailed explanations are provided elsewhere (Christiaensen, Lanjouw, Luoto, & Stifel, 2011; Elbers, Lanjouw, & Lanjouw, 2002). The poverty head count estimate (or any other welfare measure based on consumption) is defined as a function of consumption c_{cht} (for household h, in cluster c at time t) (in this case t = 2005) as $P_t(c_{cht})$. To obtain a definition of consumption that can be applied to predict consumption at any future $(t+n)$or past $(t-n)$ point in time, an estimator of log-linear consumption at time t is defined as follows:

$$lnc_{cht} = x_{cht}^{'}\beta_t + u_{cht}$$

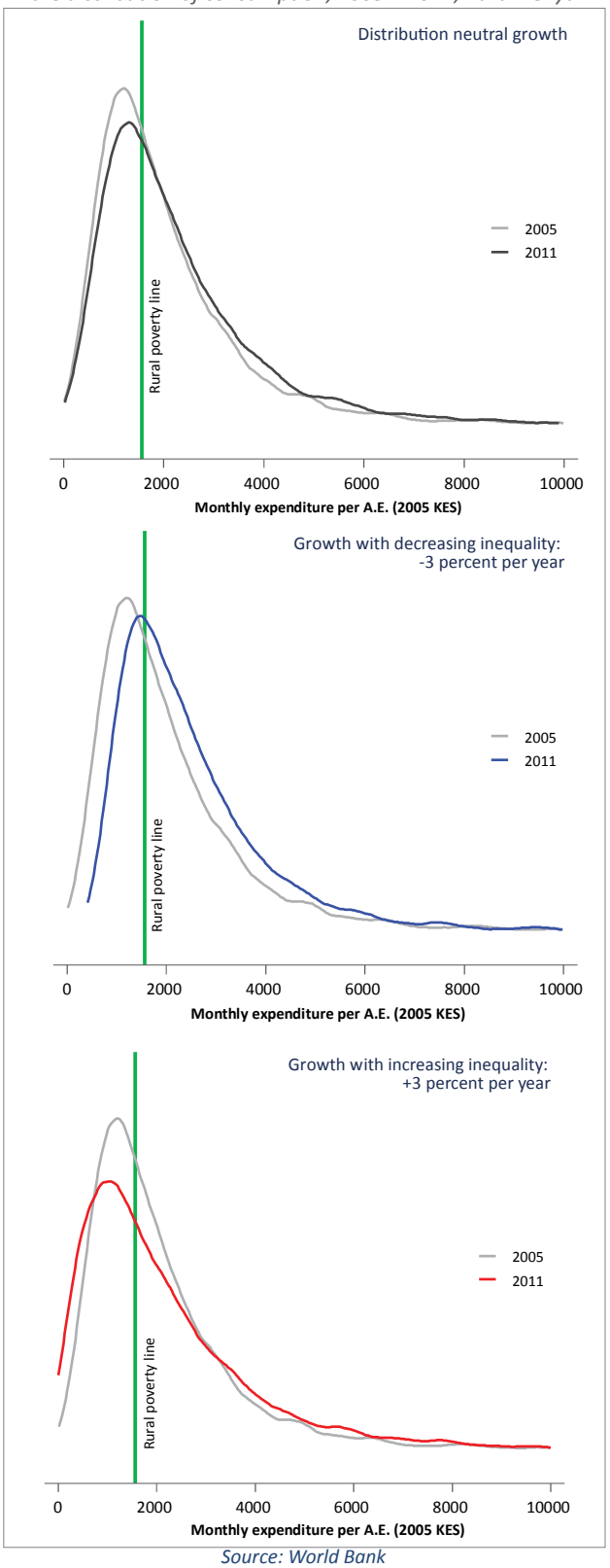
where $x_{cht}^{'}$ are the p consumption predictors that are available at the household level both at time t and $t+n$ *or* $t-n$, β_t is a vector of p parameters and u_{cht} is a heteroskedastic error term that is made up of a cluster component (n_{ct}) and a household component (ϵ_{cht}) as follows $u_{cht} = n_{ct} + \epsilon_{cht}$. To obtain the variance-covariance matrix of (1) a GLS regression model is used (as the error term is not independent and identically distributed). The procedure estimates both the variation of n_{ct} (which captures the correlation between consumption in groups of households that are spatially proximate) and the variance ofϵ_{cht}.

Since at time $t+n$ only $x_{ch,t+n}^{'}$ is observed and not consumption $c_{ch,t+n}$, the error term $u_{ch,t+n}$is also unknown and the expected value of poverty P_{t+n} is estimated given the observed $x_{ch,t+n}^{'}$ and the estimated model parameters of (1) so that $E[P_{t+n}(x_{ch,t+n}^{'}, \widehat{\beta_{t+n}}, \widehat{u_{ch,t+n}})]$. This expectation is computed through simulation by taking draws from the estimated distributions of $\beta_t$and u_{cht}. Note the core assumption is that $\widehat{\beta_{t+n}} = \hat{\beta}_t$ (the distributions of β_t remain constant over time) and the relationship determining the hetorskedastic nature of the data generating process is also assumed to be constant.

The adapted SAE technique relies on the strong assumption that the parameter estimates that define consumption are stable over time.

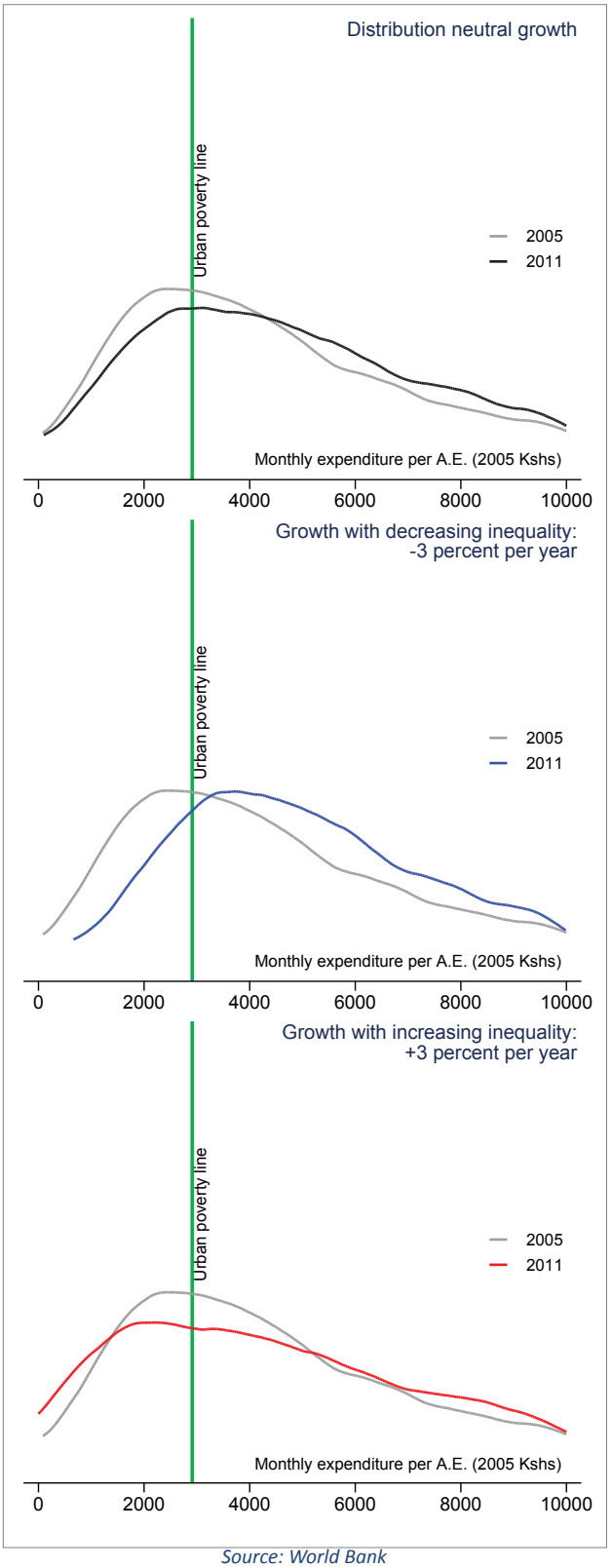
Annex 25: Illustrations of distributional impact of inequality on the distribution of consumption

The effect of growth and 3 different scenarios of inequality on the distribution of consumption, 2005 – 2011, Rural Kenya



Source: World Bank

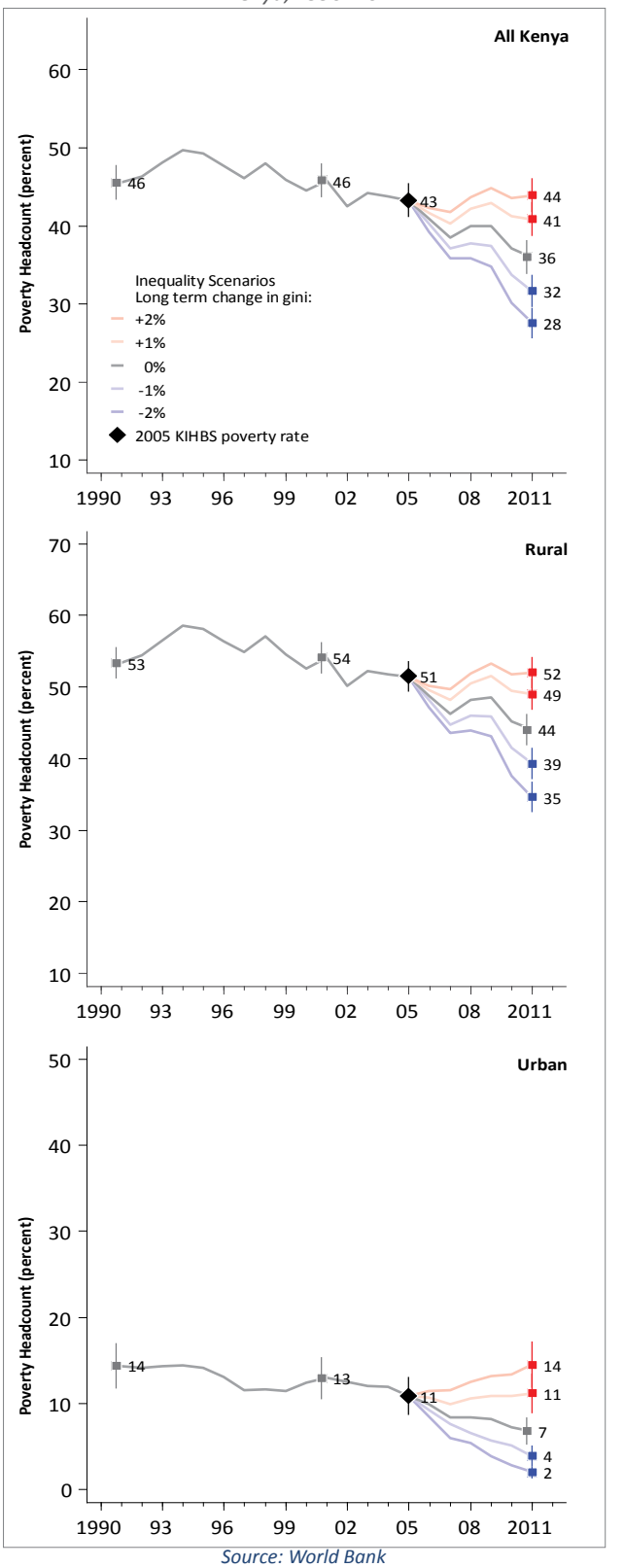
The effect of growth and 3 different scenarios of inequality on the distribution of consumption, 2005 – 2011, Urban Kenya



Source: World Bank

Annex 26. National accounts based predictions of poverty using $1.25 dollar per day poverty line

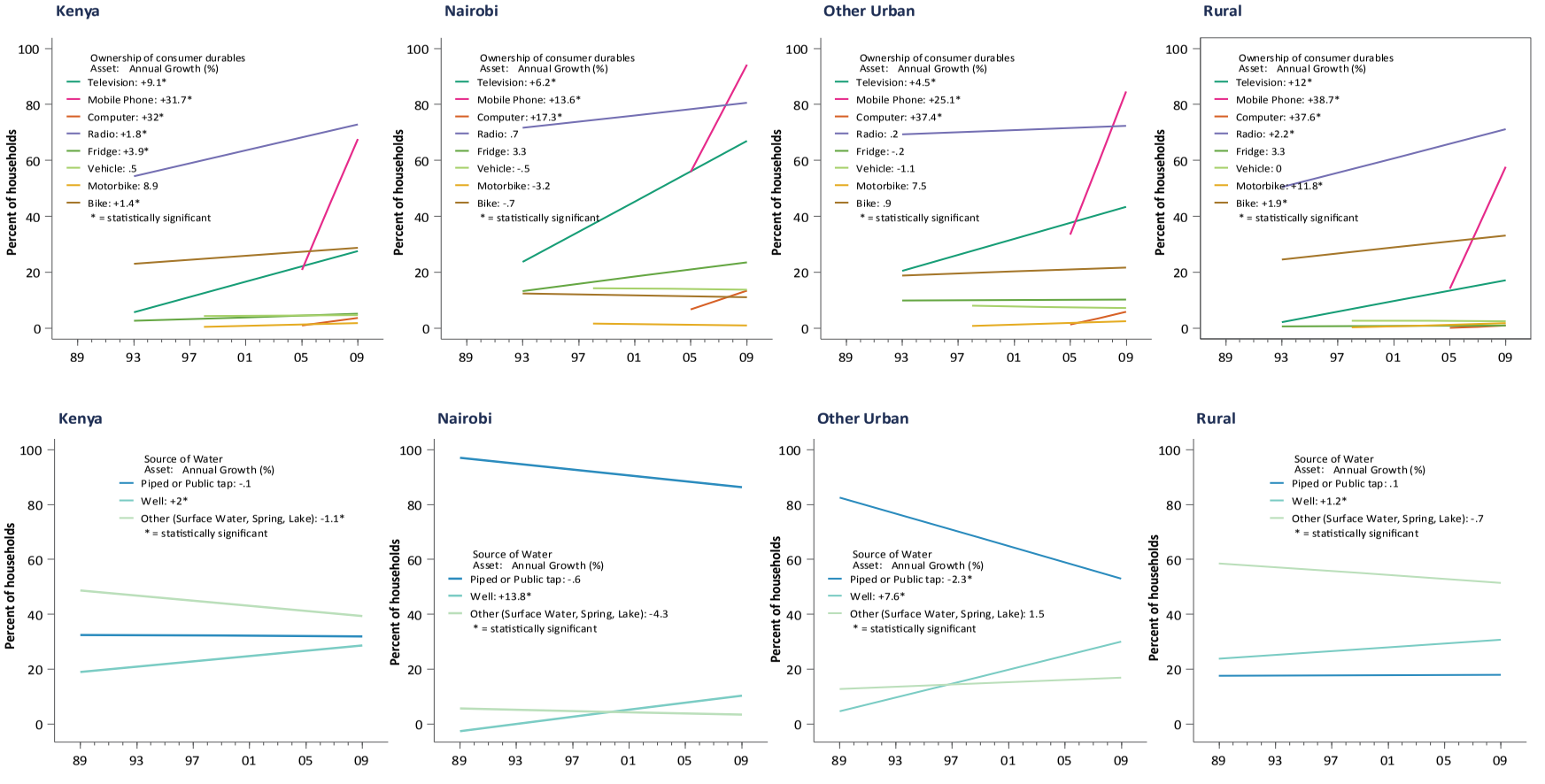
National accounts based projections of headcount poverty in Kenya, 1990- 2011

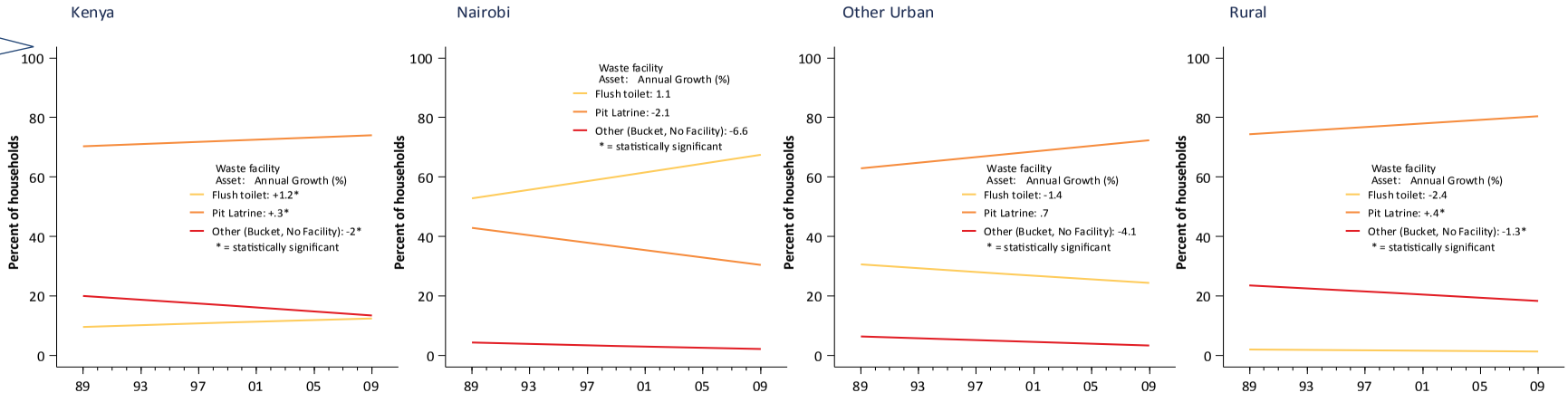


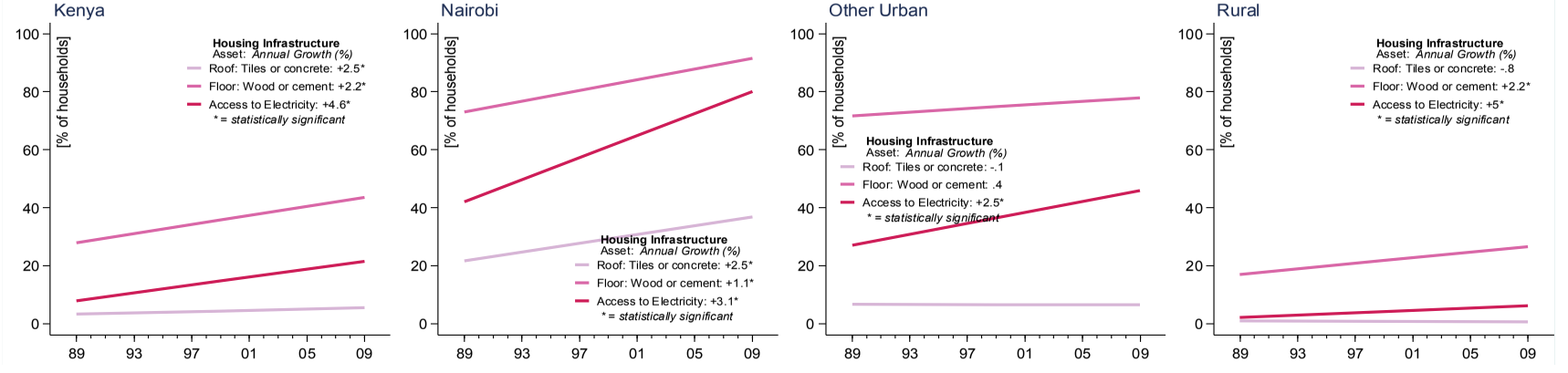
Source: World Bank

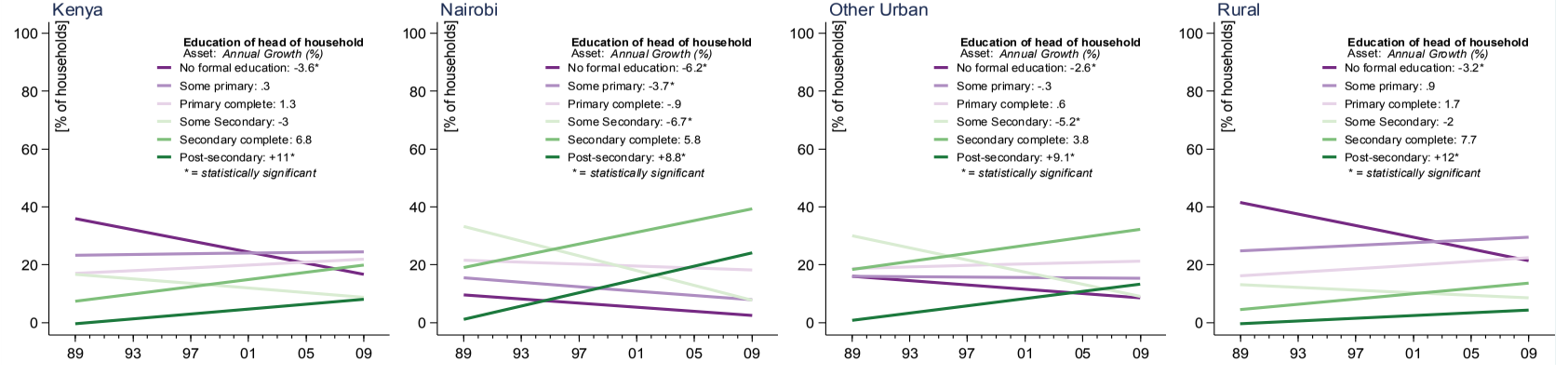
Annex 27. Trends in household living standard indicators between 1989 & 2009

Figure A.1 Average trajectory of indicators ofhousehold living standards, 1989-2009









Source: World Bank

Time to shift gears

Accelerating growth and poverty reduction in the new Kenya

Kenya entered 2013 on a strong economic footing, and after peaceful elections and transition, growth is projected to rise to 5.7 percent at the end of the year, and 6 percent in 2014, supported by lower interest rates and higher investment growth.

This report focuses on poverty reduction in the new Kenya, citing the progress made since 2005, when an estimated 47 percent of the population lived below the poverty line, to the present, where poverty estimates range between 34 and 42 percent, the imprecision resulting from the lack of any recent survey data. The report notes the spatial dimension of poverty, and the poor tend in the arid and semi-arid regions in the north and north east. It concludes with thoughts about a poverty reduction strategy, which would emphasize on job creation, enhanced productivity of smallholder farms, strengthening and expanding cash transfer programs, targeted public spending programs to provide quality education to the rural poor, and improved poverty monitoring, so that the government can rapidly see which activities have the greatest impacts on improving the lives of the poor.

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WHAT CAN GOVERNMENT DO TO REDUCE POVERTY IN KENYA?

Text message your answers to:
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