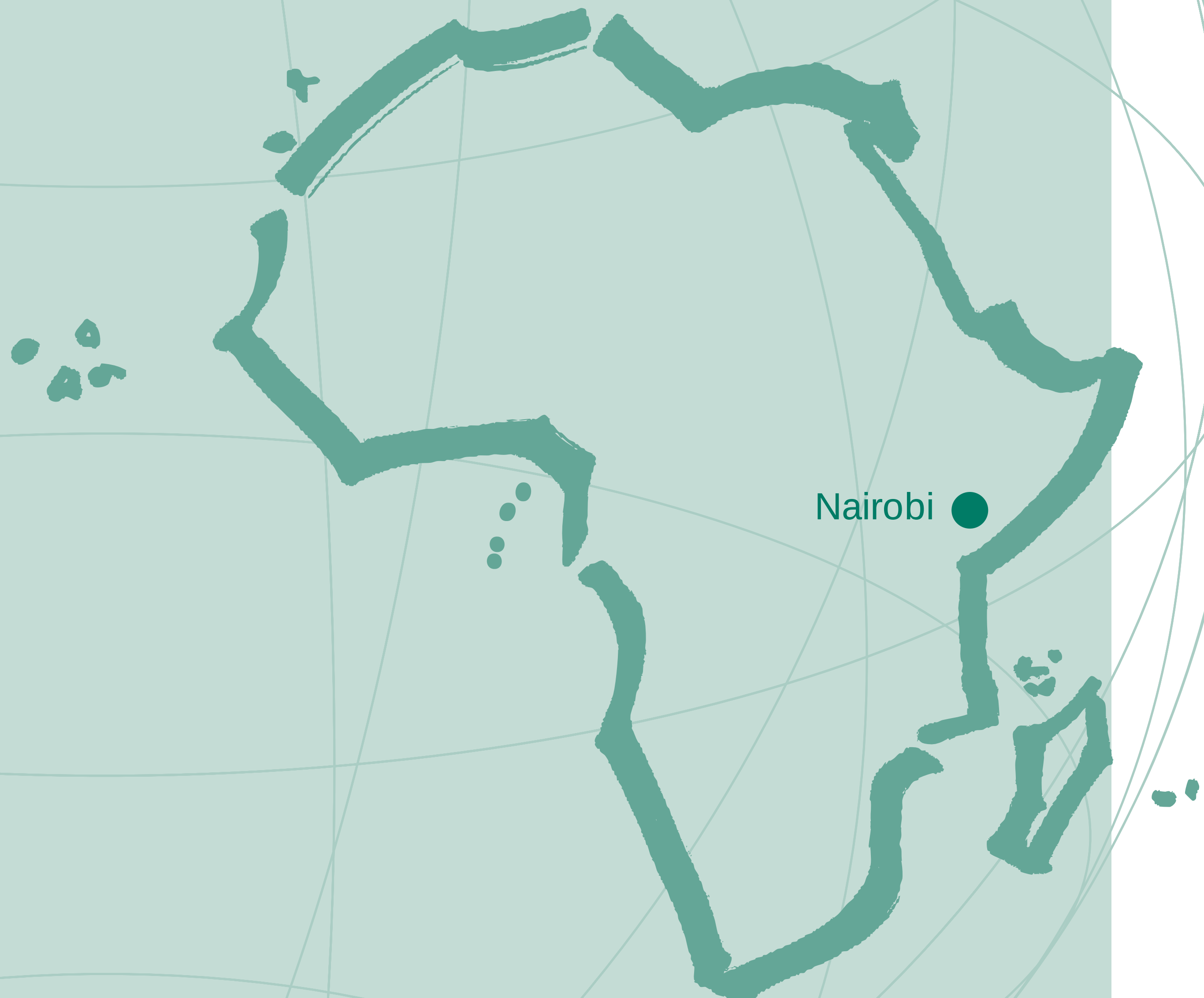
Kenya



key figures

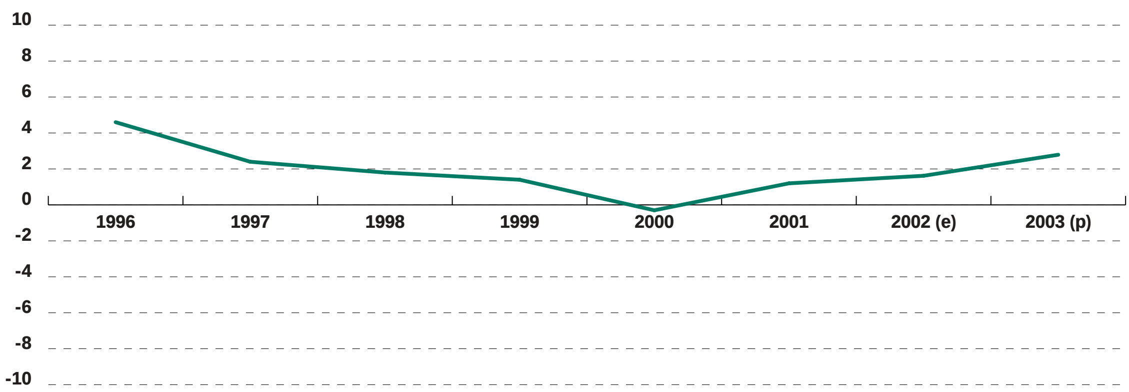
• Land area, thousands of km^2	580
• Population, thousands (2001)	31 293
• GDP per capita, $ (2001)	364
• Life expectancy (2000-2005)	49.3
• Illiteracy rate (2001)	16.6

Kenya

THE KENYAN ECONOMY RESUMED positive growth in 2001, with real GDP growth of 1.2 per cent from the negative 0.2 per cent recorded the previous year. The outlook is for Kenya to maintain positive but subdued growth, estimated at 1.6 per cent in 2002 and projected to rise to 2.8 per cent in 2003. The resumption of positive growth in 2001, however, did not reverse the five successive years of decline in income per head. Kenya's recent poor economic performance has aggravated the unemployment and poverty situations in the country, with growth in wage employment decelerating between 1998 and 2001, the first downturn since independence. The percentage of Kenyans living below the poverty line has also increased since 1997. Kenya's resumption of positive growth in 2001 was accompanied by a sharp deterioration in the government's budgetary position following increased government expenditure amidst poor domestic revenue performance that was exacerbated by the continuing withholding of international assistance due to governance related problems. The budgetary position is expected to continue to worsen in 2002 and 2003, with increased expenditure amidst stagnation in revenue. In line with the Poverty Reduction Strategy Paper (PRSP) commitments, government expenditure currently underpins core poverty alleviation programmes and makes enhanced budgetary allocations to the programmes. Kenya's monetary authorities continued in 2001, for the fifth consecutive year, to achieve success in maintaining stability of domestic prices. Inflation fell from 6.2 per cent in 2000 to 0.8 per cent in 2001 and is estimated to remain low in 2002 and 2003. In 2001, nominal interest rates were on a downward trend and given the low rate of inflation, all real interest rates were positive. Kenya's external sector worsened in 2001 as the major export commodities suffered a decline in international prices. The outlook on the external position is further deterioration in the trade accounts as imports continue to rise whilst exports stagnate. However, owing to lack of new lending the stock of external debt continued on a downward trend in 2001. Kenya continues to undertake structural reforms to diversify the economy. Since 1991 the country has pursued a privatisation programme and by June 2002, the governments had divested 174 enterprises out of a total 207. The government's commitment to

The resumption of positive growth in Kenya has not reversed the years of decline in income per capita.

Figure 1 - Real GDP Growth



Source: Authors' estimates and predictions based on IMF and domestic authorities' data.

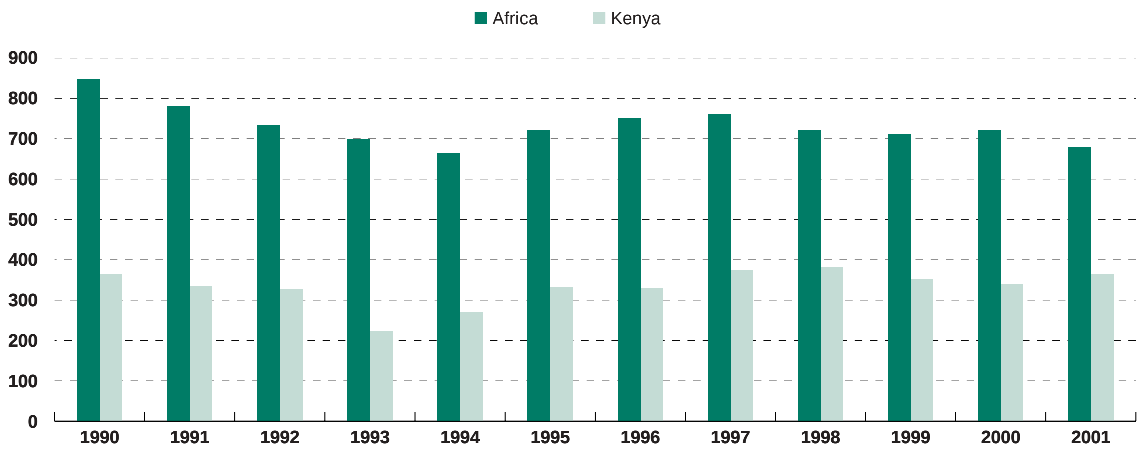
privatisation and the pace of the process remain an issue of contention with some international aid donors. Kenya's political environment was under considerable strain as the country moved towards elections in December 2002. Bitter struggles ensued for the succession to the presidency, which proved a test for the country's democratic system. Kenya's democracy deepened with the December 2002 elections as the opposition won a sweeping victory to usher in Mr Mwai Kibaki as the new president.

Recent Economic Developments

The Kenyan economy resumed positive growth in 2001 in the face of considerable adversity. Real GDP growth is estimated at 1.2 per cent in 2001 compared with a negative 0.2 per cent the previous year, and a yearly average of 2.8 per cent during the 1995-1999 period. The economy's resilience and dynamism in 2001 was demonstrated by the fact that the marginal economic upturn occurred at a time of a virtual freeze on aid flows, on which the 2001 budget had depended; there were poor commodity prices; the country suffered a decline in both savings and credit, and there was political uncertainty about pending presidential and parliamentary elections that continued to dampen investor confidence. At the same time, the marginal economic upturn in 2001 did not reverse the continual decline in income per head in Kenya, which had continued for five successive years.

The increase in total output in 2001 was driven by improved agricultural production. The economy also

Figure 2 - GDP Per Capita in Kenya and in Africa (current $)



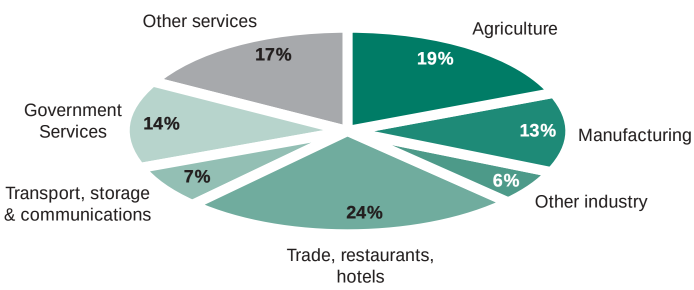
Source: Authors' estimates based on IMF data.

benefited from prudent macroeconomic policies that created subdued inflation and stable foreign exchanges and, to some extent, inspired a degree of certainty and confidence in a time of crisis. Agriculture accounted for 19 per cent of GDP and employed about three-quarters of the active population. Following the severe drought in 2000, improved weather conditions in 2001 contributed to significant expansion of agricultural output. The sector grew by 1.2 per cent in 2001 compared the decline of 2.1 per cent in 2000. The expansion in 2001 was experienced across all the sub-sectors. In the food crop sub-sector, maize output rose from 25 million bags in 2000 to 30 million bags in 2001. The production of wheat improved significantly from 70 500 tonnes in 2000 to 131 800 tonnes in 2001. Sugarcane production, however, declined by about 10 per cent from 3.90 million tonnes in 2000 to 3.5 million tonnes as a result of a host of factors including competition from cheap imports, and the long spell of dry weather during 1999-2000. Cash crop production also increased with gains in tea and cotton, while the output of coffee fell. The favourable weather conditions in 2001 coupled with improved crop husbandry contributed to the output of tea increasing by 24.7 per cent from 236 300 tonnes in 2000 to 294 600 tonnes in 2001. The cotton sub-sector was revived in 2001. The ginneries intake of cotton increased from 508 tonnes in 2000 to 535 tonnes in 2001. On the other hand, coffee output dropped to 51 700 tonnes in the 2000/01 crop year from 100 700 tonnes in the previous crop year. Coffee production continued to suffer from the low global price, which had caused the domestic producer price to tumble from KShs.25 718 per 100 kg in 1998 to KShs.11 776.05 in 2001. Other factors that contributed to the declining coffee output were the administrative problems within the domestic coffee co-operatives, low input application due to high input prices, and uncertainties surrounding current reforms in the sub-sector. Since the beginning of 2002, Kenya has been experiencing good rains, which is expected to boost agricultural production. In particular, tea production is expected to improve as well as the prices as relative stability returns to Afghanistan, the major consumer of Kenyan tea.

The Manufacturing sector contributed about 13 per cent of GDP and expanded by 0.8 per cent in 2001, compared with negative 1.4 per cent in 2000. Manufacturing was particularly boosted in 2001 by growth especially in textile production at the export processing zones (EPZs), where total sales grew by 48 per cent in the year, benefiting from the African Growth and Opportunity Act (AGOA) initiative. The improved performance of the manufacturing sector in 2001 was largely as a result of a cessation of power rationing and improved agricultural production. Agro-based industries performed well with higher production levels of processed foods. Other industries that achieved expanded output include wood and cork and basic industrial chemical products; the production of household and other chemicals, plastic products and electrical machinery was higher in 2001. These manufactures gained from expanded market outlet through the AGOA, Common Market for Eastern and Southern Africa (COMESA) and East African Community (EAC) arrangements. Kenya's manufacturing, however, continued to be hampered by the poor state of the country's infrastructure, high electricity tariffs, high interest rates, low consumer demand and lack of competitiveness. In view of the challenges facing the sector, especially competition from COMESA products, the 2002/03 budget has proposed a reduction of taxes on all raw materials and capital goods that are currently taxed at 3 per cent and 5 per cent to zero per cent in order to lower the cost of production and enhance Kenya's competitiveness in the region.

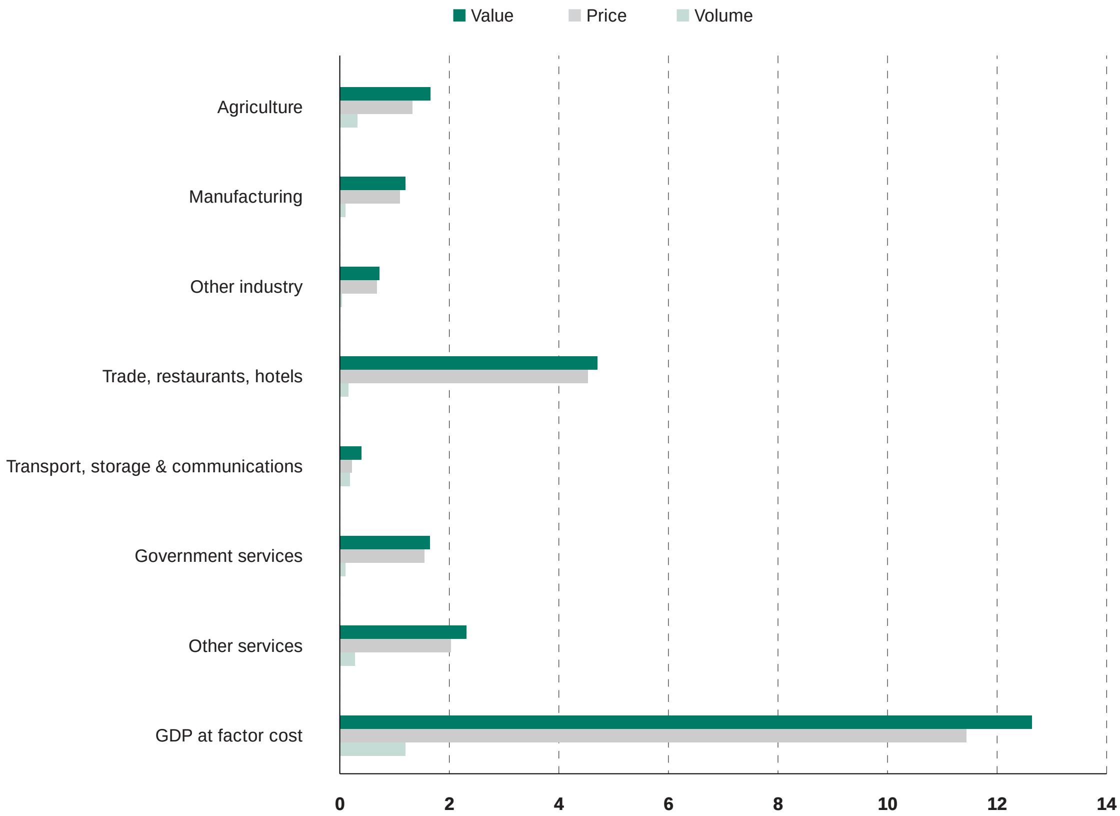
In the services sector, the transport, storage and communication sub-sector increased significantly with air transport, road transport and communications achieving significant expansion. Kenya's air transport industry expanded by 23.9 per cent in 2001 in spite of the uncertainties created by the 11 September events. Telecommunications continued to gain from the liberalisation of the sector. Telephone connections rose by 5.7 per cent from 304 000 in 2000 to 321 000 in 2001, with the cellular telephone services, internet services and cyber cafes, also expanding. Also, trade, restaurant and hotels activities achieved a modest growth of 1.3 per cent in 2001 from 1 per cent the previous year. Tourism registered increased earnings of 12.5 per

Figure 3 - GDP by Sector in 2001



Source: Authors' estimates based on IMF and domestic authorities' data.

Figure 4 - Sectoral Contribution to GDP Growth, 2001



Source: Authors' estimates based on IMF and domestic authorities' data.

cent in 2001 despite the significantly adverse effect of the 11 September attacks on the United States, which resulted in reduced numbers. Prior to the attacks, Kenyan tourist revenues were catching up, rising rapidly in the aftermath of the US embassy bombing in 1998. The effect of the 11 September attacks was experienced in reduced numbers as the 730 000 tourists that arrived in Kenya in 2001 represented a level far lower than experienced historically. The tourist industry faces an uncertain future following the terrorist attacks in Mombassa in November 2002. The attacks could not have happened at a worse time as the industry was beginning to pick up after the earlier attacks. Government services also rose significantly in 2001 by

Table 1 - Demand Composition (percentage of GDP)

	1995	1999	2000	2001	2002 (e)	2003 (p)
Gross capital formation	**21.8**	**16.2**	**15.4**	**14.5**	**14.7**	**14.8**
Public	4.3	5.5	5.5	5.0	5.2	5.2
Private	17.5	10.6	9.8	9.4	9.5	9.6
Consumption	**84.1**	**89.6**	**94.1**	**94.5**	**95.3**	**96.4**
Public	14.8	17.0	17.5	16.8	16.8	16.9
Private	69.3	72.6	76.6	77.7	78.5	79.5
External sector	**-5.9**	**-5.8**	**-9.5**	**-9.0**	**-10.0**	**-11.3**
Exports	32.8	25.5	26.6	26.2	26.1	25.8
Imports	-38.7	-31.3	-36.1	-35.1	-36.1	-37.1

Source: Authors' estimates and predictions based on domestic authorities' data.

11.9 per cent from 7 per cent in 2000, due in part to expansion in the key social services of education and health as a result of greater public outlays.

Kenya's growth performance is characterised by low and declining savings. High consumption (public and private) and low savings have led to declining public and private investment. The poor rate of capital formation, which at 14.5 per cent of GDP in 2001 continued a declining trend over an extended period of time, has been a major contributory factor to the low growth performance of the economy. Total consumption is projected to maintain the upward trend in 2002 and 2003, thus leading to continued stagnation in domestic investment.

Macroeconomic Policy

Fiscal and Monetary Policy

Kenya's recent fiscal policy has adhered to the country's Medium Term Expenditure Framework (MTEF), which links policy, planning and budgetary planning and is intended to strengthen macroeconomic management. In 2001/02, in order to maximise returns from public expenditure, changes in budgetary planning, execution and monitoring were undertaken. The Treasury introduced from 2000/01 a new format of the vote book to strengthen cash-flow planning and management. The government also created separate bank accounts for each line ministry (vote) in each district to improve budget execution at the district level. Measures were also taken in several areas to improve fiscal transparency, including strengthening the office of the Controller and Auditor-General through recruiting several new staff. The government also resumed its retrenchment exercise with the retrenchment of 23 000 employees. On the revenue side, the government sought during 2001/02 to enhance revenue through tax administration measures. The government effectively raised personal income tax by taxing housing allowances on an upper tax bracket. The VAT regulations were also amended, in order to expand the VAT base, by making it compulsory for taxpayers to keep stock records. In addition, some preserved food items already taxed at the manufacturing level, were made to be taxable up to the retail level. Besides, transparency-enhancing measures were introduced by eliminating import duty exemptions in favour of explicit budgetary provisions.

In 2001/02, although the Kenyan government maintained a tight fiscal stance and implemented both expenditure control and revenue-enhancing measures, the budget outcome deteriorated sharply. The revenue performance remained poor, with total revenue as a percentage of GDP falling from 26.8 in 2000/01 to 22.6 in 2001/02. The government's revenue position continued to suffer from the weak economic performance. Other specific factors contributing to the poor revenue situation included the government's failure to carry through its privatisation of Kenya Telecom, and the continued suspension of international assistance to Kenya. On the expenditure side, total expenditure as a percentage of GDP fell from 22.4 in 2000/01 to 21.9 in 2001/02. The major item of expenditure that increased in 2001/02 was government purchase of goods and services, as the government continued its projects under the El-Niño Emergency Project. Capital expenditure also increased due to road construction works undertaken during the financial year. The overall budget deficit increased sharply in 2001/02 reaching 2.8 per cent of GDP from the surplus of 0.3 per cent of GDP in 2000/01. Consequently, the primary balance fell from 3.3 per cent of GDP in 2000/01 to 0.7 per cent of GDP in 2001/02. The outlook on the budget position is moderation in the overall deficit estimated at 2.1 per cent of GDP in 2002/03, with an improvement in the primary balance to 2.3 per cent of GDP. A significant feature of Kenya's recent budget situation has been the sharp increase in the government's domestic arrears accumulation, which has brought about an increase of new claims of pending bills. At the start of 2001/02, the recorded stock of pending bills had increased to about 1.2 per cent of GDP. Obviously, the pending bills and the government's domestic debt will be expected to rise if donors continue to withhold funding programmes. Since the beginning of 2002/03, Kenya seems to have accepted the revenue implications of its strained relations with external donors. The government has not included external

Table 2 - Public Finances[a] (percentage of GDP)

	1994/95	1998/99	1999/00	2000/01	2001/02(e)	2002/03(p)
Total Revenue and grants[b]	**30.2**	**25.9**	**24.2**	**26.8**	**22.6**	**25.5**
Tax revenue	25.1	21.7	20.2	20.6	19.2	21.1
Grants	1.3	0.7	0.6	3.0	0.6	1.2
Total expenditure and net lending[b]	**31.8**	**25.3**	**22.7**	**26.6**	**25.4**	**27.6**
Current expenditure	24.8	23.1	20.1	22.4	21.9	23.5
Excluding interest	*17.5*	*18.1*	*16.3*	*19.4*	*18.3*	*19.1*
Wages and salaries	5.3	4.3	4.6	4.5	4.0	4.2
Interest on public debt	7.3	5.0	3.8	3.0	3.6	4.4
Capital expenditure	6.6	1.7	2.4	3.8	3.5	4.0
Primary balance	**5.8**	**5.6**	**5.3**	**3.3**	**0.7**	**2.3**
Overall balance	**-1.6**	**0.6**	**1.5**	**0.3**	**-2.8**	**-2.1**

Notes: a. Fiscal year begins 1 July.
b. Only major items are reported.
Source: Authors' estimates and predictions based on domestic authorities' data.

receipts in budget support from its development partners in the budget financing strategy.

Monetary policy in Kenya continues to emphasise the maintenance of stability of prices of domestic goods and services. Kenya has achieved considerable success in this direction. In 2001, the Central Bank of Kenya (CBK) maintained a tight monetary policy in 2001, the fifth consecutive year, aimed at keeping inflation within the 5 per cent target. During 2001, the minimum cash ratio was reviewed downward from 12 per cent to 10 per cent. Broad money (M3X) grew by 2.4 per cent in the year to December 2001 compared with 4.2 per cent the year before. The slow rate of growth of money supply was in line with the weak economic activity and was mainly the result of a 23.2 per cent decline in quasi money deposits, which more than offset an 8.9 per cent increase in currency plus deposits. On the other hand, the combination of 9.9 per cent increase in NFA, 19.8 per cent increase in domestic credit to central government and 6.5 per cent drop in credit to the private sector, accounted for 2.4 per cent growth in assets. These trends were in line with the monetary policy stance of the CBK of keeping money supply growth commensurate with that of the real sector.

The slow down in monetary expansion achieved the intended objective of containing aggregate demand and resulted in an average annual inflation rate of 0.8 per cent by December 2001 from 6.2 per cent in 2000. Other factors that contributed to the low inflation in 2001 included price falls of foodstuff as a result of the increased agricultural output, the relative stability of the shilling. According to the CBK, the rate of inflation has remained low into 2002 with the average rate at 2.4 per cent in May 2002. The rate of inflation is estimated at the annual average of 2 per cent for 2002. Inflation is however projected to pick up to 4.1 per cent in 2003, which will still be below the 5 per cent target of the CBK.

Nominal interest rates were generally lower in 2001 compared with the previous year in response to developments in the monetary sector. The treasury bill rate, which rose to 15 per cent at end-2000 came down to 10.9 per cent by end-2001 and has continued to fall — 8.3 per cent by May 2002. The decline reflects the increased availability of funds in the market as a result of the slow pace of economic recovery and, consequently, subdued demand for private sector credit. Given the low rate of inflation during 2001 all real interest rates remained positive in the course of the year.

On the foreign exchange market, the Kenyan shilling remained remarkably stable against all major currencies. Since June 2001, the Kenyan shilling has fluctuated no more than between KShs 77.50 and KShs 78.90 to the US dollar, although towards the end of 2001, the shilling came under some pressure due to deteriorating export conditions as well as the suspension of international assistance. The stability in the foreign exchange market was a reflection of the mix of monetary and fiscal policies, as well as weak demand for imports associated with the slow economic activity. Exchange-rate stability has helped to reduce perceived currency risk premiums and interest rates over the period. At the same time it points to the anaemic growth and the weak banking system.

External Position

Kenya has maintained a liberalised trade regime and made progress at further liberalisation. Kenya's trade policy has also increasingly become oriented towards the pursuit of regional integration, primarily through its membership of COMESA and the EAC. Tariff reform was formulated in 2001, aimed at simplifying the tariff structure and reducing the top tariff rate, with a view to ultimately adopting the common external tariff of COMESA and the EAC. The reform aims to reduce the top rate in stages over the next four years from 40 per cent (except for the tariff on sugar, which is 100 per cent) to 25 per cent. The number of non-zero tariff bands would also be reduced from 9 to 4 by 2004. In addition to paving the way toward the introduction of a common external tariff within COMESA and the EAC, the reforms aim to improve Kenya's competitiveness and facilitate duty collection. The 2001/02 Budget, which launched the first phase of the reforms, included a reduction in Kenya's top tariff rate from 40 per cent to 35 per cent, a decrease in the number of tariff bands from 9 to 8, and a decline of the average un-weighted tariff from 17.2 per cent to 16.6 per cent.

The external accounts position of Kenya worsened in 2001. Kenya's trade balance improved slightly from the deficit of 12 per cent of GDP in 2000 to 11.3 per cent of GDP in 2001. The narrowing of the trade deficit was due to a larger contraction of imports, as a proportion of GDP, with exports as a proportion of GDP also falling. Total exports receipts increased by 9.7 per cent in 2001 based on increases in export earnings from tobacco products, fish, hides and skins, soda ash, pyrethrum products, animals and vegetable oils, and iron and steel. However, the export trade was still dominated by tea, horticulture, petroleum products and coffee, which suffered declines in receipts. Export value of tea and horticulture dropped by 1.9 per cent and 6.5 per cent respectively in 2001. Tea exports were affected by the 11 September events as demand for Kenyan tea from Pakistan, Afghanistan and the Middle East dropped, especially in the last quarter of the year. Coffee exports dropped by 36.3 per cent in 2001 to continue the downward trend of the last five years. Coffee exports suffered from the low international price of the commodity as well as from administrative problems in the domestic coffee sector. Total imports recorded a 17.1 per cent increase in 2001. The import bill of crude oil decreased by 25.6 per cent due to the reduction of petroleum prices on the international market. Imports of agricultural machinery and tractors rose by 31.4 per cent, strengthening the base for economic recovery. Other notable increases in imports were recorded in chemicals, animal and vegetable fats and oils, medicinal and pharmaceutical products and iron and steel. In spite of the narrowing of the deficit on the trade account, the current account balance deteriorated to a deficit of 2.8 per cent of GDP from a deficit of 1.9 per cent of GDP in 2000. The deterioration was largely as a result of the decline in current transfers. However, Kenya's external reserves

Table 3 - Current Account (percentage of GDP)

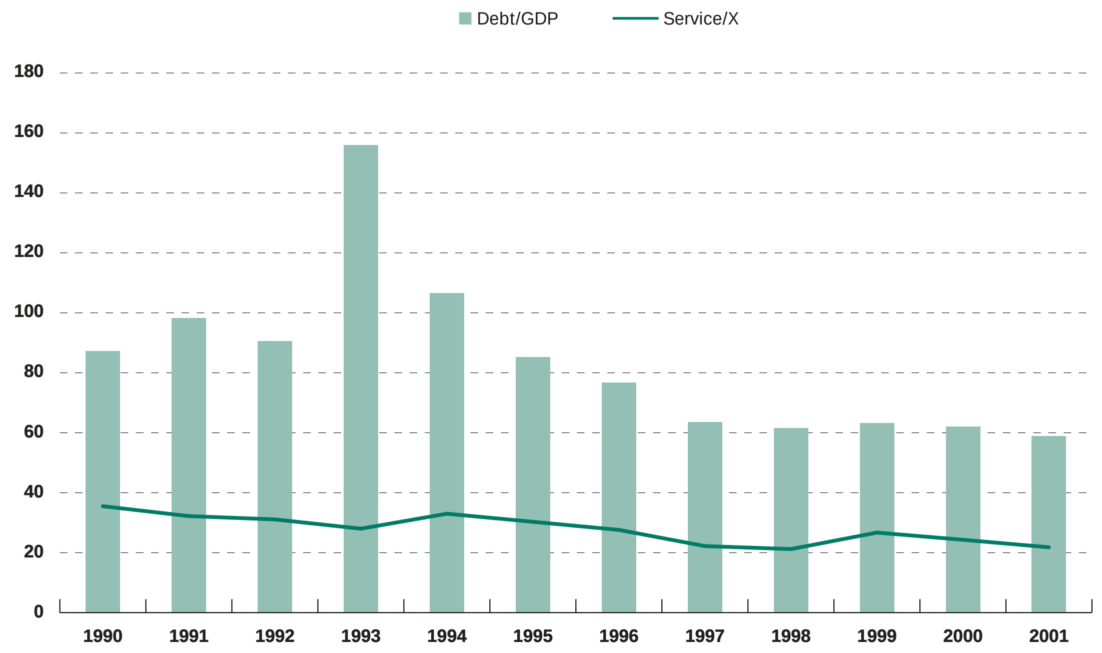
	1995	1999	2000	2001	2002 (e)	2003 (p)
Trade Balance	-8.2	-9.2	-12.1	-11.3	-12.1	-13.1
Exports of goods (f.o.b)	21.3	16.6	17.1	16.6	16.6	16.5
Imports of goods (f.o.b)	-29.5	-25.9	-29.1	-27.9	-28.7	-29.6
Services	1.7	3.5	2.6	2.3		
Factor income	-3.5	-1.5	-1.3	-1.3		
Current transfers	4.4	6.4	8.8	7.5		
Current account balance	**-5.6**	**-0.8**	**-1.9**	**-2.8**		

Source: Authors' estimates and predictions based on domestic authorities' data.

position in 2001 improved to the equivalent of three months import cover as a result of reduced debt servicing following the rescheduling agreement with the Paris Club creditors. The outlook on the external position is a widening of the trade deficit as imports continue to rise amidst stagnation in exports. The trade deficit is estimated to rise to 12.1 per cent of GDP in 2002 and further to 13.1 per cent of GDP in 2003.

The total stock of Kenya's external debt continued its downward trend to $5. 257 billion at end-2001 from $5. 327 billion at end-2000 and $5. 586 billion at end-1999. The reduced debt stock was a reflection of lack of new lending to Kenya. The debt burden also subsided following the November 2000 Agreement with the Paris Club of creditors on a flow rescheduling on non-concessional terms. The Agreement covered principal and interest arrears on not previously rescheduled pre-cut-off- date debt as of 30 June 2000 ($24 million) and debt-service maturities falling due from July 1, 2000 to 30 June, 2001 ($276 million) on previously and not previously rescheduled pre-cut-off-date debt. Kenya is not eligible for debt relief under the Enhanced HIPC initiative. According to IMF estimations Kenya's external debt appears sustainable. This assessment is based on the NPV of debt-to-export ratio of about 143 per cent and a debt service ratio of 19 per cent.

Figure 5 - Stock of Total External Debt (percentage of GNP) and Debt Service (percentage of exports of goods and services)



Source: World Bank.

Structural Issues

Kenya's has continued in its long history of structural reforms to diversify the economy and attract investment. The country's current concerns with the structural transformation of the economy focuses on four areas:

— strengthening governance measures and public sector reforms;

— accelerating local government reforms;

— restructuring and privatisation of public enterprises; and

— focusing on sector priorities and strengthening supporting policies.

Since late 2000 when Kenya's PRGF-supported programme suffered major setbacks due to governance-related problems, the government has made major efforts to bring the programmes back on track by implementing a number of measures to improve governance in the country. In 2001, following the failure of Parliament to pass the legislation for the re-establishment of the independent Kenya Anti-Corruption Authority (KACA), the government has focused its Anti-Corruption and Economic Crimes Bill — originally intended to strengthen the KACA — to strengthen the Anti-Corruption Police Unit. The Anti-Corruption Police Unit is now operational with enhanced budget to build its capacity to fight corruption. Similarly, budget provisions have been made to help implement the Bills establishing Kenya Corruption Control Authority and the Public Code of Ethics, as well as to support the special anti-corruption courts in Nairobi and similar courts to be set up in other parts of the country. The government is pursuing reforms to change local authorities and the way they are managed. In addition, the government is preparing a decentralisation policy to define the powers, functions, roles and duties of local authorities and their relationship with the central government. In this regard, a draft Bill that defines the legal framework within which local authorities are to operate in future was circulated in January 2002.

Kenya has pursued a privatisation programme since 1991 with the objective of encouraging private sector development, improving economic efficiency of state-owned enterprises (SOEs), reducing the drain on government budget by loss-making SOEs, and raising revenue for the government. Out of the total 240 enterprises that were under the control of the government, 207 enterprises formed the core of the privatisation programme and were earmarked to be sold. By June 2002 the government had divested 174 enterprises mainly to local investors (97 per cent) and foreign investors (3 per cent), with the notable foreign acquisitions including Nestle Foods Ltd., Pollman Tours, Safari Ltd, and Stanbic Kenya Ltd. In spite of the significant local participation, privatisation in Kenya is accused by the private sector of increasing the concentration of wealth in the Asian minority of the country, with most Kenyans feeling left out of the process. This accusation derives from the government's main approach of offering 100 per cent shares to a single bidder through competitive bidding. There have only been a few cases, Uchumi Supermarkets Ltd. and Housing Finance of Kenya where employees were offered opportunities to buy shares. Other problems that have slowed the process including lack of transparency, low public confidence and lack of information on the programme stem from the lack of a privatisation law. Since the inception of the programme, the government has not passed a privatisation law through Parliament as a legal framework, arguing that there was no provision in the Constitution forbidding the government's sale of assets. Kenya's record with restructuring and privatisation of public enterprises has remained an issue of contention between the government and its major development partners. In 2001, the government promised to table a Privatisation Bill aimed at streamlining and accelerating the implementation of the programme. The draft Bill was only ready in mid-2002 after extensive consultations with a broad section of stakeholders. The privatisation of Telcom Kenya (TK), which first went out to tender in April 2000 was seen by the IMF as a test of Kenya's commitment to economic reforms. This privatisation fell through following the decision of the government to reject the sale on the grounds of low bids. At the start of 2002, the government re-affirmed its determination to privatise TK by exploring alternative private sector participation (PSP) strategies to achieve its objectives. In 2001, the government sold a 30 per cent shareholding in Mumias Sugar Company. The government also made progress with the preparatory process for the privatisation of Kenya Reinsurance Corporation to the final bidding stage. This transaction is expected to be completed in the 2002/03 financial year during which the government also expects to sell its remaining 35 per cent shareholding in Kenya Commercial Bank (KCB). The government has focused its attention in the 2002/03 financial year on inviting private sector participation in the provision of some infrastructure services. It will continue efforts to cede the operations of Kenya Railway Corporation, invite private sector participation in various services at the Port of Mombasa and initiate the implementation of a PSP option for the Nairobi water supply service.

Kenya's financial sector has remained relatively stable with the KCB continuously reviewing the legal and regulatory framework to improve surveillance supervision and regulation. In 2001, one bank was placed under the management of the central bank after it failed to meet its obligations at the Clearing House. Another bank under the central bank's management was placed under liquidation after efforts to revive it failed. In 2001, the KCB was given the added challenge of regulating the micro finance sector. Consequently, drafts of a Micro Finance Policy statement and Micro Finance Bill were completed. A major challenge that continues to face the financial sector is the problem of the huge Non-Performing Loans (NPL) that pose a threat to the survival of some local banks. In 2001, NPL accounted for about 38 per cent of total loans and the realisation of collateral against such NPL proved difficult because of a slump in the property market as well as a cumbersome court system. The government recognises the NPL problem as one of weak supervision and regulation of the financial sector. Consequently, in 2002/03 the KCB has been granted more powers and autonomy. The Bank has now been ceded the powers of the Minister with regard to the licensing and de-regulation of financial institutions. Also, the government in 2002 has proposed amendments to the Building Societies Act to allow for mergers between building societies and banks or non-financial institutions. Following the events of 11 September, the government set up in early 2002 a task force to prepare regulations and legislation on money laundering.

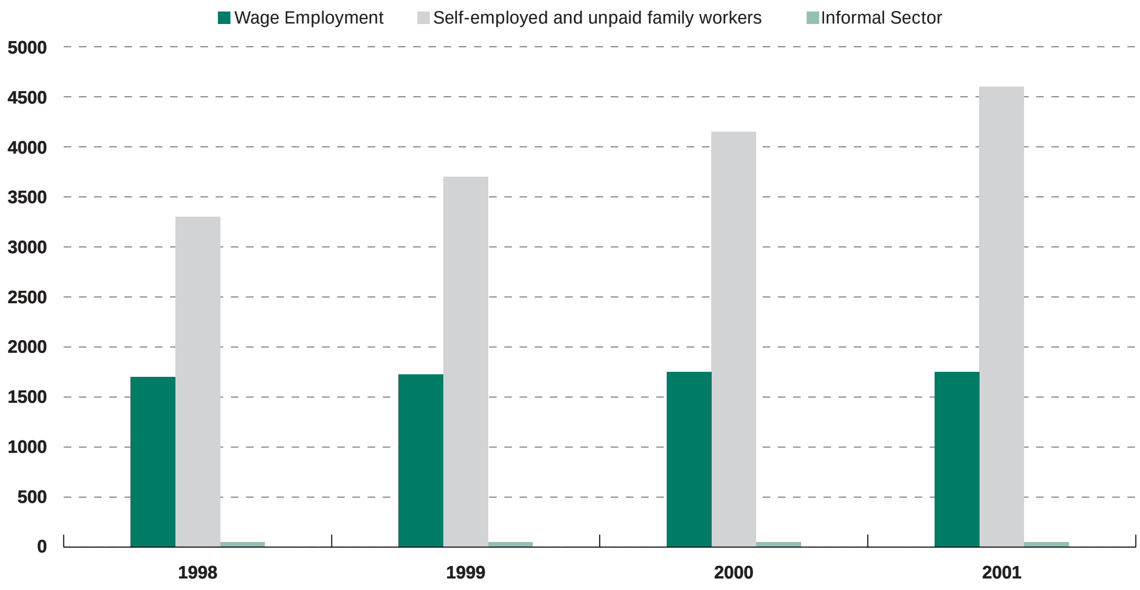
Activity at the Nairobi Stock Exchange (NSE) has continued to reflect the depressed state of the economy. The NSE 20 share index declined by 29.2 per cent between December 2000 and December 2001. The decline was due to reduced production capacity, lower corporate earnings including losses, reduced savings, and loss of investor confidence. In the equity market, the market capitalisation (total market value of all listed companies) dropped by 15.1 per cent between December 2000 and December 2001. The total number of shares traded dropped by 22.9 per cent. Under the foreign investor board (FIB) equities, the total FIB turnover dropped by 35.7 per cent between December 2000 and December 2001. The foreign investor participation in the market declined from a level of 36 per cent of the total market turnover in 1997 to a level of 12.5 per cent during 2001.

Political and Social Context

Kenya's democratic system has been under considerable stress as bitter struggles ensued for the succession to the Presidency after President Daniel arap Moi in elections in December 2002. The President re-affirmed his decision to step down in mid-2002, removing the uncertainty surrounding his retirement. However, the President Moi's backing for Uhuru Kenyatta, son of founding President Jomo Kenyatta, as his successor caused a major rift in the ruling party, with some ministers accusing President Moi of choosing a successor that he could manipulate outside office. Six ministers left the government on the issue of the successor to join the opposition, which for the first time forged a new coalition (the Rainbow Coalition) to put up the single candidate, Mr. Mwai Kibaki to contest the presidential elections. The Rainbow Coalition won a sweeping victory in the December 2002 elections from KANU that had ruled Kenya since independence, with Mr Kibaki easily defeating Mr Uhuru Kenyatta. The victory of the Rainbow Coalition marked a deepening in Kenya's democracy with the transfer of power to an opposition president.

Kenya's recent poor economic performance has aggravated unemployment and poverty in the country. Growth in wage employment has decelerated from 2.1 per cent in 1998 to 1.1 per cent in 2001. This represents the first downturn since the country's independence. There has also been a significant shift of the workforce to the informal sector, as a result of massive retrenchment in all activities in the modern sector. Employment in the public sector has also been on a downward trend due to the retrenchment of public servants and restrictive government employment policy. These factors have combined to lead to an increase in the percentage of Kenyans living below the poverty line from 52 per cent in 1997 to 56 per cent in 2002. In response to the worsening poverty situation in the country, and in line with its PRSP commitments, the government currently underpins the core poverty programmes and make enhanced budgetary allocations to the programmes. Since the beginning of 2002, the government has developed a Rural Development Strategy as part of its poverty alleviation programme. The main objective of the Strategy is to increase agricultural productivity, expand farm and non-farm incomes, reduce disease and ignorance and achieve sustainable resource management. In addition, food security is to be ensured by building and maintaining strategic grain reserves. The government is establishing a trust fund towards achieving these objectives.

Figure 6 - Total Recorded Employment, 1998-2001 (thousands)



Source: Authors' estimates based on local authorities' data.

In the health sector, the government continues to place emphasis on the HIV/AIDS pandemic. The HIV prevalence is already showing some downward trend particularly in the urban areas. The estimated HIV prevalence rate has fallen from 18.1 per cent in 1998 to 17 per cent in 2001 in urban areas, while it has remained at 13 per cent in rural areas. Nationally, the HIV prevalence rate has dropped from 13.9 per cent in 1998 to 13 per cent in 2001. Kenya also achieved some increases in its health institutions and facilities between 2000 and 2001: the total number of health institutions increased by 1.5 per cent; hospital beds increased by 2 per cent; the number of hospitals and nursing homes increased by 4 per cent; and the number of registered medical personnel increased by 2.6 per cent, though due to many medical personnel leaving the country, the ratio of medical personnel per 100 000 population decreased from 190.1 to 188.2. In spite of the gains made, Kenya faces daunting health challenges, which require increased resource allocation; in 2001 the government's allocation of the equivalent of 1.7 per cent of GDP to the health sector was lower than the continental average of 2.5 per cent of GDP.

In the education sector, Kenya's immediate post independence gains continue to give the country strong educational indicators in Africa. The government also continues to devote about 6 per cent of GDP as its expenditure on education, which compares favourably with the average 4 per cent for Africa as a whole. Nonetheless, the underlying features of the education system, which include non-enrolment, high levels of dropout and low completion rates, particularly among girls, and poor transition rates from one level of education to the other, persist. In 2001, the education sector recorded some gains in response to the increased public outlays. The areas that attracted increased funding include primary school feeding programme, the early childhood programme and curriculum support services. Pre-primary school enrolment increased by 6.1 per cent in relation to the previous year while primary school gross enrolment also rose by 4.2 per cent. However, the gross enrolment rate in primary schools, which stood at 92 per cent in 2001, was a decline from 94 per cent in 1999. The completion rate in primary education was estimated at 49 per cent in 2001, while the progression rate to secondary education was only 46.2 per cent, reflecting the high drop out rate.

