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## Paper 17: Kenya Phase 2

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# Contents


Tables and figures iii
Acronyms iv
Abstract v

1. Introduction 1
2. Effects of the crisis on Kenya: Key transmission mechanisms 2
   - 2.1 Private capital flows 2
   - 2.2 Trade 11
   - 2.3 Remittances 16
   - 2.4 Foreign aid 18
   - 2.5 Summary: Balance of payments effects 19
3. Growth and development effects 22
   - 3.1 National-level growth, investment and employment 22
   - 3.2 Sector-level effects 23
   - 3.3 Fiscal effects 24
   - 3.4 Poverty and distributional effects 25
4. Policy responses: A critical review 27
   - 4.1 Macroeconomic policies to manage the impact of the crisis 27
   - 4.2 Social policies to respond to the impact of the crisis 28
   - 4.3 Multilateral and bilateral donor responses in Kenya 30
5. Conclusions 31
   - 5.1 The impact of the crisis: An update 31
   - 5.2 Looking ahead: How well is the country positioned to gain from a future recovery and grow sustainably? 33

References 35
Annex 1: Capital held by commercial banks in Kenya, 2006-2008 38
Annex 2: Kenya's top commodity exports at HS-6 digit level 40

# Tables and figures

Table 1: ROA rate, 1998-2008 (%) 2
Table 2: Ratio of NPLs to assets, 1999-2008 (%) 3
Table 3: Consolidated cross-border claims on Kenya, Mar 2006-Jun 2009 4
Table 4: Growth of bank credit to the private sector, 2001-2008 (%) 4
Table 5: Distribution of credit by Kenya's banking system, 1997-2008 (%) 5
Table 6: Composition of commercial banks assets, 1999-2008 (%) 6
Table 7: Net portfolio equity flows, 2000-2007 (US$ millions) 7
Table 8: NSE trends, 2008 7
Table 9: Net FDI flows to Kenya, 2000-2008 10
Table 10: Tourist arrivals and earnings in Kenya, 2000-2008 12
Table 11: Recent performance of Kenya's main export commodities – tea, 2000-2008 13
Table 12: Recent performance of Kenya's main export commodities – horticulture, 2000-2008 14
Table 13: Recent performance of Kenya's main export commodities – coffee, 2000-2008 15
Table 14: Recent performance of Kenya's aggregate exports, 2000-2008 16
Table 15: Evolution and pattern of OECD-DAC-disbursed aid to Kenya, 2000-2008 18
Table 16: Evolution of Kenyan current account balance, Jan 2008-Aug 2009 (US$ millions) 20
Table 17: Kenyan imports, 2007-Aug 2009 (US$ millions) 20
Table 18: Update of the evolution of the exchange rate and foreign exchange reserves in Kenya, 2008-2009 21
Table 19: Quarterly real GDP growth by activity, 2008-2009Q2 (%) 23
Table 20: Summary of crisis transmission mechanisms and policy responses 31

Figure 1: NSE-20 Share Index, Sep 2008-Dec 2009 9
Figure 2: Foreigners' net purchases of stocks, Jan 2007-Sep 2009 (% of buyers' turnover) 9
Figure 3: Monthly net FDI flow to Kenya, 2007 and 2008 (US$ millions) 11
Figure 4: Remittances to Kenya, Jan 2004-Oct 2009 (US$ thousands) 17
Figure 5: Remittances to Kenya, Jan 2007-Oct 2009 (US$ thousands) 17
Figure 6: Net official capital flows to Kenya, 2007 and 2008 (US$ millions) 19
Figure 7: Nominal and real effective exchange rates, 1993:1 – 2008:9 21

## Acronyms

| | |
|---|---|
| AfDB | African Development Bank |
| B&H | Building and Housing |
| BIS | Bank of International Settlements |
| BS | Business Services |
| CBK | Central Bank of Kenya |
| CBR | Central Bank Rate |
| CD | Consumer Durables |
| cif | Cost, Insurance and Freight |
| CPP | Core Poverty Programme |
| COMESA | Common Market for Eastern and Southern Africa |
| CT-OVC | Cash Transfer Programme for OVC |
| DAC | Development Assistance Committee (OECD) |
| DFID | UK Department for International Development |
| DRC | Democratic Republic of Congo |
| EAC | East African Community |
| ESP | Economic Stimulus Programme |
| EU | European Union |
| F&I | Finance and Insurance |
| FDI | Foreign Direct Investment |
| FKE | Federation of Kenya Employers |
| fob | Free on Board |
| GDP | Gross Domestic Product |
| GNI | Gross National Income |
| GoK | Government of Kenya |
| IMF | International Monetary Fund |
| IPO | Initial Public Offering |
| KIPPRA | Kenya Institute for Public Policy Research and Analysis |
| KNBS | Kenya National Bureau of Statistics |
| KRA | Kenya Revenue Authority |
| KTDA | Kenya Tea Development Agency |
| M&Q | Mining and Quarrying |
| NEER | Nominal Effective Exchange Rate |
| NGO | Non-Governmental Organisation |
| NPL | Non-Performing Loan |
| NSE | Nairobi Stock Exchange |
| NSSF | National Social Security Fund |
| OA | Other Activities |
| ODA | Official Development Assistance |
| OECD | Organisation for Economic Cooperation and Development |
| OVC | Orphans and Vulnerable Children |
| PH | Private Households |
| RE | Real Estate |
| REER | Real Effective Exchange Rate |
| ROA | Return on Assets |
| SDR | Special Drawing Rights |
| T&C | Transport and Communications |
| TOT | Terms of Trade |
| TRWA | Total Risk-Weighted Assets |
| UK | United Kingdom |
| UNCTAD | UN Conference for Trade and Development |
| UNDP | UN Development Program |
| UNICEF | UN Children’s Fund |
| US | United States |
| VAT | Value Added Tax |
| WFP | World Food Programme |

# Abstract

The objective of this paper is to update and extend the examination of the effects of the global financial crisis, possible impacts and the scope and limitations of current policy responses. It should be noted at the outset that the country faced several other crises in 2008 and 2009, so it has been difficult to disentangle their effects from those of the financial crisis.

The paper addresses a whole range of issues. For example, it looks at a number of indicators to conclude that the banking system seems poised to withstand the crisis, as the fundamentals remain intact. Banks' profitability has substantially declined, however. In the capital market, by March 2009 the Nairobi Stock Exchange (NSE) 20-Share Index had fallen to a near seven-year low. It improved between March and June 2009, slumped in July-September of the same year and increased marginally by about 5% between end-September and December 2009 (0.8% in October, 4.1% in November and -0.1% in December 2009) as investors focused their portfolio on the bond market. Data on foreign direct investment (FDI) show a substantial decline in 2008 to a more normal level ($50 million) following an upsurge in 2007.

From a major decline in 2008, the tourism sector experienced some recovery in 2009. According to some estimates, by November 2009 tourism arrivals and earnings were up 90% from 2008. Tea exports, on the other hand, increased by 5.4% and earnings by 36.2% in 2008. Despite a production shortfall in 2009, earnings from tea exports increased by 17% in the first half of 2009 as a result of increased tea prices. Horticultural exports increased by 4.5% and earnings by 24.6% in 2008. Between January and August 2009, however, output declined, attributed mainly to a decline in flower production, which dropped 30% by October 2009, with exports moving in the same direction. The volume of coffee exports declined by 24.5% in 2008, with coffee earnings roughly unchanged. Coffee production peaked at 130,000 metric tonnes in the 1988/89 crop year, systematically declining since then. Less than 54,000 metric tonnes of coffee exports were expected in 2009.

Remittances from the Kenyan diaspora increased by 6.6% in 2008. In the first 10 months of 2009 they declined slightly, to $504.6 million, compared with $527.1 million in the same period in 2008 but more than $476.7 million in 2007. The database of the Organisation for Economic Development's Development Assistance Committee (OECD-DAC) shows a substantial increase in foreign aid to the country in 2008. Kenya received $1523 million in 2008 (compared with $1345 million in 2007), with committed funds fully disbursed in 2009 compared with only 53% in 2008, reflecting the urgency of the situation.

With the global financial crisis and other crises, current account and budget deficits have widened. The current account deficit rose from $2.12 billion in 2008 to $2.388 billion in the year to August 2009, affecting the exchange rate and foreign exchange reserves. Implementation of the 2008/09 budget also faced numerous challenges, which included inability to achieve revenue targets and additional drought-related expenditures. In the 2009/10 fiscal year, the government adopted an expansionary fiscal stance. A budget deficit of KSh109 billion (about 6% of gross domestic product (GDP)) is envisaged, with concerns that heavy borrowing will crowd out lending to the private sector.

Kenya has implemented various monetary and fiscal policies to deal with the crises. There have also been attempts to design cash transfer programmes targeting the very poor, the elderly and orphans and vulnerable children. All the transmission mechanisms discussed above have affected growth. In 2008, the growth rate declined to 2.1%. Growth in the first quarter of 2009 was 4%, declining to 2.1% in the second quarter. Reduced economic growth has led to reduced employment and increased poverty in the country.

# 1. Introduction

The objective of this paper is to examine, in the case of Kenya, the effects (so far) of the global financial crisis, possible impacts (economic, financial and social) and the scope and limitations of current policy responses.[2] The paper focuses on the following issues. First, elements of the global financial and economic shocks, including their type and magnitude. Second, shocks at the national level, identifying the effects so far on international capital flows, remittances, foreign aid and trade, based on before–after comparisons as well as existing or new models. Third, effects on investments, growth and poverty. Fourth, policy implications, distinguishing among actual (what has the country already done), possible (what is the capacity) and optimal policy responses, such as economic and social policies to manage shocks and accelerate normal development policies such as investment climate reform and diversification.

There is a now a relatively large literature on the global financial crisis (e.g. Kilonzo, 2008; Krugman 2008; Senbet 2008). This US-originated financial crisis has spread throughout the world. Since countries in sub-Saharan Africa are barely integrated into the global financial system, an interesting issue has been whether they might be spared the effects of the crisis. There is now consensus that Africa has not escaped the impact of the sub-prime crisis. Already, the crisis is anticipated to derail the high growth that sub-Saharan Africa has been experiencing in the past decade (of about 6.5%). Early estimates (e.g. International Monetary Fund (IMF)) have pointed to economic slowdown in Africa, to about 3.5%. These forecasts have been downgraded over time. According to an April 2009 IMF forecast, sub-Saharan African growth is projected at 1.5% in 2009 before recovering to just under 4% in 2010, which is still below the pre-crisis level (see Kang'aru, 2009a). According to the African Development Bank (AfDB)/Organisation for Economic Co-operation and Development (OECD), African economic growth will fall to 2.8% in 2009, less than half the rate forecast before the onset of the global slowdown (see Reuters, 2009a).

2 This paragraph mainly draws on the study's terms of reference.

# 2. Effects of the crisis on Kenya: Key transmission mechanisms

## 2.1 Private capital flows

### 2.1.1 The crisis and Kenya's banking system

It has been argued that African banks are insulated from foreign finance, as they rely on domestic deposits and lending and do not have derivatives or asset-based securities among their portfolios. According to Shanta Devarajan, Chief Economist of the Africa region at the World Bank (2008), 'African banks retain loans they originate on their balance sheets, the interbank market is small, and the market for securitised or derivative instruments is either small or nonexistent'. Even though some banks have significant foreign ownership, their parent banks are typically not in the US and the foreign ownership share is less than 5%, compared with an average of 40% in other developing countries.

Massa (2009) proposes a number of indicators to identify the different strengths and weaknesses of the domestic financial system in the context of the current crisis and to assess the potential magnitude of the impact of the global financial turmoil on the domestic financial sector. The following are some of the suggested financial vulnerability indicators applied to the Kenyan case.

#### Capital adequacy ratios

Adequate capital requirements help lessen the chance that banks will become insolvent if sudden shocks occur. Therefore, the higher are risk-weighted capital adequacy ratios, the lower is the probability that banks will be exposed to the risk of insolvency.

In Kenya, capital adequacy is catered for in Section 7 (1) of the Banking Act 2000. Requirements are:

- Minimum core capital. The current minimum core capital requirements are KSh250 million for banks and mortgage finance companies and KSh225 million for non-bank financial institutions.
- Gearing ratio, given by core capital/total deposit liabilities (minimum 8%).
- Core capital/total risk-weighted assets (TRWA) (minimum 8%).
- Total capital/TRWA (minimum 12%).

These requirements are continuously monitored and reviewed from time to time by the Central Bank of Kenya (CBK). A financial institution that fails to meet the minimum requirements may be urged to merge with other banks, lose its licence or be put under liquidation.

Annex 1 shows amounts of capital and capital ratios held by banks in Kenya in 2006-2008. The data show that all banks meet the four minimum capital requirements, even though the excess amounts and ratios vary from one bank to another. In 2008, for example, the average core capital was KSh3.4 billion, against a minimum requirement of KSh250 million; the average gearing ratio stood at 15.8%, above the statutory requirement of 8%; the average core capital/TRWA ratio stood at 29.5% against 8%; and the average total capital/ TRWA ratio stood at 33.1% against 12%. The values increased in 2006-2008 as the banks geared up for new requirements to be achieved by 2012.[3]

#### Rate of return on assets

ROA rate is an important financial soundness indicator, and is in particular a measure of bank efficiency and profitability. The ROA rate in Kenya generally declined in the late 1990s but has shown a general upward trend since 2000. In 2008, the ROA shows some decline (4.03%) from 2007 (4.11%).

**Table 1: ROA rate, 1998-2008 (%)**

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| ROA rate | 0.95 | 1.04 | 2.09 | 1.31 | 2.83 | 2.62 | 3.02 | 2.62 | 3.02 | 4.11 | 4.03 |

*Sources*: Oloo (2007; 2008; 2009).

3 The Finance Act 2008 increased the minimum core capital for banks to KSh1 billion, to be attained by 2012.

### Non-performing loans

The ratio of NPLs to assets is an indicator of banks' lack of asset quality and financial soundness. In the case of the current financial turmoil, a high ratio may indicate that banks are not healthy, since they have significant exposure to the origins of the problem.

In Kenya, the NPL/assets ratio decreased from a high of 23.27% in 2000 to a low of 4.02% in 2008, an indication that the banking system's asset quality had improved. This may be attributed to the requirements for bad loans provisions and increased core capital mandated by CBK. According to CBK, net NPLs as a share of total loans declined from 2.9% in March 2008 to 2.2% in November 2008. This was accompanied by increased provisions for bad loans in 2005 and 2006, with a decline thereafter in 2007 and 2008.

However, there is some evidence that the ratio increased slightly in 2009. According to CBK's September 2009 Monthly Economic Review, the ratio of net NPL to gross loans increased from 3.4% in August 2008 to 3.7% in August 2009. CBK has accused commercial banks of fuelling loans defaults by charging borrowers high interest rates (Kang'aru, 2009b).

**Table 2: Ratio of NPLs to assets, 1999-2008 (%)**

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|---|---|
| NPLs/total assets (%) | 19.98 | 23.27 | 20.67 | 16.14 | 13.92 | 12.07 | 10.56 | 8.49 | 4.29 | 4.02 |
| Provisions and interest in suspense/NPLs (%) | 52.98 | 59.90 | 58.06 | 52.85 | 67.97 | 62.33 | 111.65 | 117.57 | 91.49 | 55.84 |

*Sources*: Oloo (2007; 2008; 2009).

### Banks' ownership structure

Foreign banks are an important source of financial vulnerability as they may start to withdraw funds in order to offset losses in home countries, increasing the chances of collapse of their domestic-based subsidiaries, although there is no evidence of this in Kenya.[4] On the other hand, cross-country comparisons show that foreign banks may have better capitalisation, while bringing with them improved know-how and technical capacity, which then spills over to the rest of the banking system (Claessens and Jansen, 2000).

Financial reforms in Kenya have encouraged foreign banks to enter and expand banking operations in the country. Kamau (2009) finds them more efficient than local banks. She attributes this to the fact that foreign banks concentrate in major towns and target corporate customers, whereas large local banks spread their activities more widely across the country. Foreign banks therefore refrain from retail banking to specialise in corporate products, whereas large domestic banks are less discriminatory in their business strategy. These different operational modalities affect efficiency and profitability.

According to CBK, foreign banks comprise about a quarter of all banks in the country, with 11 foreign banks out of 43 commercial banks in 2007. They account for about 40% of commercial banks' core capital. There are five foreign banks that are fully foreign incorporated.[5] These accounted for 9.2% of the core capital of the banking system in 2007 (10.2% in 2006). These banks had a higher gearing ratio of 17.2% in 2007 compared with 15.6% for the banking system as a whole; a higher core capital/TRWA ratio of 30.1% compared with 18.1%; and a higher total capital/TRWA ratio of 30.1% compared with 19.1%.

In addition, there are six foreign but locally incorporated banks, so that they are partially owned by the locals.[6] These accounted for 31.7% of the core capital of the banking system in 2007 (34.0% in 2006). These banks had a lower gearing ratio of 14.7% in 2007 compared with 15.6% for the banking system

4 The British Financial Services Authority is reported to have conducted a 'severe stress test' on Barclays Plc and to have been satisfied that the bank did not need any fresh capital to withstand rising bad debts (Reuters, 2009b).

5 Bank of Africa (K) Ltd; Bank of India; Citibank N.A. Kenya (US); Habib Bank A. G. Zurich (Switzerland); and Habib Bank Ltd (Pakistan).

6 Bank of Baroda (K) Ltd (India); Barclays Bank of Kenya Ltd (UK); Diamond Trust Bank of Kenya Ltd (Kenya); K-Rep Bank (Kenya); Stanbic Bank of Kenya Ltd (South Africa); and Standard Chartered Bank (K) Ltd (UK).

as a whole; a lower core capital/TRWA ratio of 16.4% compared with 18.1%; and a lower total capital/TRWA ratio of 16.7% compared with 19.1%. It is therefore this group of foreign banks that policymakers should be concerned about in the context of the global financial crisis.

There is no evidence that the share of foreign banks (40% of core capital) changed fundamentally in 2008 and 2009.[7] International borrowing by the banking system has been relatively small, amounting to $183 million by June 2009 (about 6% of commercial banks' deposit liabilities). These cross-border claims declined with the onset of crisis, from 14.6% of total cross-border claims to 10.2% in June 2009 (Table 3). Since mid-2008, risk aversion has contributed to reduction in the exposure of banks to foreign currency loans and deposits (IMF, 2009b). The banking system remains relatively open, however, with foreign currency deposits accounting for 13% of total deposits and foreign currency loans about 9.7% of total loans.

**Table 3: Consolidated cross-border claims on Kenya, Mar 2006-Jun 2009**

| | Banking system (US$m) | Total claims (US$m) | Share (%) |
|---|---|---|---|
| Mar-06 | 82 | 1261 | 6.5 |
| Jun-06 | 257 | 1501 | 17.1 |
| Sep-06 | 90 | 1327 | 6.8 |
| Dec-06 | 97 | 1318 | 7.4 |
| Mar-07 | 100 | 1347 | 7.4 |
| Jun-07 | 100 | 1297 | 7.7 |
| Sep-07 | 1534 | 2761 | 55.6 |
| Dec-07 | 145 | 1614 | 9.0 |
| Mar-08 | 206 | 1651 | 12.5 |
| Jun-08 | 192 | 1767 | 10.9 |
| Sep-08 | 257 | 1757 | 14.6 |
| Dec-08 | 222 | 1624 | 13.7 |
| Mar-09 | 179 | 1657 | 10.8 |
| Jun-09 | 183 | 1795 | 10.2 |

*Source*: BIS database.

## Growth and composition of bank credit to private sector

The global financial crisis may affect the ability of borrowers to repay their loans, hence increasing non-performing assets, leading to solvency problems for many banks. In Kenya, credit to the private sector dominates the asset portfolio of the commercial banks in Kenya. As seen in the data below, private sector credit in nominal terms generally increased in 2000-2008, except for a small decline in 2001 attributable to uncertainty surrounding the 2002 elections and a large increase in 2004, after a reduction in the cash ratio in 2003 followed by a decline in 2005. Private sector credit in real terms also decreased in 2003 and 2008. This pattern also obtains for aggregate credit so that the public sector did not crowd out the private sector. Credit demand in 2008 was stifled by strict benchmarks adopted by the commercial banks over fear of contagion from the global financial crisis.

**Table 4: Growth of bank credit to the private sector, 2001-2008 (%)**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008* |
|---|---|---|---|---|---|---|---|---|
| Nominal growth in total credit (%) | -3.4 | 6.8 | 5.2 | 24.2 | 27.9 | 14.0 | 14.3 | 25.6 |
| Nominal growth in private sector credit (%) | -3.9 | 4.7 | 5.9 | 25.7 | 10.3 | 16.3 | 21.4 | 24.8 |
| Average inflation (%) | 5.9 | 2.0 | 9.8 | 11.6 | 10.3 | 14.5 | 9.8 | 26.2 |
| Real growth in total credit (%) | -9.3 | 4.8 | -4.6 | 12.6 | 17.6 | -0.5 | 4.5 | -0.6 |
| Real growth in private sector credit (%) | -9.8 | 2.7 | -3.9 | 14.1 | 0.0 | 1.9 | 11.6 | -1.4 |

*Note*: * = Provisional.
*Sources*: CBK Statistical Bulletin (various issues); Oloo (2009).

7 Some local banks have expanded their branch networks in the region. For instance, Kenya Commercial Bank has opened branches in Juba and Rumbek in Southern Sudan and has announced plans to open several additional branches in Rwanda, Uganda and Burundi. This is in addition to existing operations in Tanzania. However, the number of bank branches outside the country is relatively small to affect the stability of the banking system through cross-border transactions.

After the election of a new government in 2002, the growth of the economy picked up, as did credit to the private sector as well as investments in treasury bills. The reduction of the cash ratio from 10% to 6% in 2003 increased the liquidity of the banking system, inducing a reduction in lending interest rates. Low lending rates undoubtedly led to increased economic activity, with economic growth accelerating from 2.9% in 2003 to 5.1% in 2004, to 5.8% in 2005 and then to 6.1% and 7.0% in 2006 and 2007, respectively.

In order to increase their profitability, some banks have moved into housing and consumer lending, thus exposing themselves to the burst of the bubble in real estate markets or to the risk of a potential increase in the level of household indebtedness as a consequence of the current turmoil. In Kenya, however, only about 5% of banking system's credit went to real estate (RE) over 1997-2008, with a declining trend, about 6% to private households (PH), with an increasing trend, and 2% to consumer durables (CD), both with an increasing trend (Table 2.1.1.5).

Building and housing (B&H) took an average 5%; transport and communications (T&C) 4%; finance and insurance (F&I) 4%; mining and quarrying (M&Q) 1%; business services (BS) 6% and other activities (OA) 10%. Overall, the private sector took about three-quarters and the public sector about a quarter of the banking system's credit.

**Table 5: Distribution of credit by Kenya's banking system, 1997-2008 (%)**

| | B&C | T&C | F&I | RE | M&Q | PH | CD | BS | OA | Total private sector | Public sector | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1997 | 5 | 4 | 3 | 5 | 1 | 2 | 2 | 5 | 13 | 72 | 28 | 100 |
| 1998 | 6 | 3 | 3 | 6 | 1 | 2 | 1 | 6 | 9 | 71 | 29 | 100 |
| 1999 | 6 | 3 | 3 | 6 | 1 | 2 | 1 | 6 | 10 | 75 | 25 | 100 |
| 2000 | 5 | 3 | 4 | 6 | 1 | 3 | 1 | 7 | 9 | 76 | 24 | 100 |
| 2001 | 5 | 3 | 4 | 5 | 1 | 3 | 1 | 7 | 11 | 71 | 29 | 100 |
| 2002 | 5 | 4 | 5 | 5 | 0 | 4 | 1 | 6 | 10 | 70 | 30 | 100 |
| 2003 | 4 | 4 | 6 | 4 | 0 | 6 | 1 | 5 | 9 | 68 | 32 | 100 |
| 2004 | 4 | 4 | 6 | 4 | 0 | 8 | 1 | 5 | 14 | 74 | 26 | 100 |
| 2005 | 5 | 5 | 6 | 5 | 0 | 9 | 2 | 7 | 9 | 76 | 24 | 100 |
| 2006 | 6 | 7 | 4 | 4 | 1 | 8 | 2 | 8 | 9 | 74 | 26 | 100 |
| 2007 | 5 | 7 | 4 | 4 | 1 | 13 | 3 | 7 | 10 | 77 | 23 | 100 |
| 2008* | 5 | 6 | 4 | 4 | 1 | 15 | 4 | 8 | 11 | 79 | 21 | 100 |

*Note*: * = June.
*Source*: CBK Statistical Bulletin (various issues).

### Securities investment and exposure to new financial instruments

In a similar way, banks may also have moved into new lines of business like securities investment, and by doing this increased their exposure to new types of market risk such as a potential sudden fall in share prices. As well, a growing exposure of banks to new financial instruments for risk transfer, like securitisation and credit derivatives, may represent an additional structural weakness of the domestic banking system.

As Table 6 shows, however, assets of the banking system in Kenya are dominated by loans and advances, government securities and cash reserves at CBK. Kenya commercial banks hold minimal derivatives or asset-based securities in their portfolios. They hold mainly risk-free government securities.[8]

Overall, Kenya's banking sector has grown strongly during the past decade, by about 20% points, from around 85% of gross domestic product (GDP) in 2001 to 115% of GDP in 2008 (IMF, 2009b). It has improved tremendously in terms of product offerings and service quality, stability and profitability. During this period, only two banks have been put under CBK statutory management (Prudential Bank

8 There is no evidence that the value of bank collateral has reduced to affect the stability of the banking system. Casual evidence indicates that property prices increased substantially in 2008 and 2009, perhaps because of a flow of resources from the country's unstable neighbours (e.g. Democratic Republic of Congo (DRC) and Somalia).

and Charterhouse Bank), in comparison with the 1980s and early 1990s, when a large number of banks collapsed.[9] The banking system therefore seems poised to withstand the global financial and economic crisis, unless overcome by pure contagion, as the fundamentals seem quite sound.[10] This was confirmed by a survey carried out by CBK in October 2008 to establish the exposure of the Kenyan banking system to the global crisis. All institutions indicated that they are unlikely to be affected by the crisis owing to the low level of their participation in global financial markets. However, they agreed that they stand to suffer from indirect effects emanating from crisis impacts on the entire financial sector and the economy in general.

**Table 6: Composition of commercial banks assets, 1999-2008 (%)**

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|---|---|
| Loans and advances (net)/total assets | 65.8 | 52.0 | 50.6 | 48.8 | 47.7 | 51.2 | 52.2 | 51.5 | 51.4 | 53.8 |
| GoK securities/total assets | 16.9 | 16.9 | 21.8 | 22.7 | 27.6 | 20.7 | 19.8 | 20.5 | 19.8 | 15.6 |
| Cash and balances with CBK/total assets | 9.7 | 8.6 | 8.7 | 8.4 | 7.0 | 7.6 | 7.5 | 7.3 | 8.0 | 7.7 |
| Other* | 7.6 | 22.5 | 18.9 | 21.5 | 17.7 | 20.5 | 20.5 | 20.7 | 20.8 | 22.9 |
| | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

*Note*: * = Provisions for bad debts.
*Sources*: Compiled from Oloo (2008; 2009).

According to the IMF (2009b), the banking sector has weathered the crisis quite well. During the second half of 2008, its net financial position declined and then remained flat, as banks assets fell as a result of the slow growth in loans as the credit position tightened, which allowed banks to moderate their vulnerability to deterioration in their balance sheets owing to the global crisis. Banks reported a slowdown in profits in the first half of 2009, with half-yearly results increasing by a marginal 2.7%. Of the big four (Barclays, Standard Chartered, Kenya Commercial Bank and Equity Bank), only Standard Chartered returned a more robust performance than it did in the first half of 2008, recording a 43% growth in profits, attributable to the fact that the bank had been more cautious in its branches expansion. The reasons for the decline in profitability include low foreign exchange earnings, as the shilling has appreciated after the initial depreciation, and the adoption of a more risk-averse stance, by reducing lending to the private sector and lending more to government, explained by reduced opportunity for lending.

Kenya, which is less resource dependent, has not faced a dramatic impact on its banking sector as countries in have West and Southern Africa. Liquidity in the country has been kept alive by allowing banks to borrow from other banks using government securities as collateral (horizontal repos). This is the first time such trades have occurred in the country and this has provided liquidity that would otherwise not have been available. High interest rates and high inflation have reduced disposable income, pushing bad debts in banks and causing policy lapses in the case of insurers.

### 2.1.2 The crisis and the capital market

Over the past decade, foreign investors have increased their investments in the Nairobi Stock Exchange (NSE) attracted by high returns (see Table 7). As a consequence, the crisis has adversely affected the stock market, with foreign sales exceeding foreign buys in many counters, as foreign investors diversify away from the market (Kibaara, 2008). Tables 7 and 8 show a decline in net portfolio flows in 2005-2008 from a peak of $15 million in 2005, and substantial outflows since June 2008. The NSE 20-Share

9 By 1998, 37 banks had collapsed following the banking crises of 1986-1989, 1993-1994 and 1998, which led to a tightening of the regulatory framework.

10 Another view states that financial links among the world capital centres would bring the crisis to Kenya. Since cities are closely connected through the international system, Nairobi, which reportedly accounts for 60% of Kenya's output, would impact negatively on the rest of the country if its economy was not financially well.

Index has therefore taken a hit since the mid-2008 on the back of the post-election violence and the crisis.[11] This has significantly reduced market capitalisation.

**Table 7: Net portfolio equity flows, 2000-2007 (US$ millions)[12]**

| 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| 4 | 5 | 5 | 1 | 5 | 15 | 3 | 1 |

*Source*: CBK (2008).

The NSE 20-Share Index slumped by 35% in 2008, 25% since July 2008.[13] By end-February 2009, the index had declined by 23.2% in the previous one month, by 26.8% in the previous three months and by 46% in the previous one year, offsetting the gains made in the previous three years (one of the largest offsets in sub-Saharan Africa).[14] Data therefore show Kenya's bourse to be one of the worst hit in the region in the previous one year, after Nigeria and Mauritius, countries that for long have liberalised their capital markets. They also show a high correlation in the movements of equity prices across African countries. Kenya has the fifth-largest bourse by market capitalisation in Africa, after South Africa, Egypt, Nigeria and Morocco.[15]

In March 2009, the index fell further to about 2000 points, near its seven-year low of 1983 points. The index then reversed its trend, picking up an upward trajectory, raising hopes that the market could be finally getting out of the woods, as the economy showed some signs of recovery. As seen in Figure 1, the NSE 20-Share Index improved between March and June 2009 by 17.5%, but slumped in July-September 2009, shaving its value by 8.8%. The index increased by about 5% between end-September and December 2009 (0.8% in October, 4.1% in November and -0.1% in December 2009).

**Table 8: NSE trends, 2008**

| 2008 | Net portfolio capital flow (US$m) | Market capitalisation (US$b) |
|---|---|---|
| Jan | 2.0 | 10.9 |
| Feb | 11.3 | 12.0 |
| Mar | 9.9 | 12.4 |
| Apr | 0.7 | 14.6 |
| May | 9.2 | 14.8 |
| Jun | -47.5 | 19.0 |
| Jul | -1.8 | 16.8 |
| Aug | 0.0 | 16.3 |
| Sep | -3.9 | 13.6 |
| Oct | -11.5 | 10.0 |

*Source*: Kilonzo (2008).

The fall in share prices has been blamed on the crisis, which has seen foreign investors offload their shares as they have retreated to their markets to buy safer investments in government bonds (see Figure 2). It is also attributed to panic selling, triggered by loss of investor confidence following the collapse of stockbrokerage firms as poor management and outright theft took their toll on the firms. Within a span of two years in 2007-2008, at least two stockbrokers had collapsed and another was put under a caretaker arrangement, eventually collapsing, going down with substantial amounts of investor

11 It is difficult to document the share of foreign holdings of equity because a large number of shares are bought indirectly through nominee companies and accounts.

12 The CBK 2008/09 Annual Report gives completely different data for net portfolio flows, which are difficult to reconcile with those reported in the 2007/08 report:

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|
| US$m | -5 | -38 | -66 | -30 | -21 | -25 | -26 |

*Source*: CBK (2009).

13 The index declined from 4696.22 on 31 July to 3521.18 on 31 December 2008.

14 See data from www.AfricanFinancialMarkets.com.

15 Among other indicators of vulnerability, the price-to-earnings ratio has declined from 19.8 at beginning of 2008 to 15.6 in September 2008 and averaged 9.3 on 3 March 2009.

funds.[16] The lack of confidence could have had more lasting impact on the stock market's performance than the global financial crisis, with the NSE lagging other markets in the region (Kang'aru, 2009c).

By early 2009, some operators in the NSE were predicting that the worst was over. According to Jimnah Mbaru, 'most foreign portfolio investments on the NSE have been liquidated by the fast moving and unpredictable hedge funds who had invested on the NSE' (Xinhua, 2008). Hence, 'the exit of foreign investors has already happened and the only way is for them to come back'.[17] Operators have also claimed that, after fleeing at the height of the crisis, foreign investors are back at the NSE, taking advantage of the low priced shares. Monthly statistics from the NSE show that, in July 2009 foreign investors' activity at the bourse accounted for more than 60% of the total market turnover, so that, since March 2009, foreign investors have been doing a lot of business (Kang'aru, 2009d).

It is postulated that foreign investors are supporting the stock market after local investors have opted to invest in the bond market, where returns are more attractive, as supported by Figure 2. The returns that the fixed income investments are offering are decent, almost matching long-term average returns on investment. The September 2009 10-year KSh15 billion Kenya Electricity Generating Company (KenGen) Infrastructure Bond, for example, offered a tax-free interest rate of 12.5%. It was oversubscribed, and the company took an extra KSh10 billion through the so-called 'green shoe' option. Similarly, in October 2009 Safaricom's five-year bond offered a 12.25% return; earlier, the government successfully issued a 12-year KSh18.5 billion bond at a rate of return of 14.5% to finance projects in energy, roads, water and sewerage. The issue was oversubscribed by 45%, attracting a total of KSh27 billion against a target of KSh18.5 billion.

To encourage investment in long-term treasury bonds and promote the development of the bond market, the government in the 2009/10 budget reduced the withholding tax charged on interest income earned from long-term bonds from 15% to 10%. CBK was to implement this policy from 12 June 2009, subject to the condition that the bonds are not issued for infrastructure financing (already exempt from tax) and the tenor of the bonds is 10 years and above. To increase confidence in the stock market, the authorities have increased the minimum capital requirements for stockbrokers from KSh5 million to KSh50 million and for investment banks from KSh50 to KSh250 million, effective from December 2010.

Further reforms at the capital market require stockbrokers and investment banks publish their half- and full-year financial results. The disclosure is expected to help investors gauge how well an institution is funded and managed before placing their money with it. The new law became operational with the passing of the 2009/10 Finance Bill, while the deadline for the first six months fell on 31 August 2009. Bar the format and additional disclosure, compliance was almost 100% (Daily Nation, 2009a).

The stock market decline has made it more difficult to borrow from the capital market through initial public offerings (IPOs). The public listing of the Cooperative Bank of Kenya in 2008 managed only 81% subscription even after scaling down the target from KSh10 billion to KSh6.7 billion, the first under-subscription on the NSE in recent times. Several IPOs have been postponed because of the crisis.[18]

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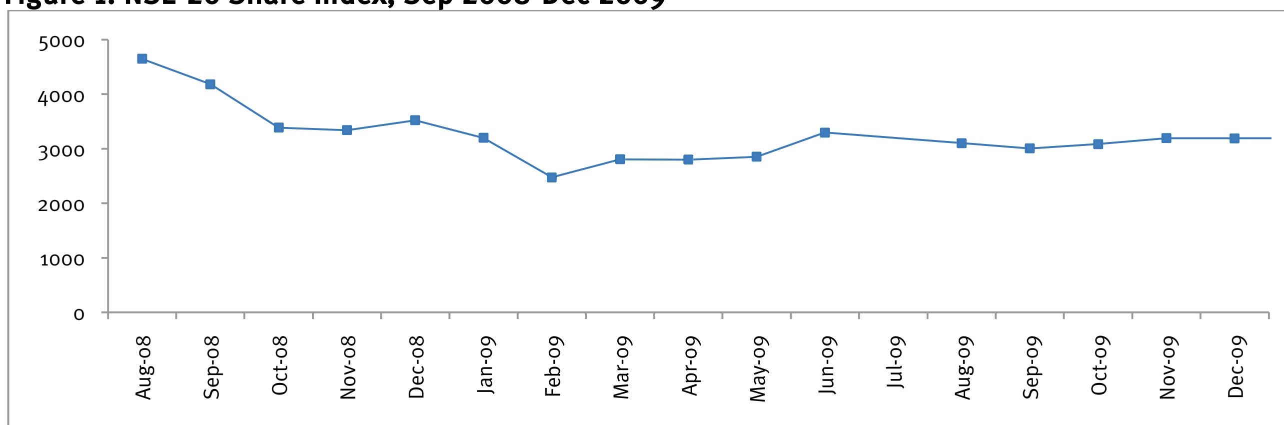
16 Francis Thuo and Partners; Nyaga Stock Brokers; Discount Securities.

17 Jos Konzolo, Chairman, Kenya Association of Stock Brokers and Investment, in Wahome (2009a).

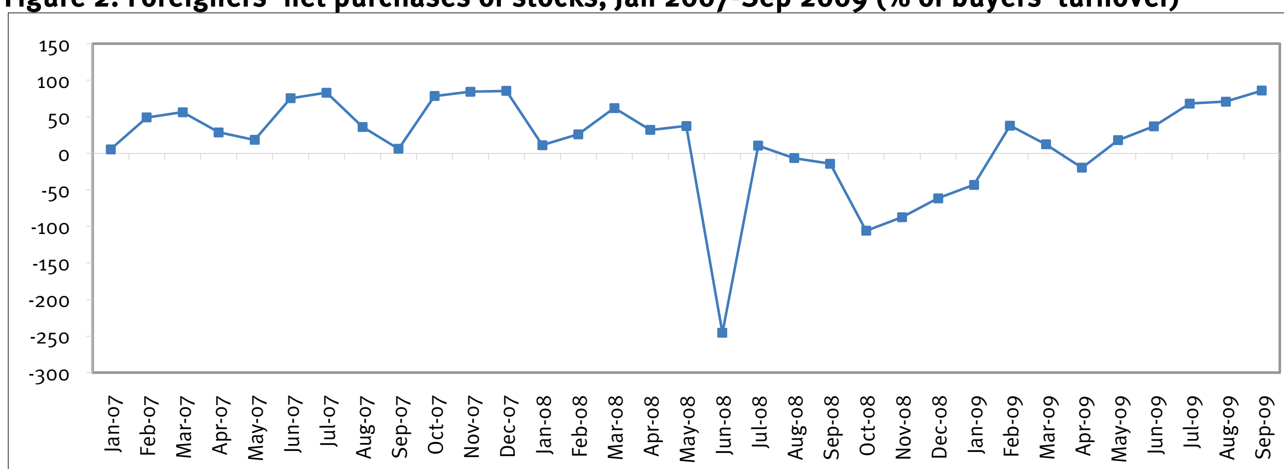
18 Plans by the bread maker DPL to raise funds through a public offer by March 2009 have not taken off, reportedly because the IPO has not been approved by the Capital Market Authority. Similarly, plans to privatise a number of parastatals through IPOs in 2009 and beyond have not yet taken off. These include the National Bank of Kenya, Kenya Pipeline Company, Kenya Wine Agencies, Chemilil Sugar Company, Nzoia Sugar Company, Muhoroni Sugar Company, South Nyanza Sugar Company and several state-owned hotels. See investing.businessweek.com.

**Figure 1: NSE-20 Share Index, Sep 2008-Dec 2009**




*Source*: CBK Monthly Reports.

**Figure 2: Foreigners' net purchases of stocks, Jan 2007-Sep 2009 (% of buyers' turnover)**




*Source*: NSE unpublished data.

### 2.1.3 Foreign direct investment

FDI includes equity capital, reinvested earnings and intra-company loans, with the first two dominating net FDI to Kenya.[19] FDI brings investable financial resources to host countries, provides new technologies and may enhance the efficiency of existing technologies. FDI may facilitate access into export markets, thereby playing an important role in strengthening the export capabilities of domestic economies; may enhance skills and management techniques; and may provide cleaner technologies and modern environment management systems.

FDI has also the potential of enhancing growth of domestic firms through complementarity in production and productivity spillovers (Borensztein et al., 1995). Phillips et al. (2001) have found that FDI stimulates domestic investment. A 1% increase in the FDI/GDP ratio is followed by as much as a 0.80% increase in future domestic investment/GDP in Africa. Phillips et al. conclude that FDI provides positive externalities and spillovers, particularly to developing countries, that make private domestic investment more profitable. In a survey, they found that nearly all the interviewed business leaders in Kenya favoured foreign investment, and recognised that it offered them economic opportunities. The anticipated decline in FDI as a result of the financial crisis would therefore adversely affect the country's performance.

19 Data are not available on the sectoral allocation or the source countries of the FDI flows to Kenya. However, the country does not have significant mineral resources, so much of the FDI goes to agriculture, manufacturing and services. The list of transnationals in the country is available on the UN Conference for Trade and Development (UNCTAD) website (www.unctad.org). See Mwega and Ngugi (2004).

However, FDI has played a small (though increasing important) role in the Kenyan economy. Net FDI flows (inward minus outward flows) to Kenya have been highly volatile and generally declined in the 1980s and 1990s, despite the economic reforms that took place and the progress made in improving the business environment (Mwega and Ngugi, 2004). The investment wave of the 1980s dwindled in the 1990s as the institutions that had protected both the economy and the body politic from arbitrary interventions were eroded (Phillips et al., 2001).

In absolute terms, net FDI inflows declined from an average $30.67 million in the 1980s to $17.7 million in the 1990s. The net FDI/GDP ratio declined from an average of 0.42% in the 1980s to 0.20% in 1990s. The data also show that the share of net FDI in gross capital formation declined from 2.02% in the 1980s to 1.13% in the 1990s. FDI was therefore minuscule when compared with domestic investment (which is generally true across regions, both underdeveloped and developed). Consequently, there was much concern among Kenyan policymakers over the falling off of FDI, which they attributed to low investor confidence, resulting from insecurity, corruption, poor infrastructure, high utility costs and patch service, high real interest rates and limited legal recourse (GoK, 2003).

The performance of FDI has improved recently and averaged $123.6 million in 2000-2007, although this reflects the results for 2000 and 2007. FDI increased to an average of 0.70% of GDP and to an average of 3.2% of gross investment in 2000-2007 (Table 9). The data show, however, that the good performance was driven by a big jump of net FDI flows to the country in 2000 and 2007. The 2000 jump owed to new investments by mobile phone companies (involving mergers and acquisition of $3 million) and accelerated offshore borrowing by private companies to finance electricity generation activities, which became necessary because of the drought that prevailed that year. The 2007 upsurge in FDI owed to the coming in of a new mobile telephone operator and the privatisation of Telkom Kenya. Net FDI was estimated at $52 million in 2008, a step back to its normal value (CBK, 2009a). According to UNCTAD's cross- border merger and acquisitions overview, net sales averaged $7 million over 1990-2000 and were $2 million in 2006, this jumping to $396 million in 2007 before declining to a net purchase of $18 million in 2008.

According to UNCTAD, Kenya has about 114 foreign-affiliated firms located in the economy. Many of the big multinational firms are in the tertiary sector (composed mainly of trade, transport and telecommunications). Most of these are from developed countries, with a majority from the UK and US, and hence likely to be affected by the crisis.

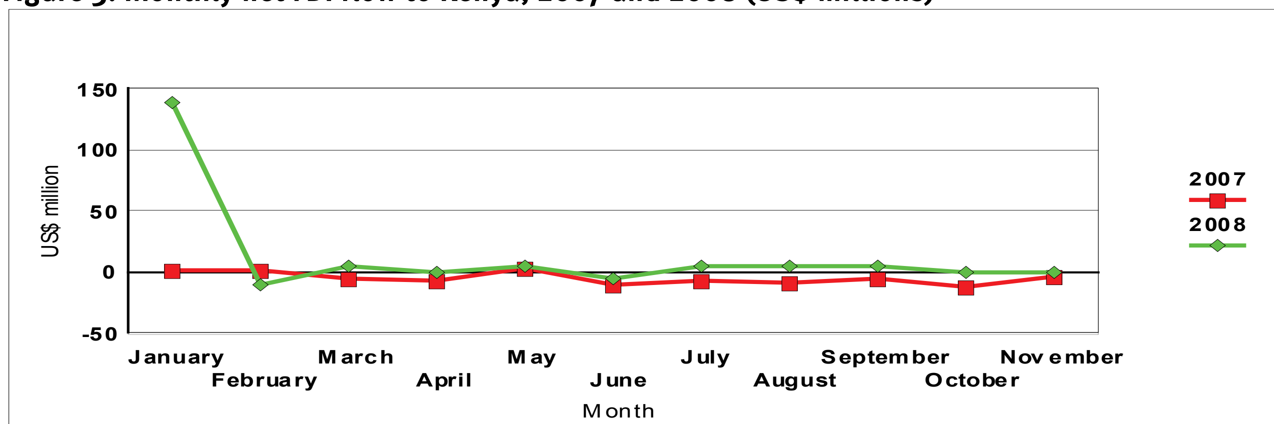
**Table 9: Net FDI flows to Kenya, 2000-2008**

| | Net FDI (US$m) | FDI stock (US$m) | Net FDI/GDP (%) | Net FDI/gross fixed investment (%) | FDI stock/GDP (%) |
|---|---|---|---|---|---|
| 2000 | 111 | 931 | 1.05 | 6.84 | 8.82 |
| 2001 | 5 | 937 | 0.04 | 0.31 | 8.34 |
| 2002 | 21 | 964 | 0.17 | 1.03 | 7.66 |
| 2003 | 80 | 1046 | 0.58 | 3.27 | 7.54 |
| 2004 | 42 | 1092 | 0.29 | 1.50 | 7.61 |
| 2005 | 11 | 1113 | 0.07 | 0.33 | 6.86 |
| 2006 | 27 | 1164 | 0.15 | 0.64 | 6.47 |
| 2007 | 692 | 1892 | 2.34 | 12.70 | 6.4 |
| 2008 | 52 | 1988 | 0.17 | 0.80 | 6.8 |

*Source*: UNCTAD FDI database

Figure 3 shows that the January 2008 upsurge in FDI dominated flows in 2007 and 2008, with a high correlation of monthly FDI in the two years.

**Figure 3: Monthly net FDI flow to Kenya, 2007 and 2008 (US$ millions)**




*Source*: CBK unpublished data.

In a cross-country empirical study (the Kenyan dummy was insignificant, suggesting that Kenya is on the regression line), Mwega and Ngugi (2004) found the following variables to significantly influence the FDI/GDP ratio. First, the trading partners' economic growth rate (DYNT) increases the ratio. Second, the terms of trade shocks (TOTS) reduce the ratio. Third, the external debt income ratio (DEBTY) increases the ratio. However, its squared counterpart (DEBTY2) reduces the ratio, hence the current debt stock stimulates FDI but at a decreasing rate. The optimal debt level above which the FDI ratio declines is 250% to 280%, outside Kenya's range. Lastly, the quality of institutions (ICRGE) improves the ratio.

The crisis is therefore likely to adversely affect the Kenya FDI ratio by reducing the growth of the country's main trading partners (a 1% reduction in growth reduces the FDI ratio by 0.45%), as well as by a worsening of Kenya's terms of trade (a 1% worsening of the country's TOT reduces the ratio by 0.057%). However, given the FDI/GDP ratio (except in 2000 and 2007), these effects are likely to be small. They would also be offset by the availability of loans and grants to finance the crisis, and if the country improved on its governance, which would require actions such as reducing corruption, rebuilding institutions and enhancing the rule of law and order, with clear and transparent regulations, uniformly enforced (Phillips et al., 2001).

Table 9 shows, however, that the stock of net FDI inflows increased from $931 million (or 8.8% of GDP) in 2000 to $1988 million (or 6.8% of GDP) in 2008, so that a major divestment as a result of the global financial crisis would adversely affect the economy. Such a major divestment seems unlikely, given the irreversible nature of fixed investment, even though a few companies, such as the pay-TV firm GTV, have suddenly quit the country citing the credit crunch.

## 2.2 Trade

### 2.2.1 Tourism

Before the crisis, as seen in Table 10, the tourism sector maintained an upward trend in 2001-2007, realising a 13.6% growth in 2007 in tourist arrivals compared with 8.2% in 2006. Earnings also maintained an upward trend and increased by 28.9% in 2007, compared with 19.9% in 2006. In 2004-2007, net tourism earnings (foreign travel in Kenya's balance of payments) accounted for about 9% of Kenya's exports of goods and services, from 5% to 6% in 2000-2003.

**Table 10: Tourist arrivals and earnings in Kenya, 2000-2008**

| | Arrivals ('000s) | Earnings (US$m) |
|---|---|---|
| 2000 | 1036 | 216.2 |
| 2001 | 994 | 262.8 |
| 2002 | 1001 | 282.0 |
| 2003 | 1146 | 346.5 |
| 2004 | 1361 | 497.2 |
| 2005 | 1479 | 675.4 |
| 2006 | 1601 | 809.8 |
| 2007 | 1819 | 1044.3 |
| 2008 | 1203 | 836.5 |

*Source*: CBK Statistical Bulletin (various issues).

However, in 2008, the sector suffered a major blow as a result of the post-election violence, increased oil prices and, more recently, the crisis. In 2008, tourist arrivals declined by 33.9% and dollar earnings declined by 19.9%. About 69% of Kenya's tourists come from Europe and 6% from the US, so that, according to some estimates, if the number of tourists from North America and Europe were to be halved, the loss would be in the range of $316 million, about 5.2% of Kenyan exports of goods and services (in 2007).

There has been some recovery in 2009, to suggest that the tourism effect owed to the post-election violence rather than the crisis. According to the CBK Monthly Economic Review (October 2009), between January and September 2009 tourist arrivals increased by 38.7% compared with the same period in 2008, giving hope that the industry will be back to the level before the national and international crises by March 2010. According to the Ministry of Tourism, by November 2009 tourism arrivals and earnings were up 90% from 2008, which the Ministry attributed to aggressive marketing by the Kenya Tourist Board in customary source markets in Europe (Ringa and Ndurya, 2009).

To enhance the recovery, the Ministry has called on the Treasury to give it 5% of what the sector generated in 2007 for its promotion and marketing, as what the government was giving for promotional campaign was too little compared to what obtains in countries such as Egypt ($100 million), South Africa ($70 million) and Tunisia ($48 million) (Mwakera, 2009). The 5% would amount to about $40.6 million. With these resources, the Ministry projects that 2010 could be the year the country turns around to surpass the boom of 2005-2007. During this period, the sector was the biggest earner of foreign exchange ahead of tea and horticulture (it generated about KSh48 billion a year). The government had already reduced visa charges from $50 to $25 and waived visa fees for children. According to the Ministry, for every tourist who visits the country, three people are employed either directly or indirectly.

### 2.2.2 Commodity exports

As seen in Annex 2, tea, horticulture (especially cut flowers) and, to a lesser extent, coffee are Kenya's main individual commodity exports. The country mainly re-exports petroleum products in the region after processing, so its foreign exchange value added is small. The country has a fairly diversified economy, with its top five exports accounting for 54% of total exports (te Velde, 2008). Kenya's export destinations are fairly diversified, covering several European countries (plus Pakistan and Afghanistan for Kenya's tea exports).

#### Tea

Kenya is the world's largest exporter of black tea. Tea counts for 4% of GDP and 14% of agricultural GDP. Tea output declined by 6.4%, from 369 million kilograms in 2007 to 345 million kilograms in 2008.[20] Between January and September 2009, tea output declined further, with the country producing 209.4 million kilograms of tea, down 12% from a year earlier, the lowest output in five years. Output

20This is according to the Kenya Tea Growers Association.

was expected to be about 325 million kilograms in 2009, down 6% from the 345 million kilograms produced in 2008.

The decline in output is attributed to bad weather and failure to use fertiliser owing to its high cost, as well as displacement of labour following the post-election crisis in tea-growing areas. The Kenya Tea Development Agency (KTDA) only resumed importation of fertiliser in 2009 following its suspension as a result of high prices. The halt came after prices rose to a high of KSh6000 per a 50-kilogram bag mid-2008, forcing the agency to stop buying it on behalf of the farmers. World fertiliser prices dropped from a high of $847 in April 2008 to $350 early in 2009 (Marete et al, 2009).

Table 11 reports the recent performance of Kenya tea exports, which shows an upward trend in the quantity of exports over 2000-2008, offset by a decline in the shilling price of tea in 2007, which then increased in 2008.[21] Despite the overall production shortfall in 2009, export earnings rose to KSh50.3 billion, up from KSh45.1 billion in 2008, owing to higher tea prices.[22] The decline in output affected several producing countries, reducing supply in the global market. According to KTDA, prices have increased by 30% in the year since September 2008, averaging $2.5 per kg of made tea and reaching a high of $3.5 per kilogram of some primary grades at recent auctions (Nyabiage, 2009a). Kenya's income from tea exports increased by 17% in the first half of 2009, amounting to KSh30.8 billion, compared with KSh26.3 billion in the same period in 2008. The average price at the weekly auction was $2.42 compared with $2.36 in the first half of 2008. Changes in tea prices and output have major implications for poverty, with much of the product grown by small-scale farmers.

To cushion the industry from the vicissitudes of the international market, tea agencies are promoting the domestic consumption of tea in the country. They have asked for tea to be placed in the category of food items, hence exempting it from VAT and other duties in order to spur demand. The consumption of tea in the country increased from 12.5 million kilograms in 2005 to 20 million kilograms projected for 2009. However, only 5% of tea is consumed domestically, compared with 95% exported.

**Table 11: Recent performance of Kenya's main export commodities – tea, 2000-2008**

| | 'ooo tonnes | KSh per kg | Value (KSh.b) |
|---|---|---|---|
| 2000 | 217 | 162 | 35 |
| 2001 | 270 | 127 | 34 |
| 2002 | 273 | 126 | 34 |
| 2003 | 262 | 126 | 33 |
| 2004 | 275 | 131 | 36 |
| 2005 | 341 | 124 | 42 |
| 2006 | 319 | 148 | 47 |
| 2007 | 370 | 126 | 47 |
| 2008 | 390 | 163 | 64 |

*Source*: CBK Statistical Bulletin (various issues).

### Horticulture/cut flowers

Horticultural output increased marginally by only 0.5% in 2008, from 192.1 million kilograms in 2007 to 193.1 million kilograms in 2008. Between January and August 2009, however, horticultural output declined by 35%, to 123.9 million kilograms, compared with the same period in 2008 and mainly attributed to a decline in flower production, which dropped 30% by October 2009 (Kang'aru, 2009e).

Table 12 shows the recent performance of Kenyan horticulture exports, which show an upward trend in the quantity of exports in 2000-2008, partially offset by a slight decline in the price of horticulture in 2007, but with a recovery in 2008. The horticultural sub-sector realised growth of 4.5% in exports in 2008, 20.3% in the shilling price per kilogram, hence increasing earnings by about 24.6% in 2008. The

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21 The data suggest that Kenya exported more than it produced in 2007 and 2008, hence drawing down stocks, raising the issue of sustainability.

22 According to the Tea Board of Kenya.

volume of horticultural exports declined by 7.8% to 209,455 metric tonnes in the period January-September 2009, compared with the same period in 2008.

In 2009, the labour-intensive horticultural industry, which employs an estimated 3 million people, had to cut around 1200 jobs, as it suffered a 35% drop in exports of flowers by April 2009 (compared with the year before). According to some reports, more than half of the over 200 flower exporters registered in Kenya were on the verge of closing down as the combined effect of the crisis and climate change hit export markets, with operating losses up to 30%. While large exporters were doing well, smaller farms especially were being hit by 'shrinking markets, reduced earnings, increasing costs of production and diminishing water supplies'.[23]

As with tea, actors in the flower market are targeting increased domestic consumption to cushion the industry from the vicissitudes of the international market. The Kenya Flower Council and flower vendors in May 2009 staged the third flower show, for example, in response to a growing local market, as the industry strived to shed overreliance on exports (Daily Nation, 2009b).

**Table 12: Recent performance of Kenya's main export commodities – horticulture, 2000-2008**

| | '000 tonnes | KSh per kg | Value (KSh.b) |
|---|---|---|---|
| 2000 | 194 | 109 | 21 |
| 2001 | 193 | 103 | 20 |
| 2002 | 263 | 108 | 28 |
| 2003 | 294 | 105 | 31 |
| 2004 | 274 | 144 | 39 |
| 2005 | 298 | 140 | 42 |
| 2006 | 301 | 155 | 47 |
| 2007 | 397 | 143 | 57 |
| 2008 | 415 | 172 | 71 |

*Source*: CBK Statistical Bulletin (various issues).

**Box 1: Flower exports**

Floriculture (flowers and ornamentals) has in the past decade maintained an average growth of 20% per annum and is estimated to employ over 50,000-60,000 people directly and 500,000 people indirectly through affiliated services to the industry, e.g. farm inputs, transport, packaging, banking and so on. The fact that these opportunities in employment are in rural areas is very important, as it not only stems rural urban migration but also contributes to poverty alleviation.

Although Kenya is on the equator, considerable differences in altitude allow a great variety of climatic conditions, from the hot coastal plain up to the cool highlands. The country therefore has an ideal climate for producing a wide range of top quality flowers all year round. The main flower-growing areas in Kenya are regions around Lake Naivasha, Kinangop, Nakuru, Mt Elgon, Kitale, Eldoret, Kericho, Limuru, Kiambu, Athi Plains, Thika and Mt Kenya.

Kenya's export volume grew from 14,000 tonnes in 1990 to 39,000 tonnes in 2000 to 61,000 tonnes by 2003. As seen below, in 2007, 91,000 tonnes were exported compared with just over 93,000 in 2008. The value of flower exports rose from about KSh1 billion in 1990 to KSh23 billion in 2006, to a record high of KSh43 billion in 2007. In 2008, the value of exports stood at KSh40 billion. There are currently over 300 active exporters of floricultural products to the European Union (EU), with total capital investment being more than $800 million (€600 million). The area under commercial floriculture is more than 2000 hectares.

Kenya supplies over 35% of cut flowers and ornamentals to the EU, which is believed to consume 50% of the world's flowers, followed by Colombia with 17% and Israel 16%. The main destinations of Kenya's flower exports are Holland (65%), the UK (23%), Germany (7%), France (2%) and other countries (3%). From Dutch auction statistics, Japan and North America are the biggest export destinations outside of Europe. With market diversifications, the US, Japan and the Middle East are coming up quite fast.

23 This paragraph is based on http://www.theeastafrican.co.ke/news/-/2558/561646/-/rigsbaz/-/index.html.

| Kenya floriculture exports | | |
|---|---|---|
| Year | Volume (tonnes) | Value (KSh.m) |
| 2004 | 70,666.26 | 18.72 |
| 2005 | 81,218.00 | 22.90 |
| 2006 | 86,480.00 | 23.56 |
| 2007 | 91,192.71 | 42.37 |
| 2008 | 93,638.6 | 39.77 |

The reasons attributed to the industry's success are:

- Massive investments by both local and overseas investors in high-tech projects with emphasis on varieties and adding value.
- Maintenance of high standards through compliance to codes of practice, traceability, due diligence and ethical trading.
- Good and informed marketing by the growers.
- A liberalised economy over the years with the removal of exchange controls and other constraints.
- Availability of airfreight, Kenya being a 'hub' for the airline industry in the East African and Central Africa region, thereby providing crucial cargo capacity.
- Reasonable infrastructure.
- Good climatic conditions providing an opportunity to grow quality produce throughout the year.
- Highly educated/qualified workforce.
- Minimum government involvement, but mainly facilitating trade through the provision of incentives in the form of low duties and other taxes on imported inputs crucial to the sector, e.g. greenhouses, greenhouse covers, refrigeration equipment for cooling and cold stores, dam construction, lining, shade netting, etc.
- Dynamic smallholder farmers for certain crops which are labour intensive.

*Source*: Compiled from the Kenya Flower Council website (www.kenyaflowercouncil.org/).

### Coffee

Coffee output declined by 26% in 2007-2008 from 52.3 million kilograms in 2007 to 38.7 million kilograms in 2008 owing to drought in the country. Between January and September 2009, it increased by 43.7% to 44.4 million kilograms, in response to improved export prices, reaching a peak of $3.39 per kilogram in August 2009.

Table 13 shows the recent performance of Kenyan coffee exports, which show a downward trend in the quantity of exports (with some recovery in 2007 and a decline in 2008), partially offset by changes in the shilling price of coffee. The volume of coffee exports declined by 24.5% in 2008, although the shillings price expanded by 29.1%, leaving coffee export earnings unchanged. Coffee production peaked at 130,000 metric tonnes in the 1988/89 crop year, systematically declining thereafter. Fewer than 54,000 metric tonnes of coffee exports are expected in 2009. Prices would be expected to be relatively high, however, as a global demand and supply imbalance exists.

**Table 13: Recent performance of Kenya's main export commodities – coffee, 2000-2008**

| | 'ooo tonnes | KSh per kg | Value (KSh.b) |
|---|---|---|---|
| 2000 | 87 | 135 | 12 |
| 2001 | 64 | 117 | 7 |
| 2002 | 49 | 132 | 7 |
| 2003 | 59 | 107 | 6 |
| 2004 | 50 | 139 | 7 |
| 2005 | 47 | 193 | 9 |
| 2006 | 46 | 200 | 9 |
| 2007 | 55 | 189 | 10 |
| 2008 | 41 | 244 | 10 |

*Source*: CBK Statistical Bulletin (various issues).

**Aggregate exports**

At the aggregate level, a large proportion of Kenya's exports are sold in Africa. The Common Market for Eastern and Southern Africa (COMESA) accounted for 31.4% of Kenya's total exports in 2007 (with 70% of these going to the East African Community (EAC) countries of Uganda, Tanzania, Rwanda and Burundi). While these are mainly manufactured products, high reliance on regional markets makes the country vulnerable to an economic slowdown in the region, which may come from reduced aid flows to these regional trading partners. The EU accounts for another 26.4%, which comprises mainly agricultural products like tea, cut flowers, vegetables, fruits and coffee. The US accounts for less than 5% of the export share. A depreciating currency has helped cushion export earnings.[24] Table 14 shows that the quantity index increased up to 2005 and then declined, with some recovery in 2007. Aggregate export prices generally increased, although the country experienced declining terms of trade, with import prices increasing faster than export prices.

In 2008, the exports quantity index increased by 23.3% and the price index by 18.9%, with the TOT increasing by 10%. Commodity exports amounted to $1099 million in January-March 2009, declined to $1024 million in April-June, but increased to $1163 million in July-September. Overall, dollar export earnings declined by 9.0% in the year to September 2009 compared with the same period in 2008.

**Table 14: Recent performance of Kenya's aggregate exports, 2000-2008**

| | Quantity index | Price index | TOT |
|---|---|---|---|
| 2000 | 191 | 620 | 84 |
| 2001 | 204 | 637 | 79 |
| 2002 | 226 | 652 | 78 |
| 2003 | 260 | 620 | 81 |
| 2004 | 296 | 636 | 77 |
| 2005 | 318 | 676 | 72 |
| 2006 | 256 | 869 | 72 |
| 2007 | 279 | 866 | 70 |
| 2008 | 344 | 1, 030 | 77 |

*Source*: CBK Statistical Bulletin (various issues).

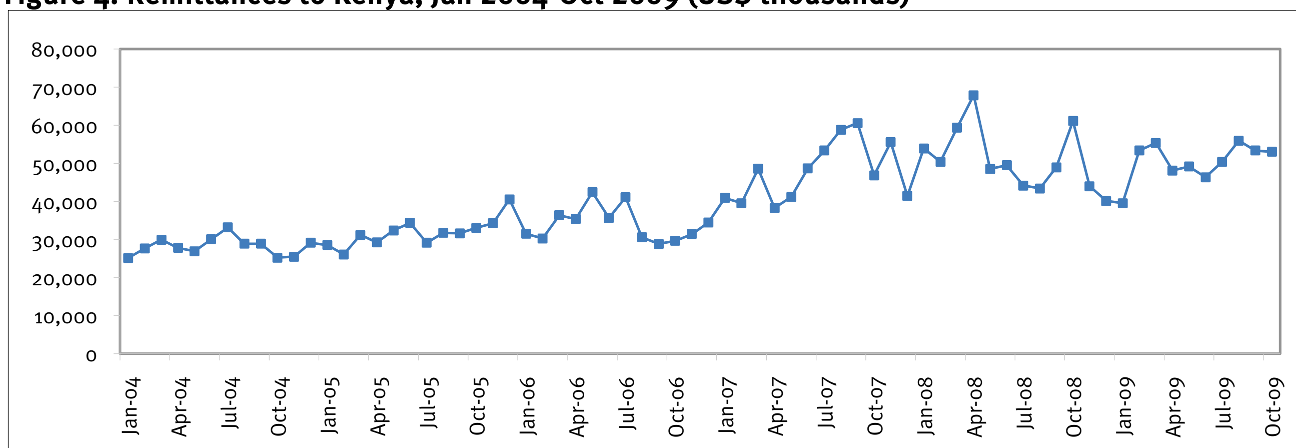
## 2.3 Remittances

Migration is an important issue in Kenya. It is a major destination, particularly of refugees running away from civil conflicts in the region (about 234,000 in the early 2000s). It is also a major source of migrants, going both within and outside the region. According to one estimate, there are more than 47,000 Kenyans in the US, 21,000 in Canada, 15,000 in the UK, 7000 in Australia, 5000 in Germany and 1300 in Sweden (Okoth, 2003). Overall, there are about 200,000 Kenyan migrants in OECD countries (Lucas, 2005).

One benefit of migration is remittances. Figures 4 and 5 show that remittances have significantly increased over time with the number of Kenyan migrants (Lucas, 2005). Remittances actually increased in 2008 compared with 2007. As seen in the figures, while remittances were quite volatile in 2008, there was a general downward decline from May 2008, even though they increased in September and October 2008 and declined thereafter. In the second half of 2008, monthly remittances declined relative to the same period in 2007, except in October. Overall, Kenya received $611.2 million in 2008, from $573.6 million in 2007, about 2.7% of GDP in 2008.

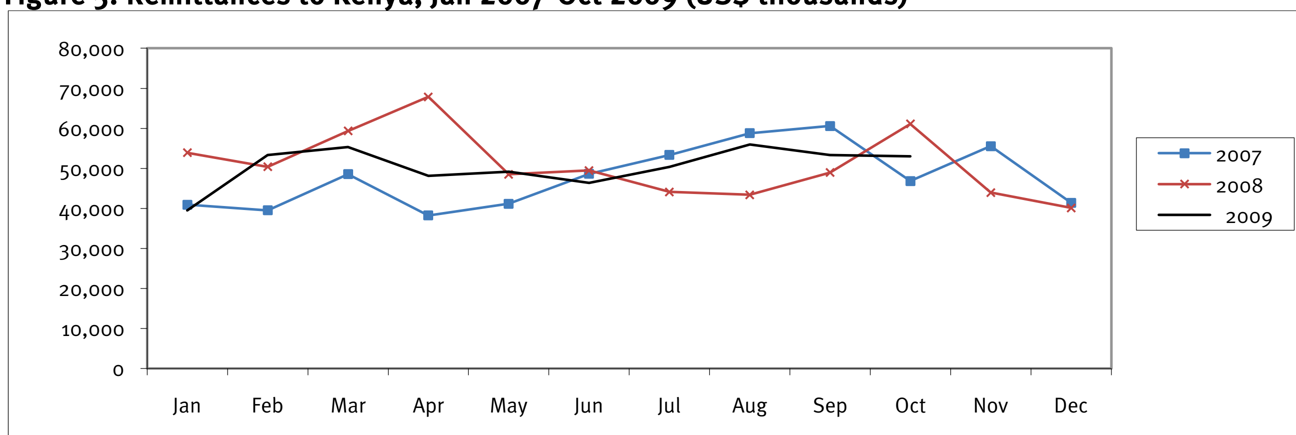
24 The real appreciation of the exchange rate before the crisis was driven mainly by the strong prices of coffee and tea as well as a strengthening of net foreign asset position, both accounting for about 90% of its variation (IMF, 2008). The crisis has reversed this situation.

**Figure 4: Remittances to Kenya, Jan 2004-Oct 2009 (US$ thousands)**




*Source*: CBK website (www.centralbank.go.ke/).

**Figure 5: Remittances to Kenya, Jan 2007-Oct 2009 (US$ thousands)**




*Source*: CBK website (www.centralbank.go.ke/).

In the first 10 months of 2009, remittances slightly declined, to $504.6 million compared with $527.1 million in the same period in 2008. According to CBK, remittances inflows were higher in 2008 mainly as the diaspora responded to cushion relatives against adverse effects of the multiple shocks, including the aftermath of the post-election violence and drought. In addition, the surge also reflected increased equities investments by the diaspora, who took advantage of the Safaricom IPO and the Cooperative Bank IPO, showing as peak inflows in April and October 2008, respectively. This implies that remittances inflows were used mainly for smoothing consumption and for investment. CBK reports that more than half of remittances have come from North America in the past half decade and postulates that the 'stabilisation in remittances flows in the second quarter of 2009 may in part reflect the bottoming up of the global economic recession as a result of coordinated intervention by policy makers' (Reuters, 2009c). Remittances from informal sources are not captured by these CBK data, however, and information on their magnitude is not available.

Remittances are therefore an important source of domestic household incomes, hence reducing poverty. The World Bank (2006) estimates that remittances reduce the number of people living in absolute poverty in Kenya by 8.5%, even though the poorest do not often have relatives abroad, so do not benefit from remittances directly.

On the other hand, remittances may have adverse macro effects, which include the possibility of Dutch disease arising from an appreciation of the real exchange rate, hence undermining the production of cost-sensitive tradeables such as cash crops and manufactures. It could also be counteracted by increasing government investment on infrastructure and adopting more liberal trade policies that increase productivity and competitiveness.

Reduction of incomes and loss of jobs by the Kenyan diaspora are expected to reduce remittances. On the other hand, imports of services from developed countries (college fees and upkeep expenses, etc) may also reduce as parents now look inward, with local education institutions benefiting. Migration also relieves labour market pressures by reducing unemployment and increasing domestic wages, although this effect might be minor in Kenya since only a small share of the labour force (about 15%) is in formal employment, with many of these employed in the public sector. Migration also improves access to capital, technology, information, foreign exchange and business contacts, which are important in the promotion of non-traditional exports. Hence, a forced return of migrants to the country (e.g. from Dubai) or reduced out-migration would adversely affect the economy. It is possible that the country may benefit from return migration in terms of better know-how, capital brought back by migrants and so on.

## 2.4 Foreign aid

Since the 1980s, the country has experienced relatively unpredictable flows of international aid. According to OECD Development Assistance Committee (DAC) statistics on official development assistance (ODA), Kenya experienced a dramatic build-up in nominal aid flows in the 1980s but a slackening of donor support in the 1990s. Nominal aid flows increased from $393.4 million in 1980 to an average peak of $1120.5 million in 1989-1990, before declining to a low of $377.8 million in 2002, with some recovery thereafter with the coming of a new government in December 2002 (Mwega, 2007).

**Table 15: Evolution and pattern of OECD-DAC-disbursed aid to Kenya, 2000-2008**

| | ODA at current prices (US$m) | ODA as share of GDP (%) | Bilateral as share of total ODA (%) | ODA as share of government expenditure (%) | Share of disbursed in committed ODA (%) |
|---|---|---|---|---|---|
| 2000 | 509.94 | 4.5 | 57.8 | 22.2 | 53.2 |
| 2001 | 461.55 | 4.0 | 58.6 | 15.6 | 97.5 |
| 2002 | 377.82 | 3.2 | 77.6 | 13.2 | 125.6 |
| 2003 | 583.24 | 4.4 | 66.1 | 17.3 | 80.8 |
| 2004 | 683.73 | 4.8 | 72.5 | 18.7 | 48.6 |
| 2005 | 741.51 | 4.4 | 71.4 | 18.7 | 68.0 |
| 2006 | 1011.03 | 5.0 | 78.0 | 19.8 | 58.1 |
| 2007 | 1345.43 | 5.6 | 69.8 | 22.4 | 53.5 |
| 2008 | 1522.77 | 5.7 | 71.0 | 19.7 | 106.3 |

*Source*: OECD-DAC database (www.oecd.org); Oloo (2007; 2008; 2009).

Kenya is not considered to be a highly aid-dependent economy. At its peak in 1989-1990, net ODA inflows averaged 14.6% of gross national income (GNI), declining to 2.52% in 1999 and 2.94% in 2002 (3.2% of GDP), before increasing to 4% of GNI (5% of GDP) in 2006. This indicates a decreasing importance of ODA to the economy, especially in the past decade. At 3% to 6% of GDP (Table 15), Kenyan dependence on foreign assistance is low, compared with neighbouring countries.

Aid flows may reduce as a result of the crisis, owing to massive bailouts in source countries. Support from Northern non-governmental organisations (NGOs) may also decline.[25] However, the impact is likely to be limited given the reduced aid dependence in the country. Kenya receives approximately 70% of its total aid from bilateral donors, the source of aid most likely to be affected by the crisis. Bilateral aid has been mainly in the form of grants (72% of the total), whereas multilateral aid has mainly been in the form of loans (86%). The principal source of multilateral loans has been the World Bank Group, which pledged to fund a number of projects in the country in 2009.

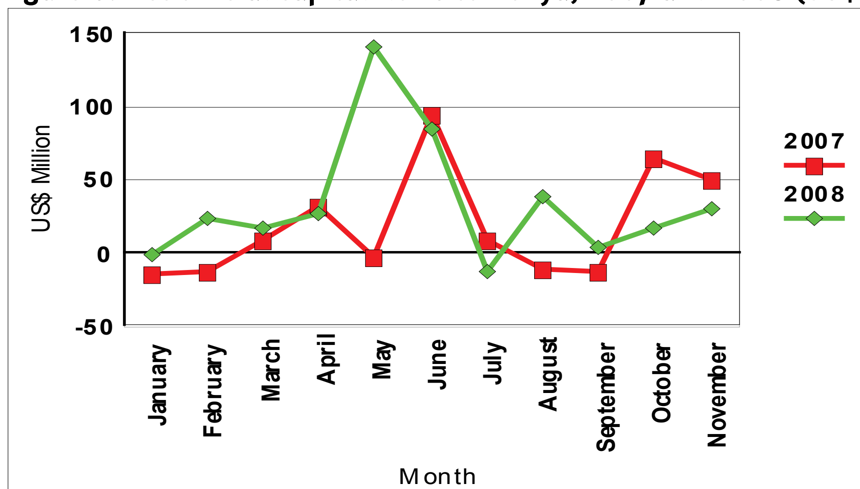
The OECD-DAC database shows a substantial increase in foreign aid to the country in 2008. Kenya received $1523 million in 2008 (compared with the $1345 million in 2007), with committed funds fully

25 We have not seen any evidence so far of NGOs reducing their activities or closing as a result of the crisis.

disbursed in 2009, compared with only 53% in 2008, reflecting the urgency of the situation with regard to the global financial crisis and other crises facing the country.

Figure 6 shows that net official flows to Kenya in September-November 2008 were below those of the corresponding period in 2007, reversing the pattern earlier in the year, although it is not clear to what extent to this may be attributed to the global financial crisis.

**Figure 6: Net official capital flows to Kenya, 2007 and 2008 (US$ millions)**




*Source*: CBK Statistical Bulletin (various issues).

Not reflected in the above analysis is aid from countries that do not belong to the OECD-DAC. Of these, China is probably the most significant, especially in the area of infrastructure assistance (McCormick et al., 2007). In the past two decades, China has moved to increase its assistance to African countries 'to the best of its ability'. Since the mid-1990s, China has increasingly used foreign aid to achieve broader strategic objectives, including strengthening links with resource-rich African economies.

In Kenya, loans and grants from China became significant in size after 2002, when a new government was elected, when China's share in total aid exceeded 1%. Since then, China appears in Kenya's national statistics among bilateral donors; before then it was classified in the category of 'other donors' (Onjala, 2008). As a ratio of total loans and grants to Kenya, China accounted for 1.23% of the total in 2003 and 1.15% in 2004, with the share increasing to 8.25% by 2005 (UNDP, 2006). Hence, China rose from among the lowest contributors of development assistance in Kenya to become one of the largest by 2005, second only to the EU. This should not be taken as a trend, however. Aid disbursed to Kenya by different donors varies greatly from year to year, depending on the country's institutional capacity to absorb funds and delays in project preparation and tendering (Chege, 2008). With the exception of 2004, the grant component of China's loans and grants is relatively high.

China has pledged not to reduce aid to African countries as a result of the global financial crisis. At the China–Africa summit in November 2009, China's Premier pledged $106 billion in new low-cost loans to Africa over the next three years, double the commitment made in the 2006 summit. China will also write off some loans to the poorest and most heavily indebted countries (te Velde and Massa, 2009).

## 2.5 Summary: Balance of payments effects

According to the IMF (2008a), the current account deficit was marginally sustainable before the global financial crisis, despite an appreciating exchange rate in the period because of productivity growth that reduced labour costs and enhanced the competitiveness of the economy in exporting to the region and outside, with capital flows more than covering the rising import bill, especially of oil. The study concludes that further improvements in Kenya's export performance would require reducing further non-factor (infrastructure) costs as well as continuing to raise factor productivity.

With the crisis accompanied by reduced exports and a large imports bill (e.g. of food and oil), the current account deficit has widened, continuing an earlier trend. The current account deficit, for example, rose from $1.10 billion in 2007 to $2.12 billion in 2008, attributed mainly to the huge increase in the value of oil imports of $1.12 billion. The oil bill increased from $739 million in 2008Q2 to $1081 million in 2008Q3, but significantly declined to $540 million in 2008Q4 as a result of the fall in international oil prices (see Table 17). This increased imbalance in the context of reduced capital inflows has caused a depreciation of the Kenyan shilling (as seen in Figure 7) as well as a running down of foreign exchange reserves.

The current account deficit increased further from $1470 million in the year to August 2008 to $2388 in the year to August 2009 as a result of reduced current transfers (mainly remittances). The trade account remained fairly constant, with a decrease in merchandise imports as a result of the decrease in imports of oil (owing to the decrease in oil prices) and manufactured goods.

**Table 16: Evolution of Kenyan current account balance, Jan 2008-Aug 2009 (US$ millions)**

| | Export of goods (fob) | Import of goods (cif) | Balance on goods | Non-factor services (net) | Factor services income (net) | Current transfers (net) | Current account balance |
|---|---|---|---|---|---|---|---|
| Jan-08 | 348.9 | 945.06 | -596.16 | 148.37 | 11.35 | 197.15 | -239.29 |
| Feb-08 | 458.56 | 823.47 | -364.9 | 143.85 | 44.48 | 163.29 | -13.29 |
| Mar-08 | 417.65 | 819.43 | -401.78 | 100.68 | -1.79 | 196.85 | -106.05 |
| Apr-08 | 468.81 | 880.01 | -411.19 | 159.98 | 7.99 | 203.94 | -39.28 |
| May-08 | 415.83 | 918.87 | -503.04 | 131.17 | 5.11 | 194.36 | -172.39 |
| Jun-08 | 396.81 | 783.24 | -386.43 | 99.95 | 4.88 | 210.59 | -71.01 |
| Jul-08 | 454.83 | 1053.91 | -599.08 | 207.48 | 34.92 | 137.65 | -219.03 |
| Aug-08 | 439.63 | 1073.37 | -633.75 | 97.97 | -25.74 | 145.28 | -416.23 |
| Sep-08 | 398.94 | 1047.12 | -648.18 | 158.75 | 2.17 | 163.44 | -323.82 |
| Oct-08 | 424.49 | 976.5 | -552.01 | 126.57 | 4.22 | 128.98 | -292.23 |
| Nov-08 | 371.71 | 874.8 | -503.09 | 154.95 | 5.9 | 162.01 | -180.23 |
| Dec-08-Feb 09 | 1088 | 2509 | -1421 | 493 | -25 | 376 | -577 |
| Mar-May 09 | 1054 | 2344 | -1290 | 407 | -29 | 423 | -489 |
| Jun-Aug 09 | 1140 | 2421 | -1281 | 355 | -10 | 408 | -529 |
| Year to Aug 08 | 4835 | 10670 | -5835 | 2092 | -71 | 2344 | -1470 |
| Year to Aug 09 | 4495 | 10299 | -5804 | 1802 | -72 | 1687 | -2388 |

*Source*: CBK Statistical Bulletin (various issues).

**Table 17: Kenyan imports, 2007-Aug 2009 (US$ millions)**

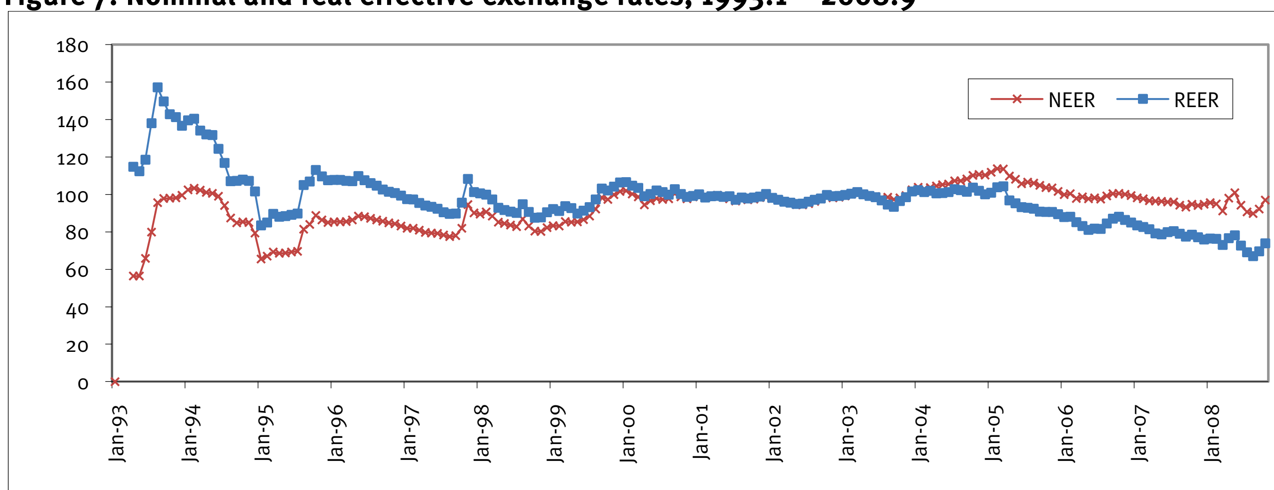
| | Year to Dec-07 | 2008 Q1 | 2008 Q2 | 2008 Q3 | 2008 Q4 | Year to Dec-08 | Annual ch. (%) | Year to Aug-08 | Year to Aug-09 | Annual ch. (%) |
|---|---|---|---|---|---|---|---|---|---|---|
| Imports (cif) | | | | | | | | | | |
| Oil | 1919 | 692 | 739 | 1081 | 540 | 3051 | 59 | 2869 | 2142 | -25.3 |
| Chemicals | 1156 | 359 | 363 | 384 | 339 | 1446 | 25.1 | 1358 | 1363 | 0.4 |
| Manufactured goods | 1435 | 357 | 379 | 409 | 445 | 1589 | 10.7 | 1521 | 1471 | -3.3 |
| Machinery and transport equipment | 2800 | 709 | 666 | 862 | 825 | 3063 | 9.4 | 2888 | 3043 | 5.4 |
| Other | 1752 | 471 | 434 | 439 | 582 | 1925 | 9.9 | 2033 | 2334 | 14.8 |
| Total | 9062 | 2588 | 2582 | 3174 | 2730 | 11074 | 22.2 | 10670 | 10299 | -3.5 |

*Source*: CBK Monthly Economic Review, January 2009.

In 2008, the Kenyan shilling depreciated by 22.6% against the US dollar, and by 15.6% from July 2008 as capital outflows increased.[26] Between January and September 2009, the shilling appreciated by 3.1%. According to CBK, the real effective exchange rate (REER) appreciated by 2.6% between June 2008 and June 2009, reflecting higher inflation in Kenya relative to inflation in trading partner countries, and by 10.0% between June 2008 and September 2009, according to the IMF (2009a).

Foreign exchange reserves, on the other hand, declined from 4.94 months of import cover as of 15 January 2008 to 3.26 months of import cover as of 15 January 2009, below the statutory minimum of 4 months of import cover. CBK argues that the decline was accounted for mainly by valuation losses, which are mainly book value in nature, while the net outflow has been minimal, the two effects accounting for 76% and 24%, respectively, of the reserve loss between July 2008 and March 2009.[27] The valuation losses were partially caused by the appreciation of the US dollar against major currencies (IMF, 2009b). Foreign exchange reserves subsequently increased, from 3.3 months of imports cover in April 2009 to 4.1 months of imports cover in September 2009, following increased allocation of Special Drawing Rights (SDRs) by the IMF, borrowing from the IMF under its Exogenous Shocks Facility in May 2009 and purchases by CBK from the domestic interbank market.

**Figure 7: Nominal and real effective exchange rates, 1993:1 – 2008:9**




*Source*: CBK unpublished data.

**Table 18: Update of the evolution of the exchange rate and foreign exchange reserves in Kenya, 2008-2009**

| | 2008 | | | | 2009 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Jul | Aug | Sep | Dec | Apr | May | Jun | Jul | Aug | Sep |
| KSh per US$ | 66.70 | 67.68 | 71.41 | 78.04 | | 77.66 | 77.85 | 76.75 | 76.37 | 75.60 |
| Gross forex reserves (US$m) | 5616 | 5287 | 5012 | 4641 | 4620 | 4370 | 4822 | 4830 | 4810 | 5235 |
| Months of imports cover | 4.4 | 4.2 | 3.9 | 3.4 | 3.3 | 3.3 | 3.6 | 3.6 | 3.6 | 4.1 |

*Source*: CBK Statistical Bulletin (various issues).

26 On 2 March 2009, the Kenyan shilling fell to a four-year low against the dollar, hitting KSh80.30 per US dollar, a level not seen since December 2004 (Reuters, 2009d). CBK attributes the depreciation of the Kenya shilling mainly to the appreciation of the US dollar.

27 CBK (2009b). CBK data show that the institution suffered a foreign exchange translation loss of KSh1265 million in 2008 from foreign deposits (KSh532 million) and IMF accounts (KSh771 million). The decline in reserves was also caused by stepped up demand for foreign exchange by risk-averse firms and households (IMF, 2009b).

# 3. Growth and development effects

## 3.1 National-level growth, investment and employment

The effects of global crisis on growth and development depend on the structure of the economy and the level and extent to which it is integrated into the global economy. These factors influence the extent to which macro prices (stock prices, interest rates and exchange rates) are affected and how these in turn affect the real economy.

There was undoubtedly substantial uncertainty regarding the future in the early days of the global financial crisis. Although some private sector actors were not initially affected, they expected things to get worse. Hence, players in the construction industry had not seen a slowdown but fear of a recession was palpable, as much of housing construction is financed by remittances, which could dry up when migrants are laid off or have their pay cut, although these fears were not supported by evidence. Similarly, banks said they had not yet seen the negative effects of the crisis but acknowledged that they could be hit hard in the future. They therefore tightened risk assessment of customers seeking loans, with a number of banks increasing their lending rates and/or restricting lending to particular sectors as a result of the perceived risks emanating from the crisis (Ondari, 2009a). Uncertainty is a major deterrent of investment, as investors exercise their option value of waiting, although gross fixed capital formation remained fairly constant in 2007-2008, at 19.4%. Investment in turn is a major driver of economic growth in Kenya and other countries.

All the transmission mechanisms discussed above affect growth in one way or another. In 2007, the country experienced a growth rate of 7%, the highest in over two decades. In 2008, the growth rate declined to 2.1% as a result of post-election violence in the first quarter of the year, drought in the country and the global financial crisis. Growth in the first quarter of 2009 was 4%, declining to 2.1% in the second quarter. According to CBK, the growth in real GDP in the first quarter of 2009 was primarily a culmination of rebound activities in wholesale and retail trade, transport and communications, transport and hotels and restaurants, as well as a drop in fuel prices. The lower growth in the second quarter was reflected across most sectors following prolonged drought, the crisis and repercussions thereof.

There are several forecasts of overall growth in 2009. The government expects the economy to grow at 3.9%. The IMF forecasts 3.2% growth, a 1% point improvement over 2008 (Wahome, 2009b). AIG Investment, on the other hand, downgraded Kenya's economic growth prospects from the 3% it had forecast late in 2008 to 2% (Kang'aru, 2009a). The investment company attributed this to political instability as a result of bickering among political partners in the coalition government. Other analysts predict that the economy will grow by 2.5% in 2009, hindered by poor rains and the global crisis, according to a poll forecast by Reuters. The survey of 13 analysts showed a weakening of sentiment since the last Reuters survey in January 2009, which predicted growth of 4.1% in 2009 (Nyambura-Mwuara, 2009).

CBK forecast that the country's economy would start improving its growth at the beginning of the third quarter of 2009, when government spending for the fiscal year was to begin. A slow approval process for national spending plans presented by the Minister of Finance in June 2009 compounded the effects of the crisis, along with a severe drought at home. Among the indicators of recovery are a return of foreign investors to the NSE, improvements in tourist arrivals and a decline in inflation.

In terms of governance, Kenya dropped seven places on the 2009 Ibrahim Index of Governance, based on 84 indicators (from 59.3 in 2008 to 53.7 in 2009). Kenya was also ranked the 14th most failed state in the world by the Washington-based Foreign Policy Magazine. The authors of the index warned that the crisis could worsen conditions in failed and failing states and that there was a real danger that

many states could slip all at once into the ranks of the failing, although this would not affect Kenya's relative position (Warah, 2009).

Reduced economic growth is expected to lead to reduced employment. The Federation of Kenya Employers (FKE), for example, released a report that indicated that 30% of Kenya companies were laying off workers, with employers jittery about economic recovery. FKE reported that 8000 workers were laid off in the first six months of 2009 and more firms were scaling down and others folding up (Daily Nation, 2009c). According to the 2009 Kenya Economic Survey, available jobs declined from 486,000 in 2007 to 467,000 in 2008 (Oloo, 2009). A number of firms have announced layoffs. In April 2009, for example, East African Breweries trimmed a 'significant number' of its workforce; mobile service firm Zain laid off 141 workers.

## 3.2 Sector-level effects

Table 19 shows the structure and quarterly performance of the Kenyan economy in 2008 and 2009. Agriculture is the dominant sector, accounting for about 23% of GDP, followed by transport and communications (12%), wholesale and retail trade (10%) and manufacturing (10%). Other important sectors are education (6%), real estate, renting and business services (5%), construction (3%) and other services (6%).

**Table 19: Quarterly real GDP growth by activity, 2008-2009Q2 (%)**

| | Share of GDP (average) | Growth | | | | | |
|---|---|---|---|---|---|---|---|
| | 2008 | 2008 | | | | 2009 | |
| | | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 |
| Agriculture and forestry | 23 | -4 | 3 | -5 | -10 | -1.1 | -2.7 |
| Fishing | 1 | -1 | 3 | 3 | 6 | 3.0 | -3.0 |
| Mining and quarrying | 1 | 23 | 37 | 26 | 7 | -7.9 | -3.2 |
| Manufacturing | 10 | 0 | 3 | -1 | 3 | 3.3 | -0.7 |
| Electricity and water | 2 | 10 | 5 | 3 | 4 | -1.7 | -5.0 |
| Construction | 3 | 14 | 35 | 33 | 4 | 30.7 | 10.7 |
| Wholesale and retail trade | 10 | 0 | 6 | 9 | 6 | 4.8 | 2.2 |
| Hotels & restaurants | 1 | -59 | -32 | -35 | -29 | 59.0 | 24.2 |
| Transport and communications | 12 | -2 | -2 | 0 | 3 | 4.1 | 5.7 |
| Financial intermediation | 4 | 7 | 9 | 5 | 4 | 6.0 | 2.4 |
| Real estate, renting, business services | 5 | -4 | 4 | 0 | 8 | 5.5 | 1.5 |
| Public administration | 3 | 0 | 2 | 3 | 4 | 2.2 | 1.8 |
| Education | 6 | 2 | 3 | 4 | 7 | 4.7 | 4.1 |
| Other services | 6 | 3 | 3 | 4 | 2 | 2.9 | 3.0 |
| All industries at basic prices | 100 | -2 | 4 | 1 | -1 | 4.0 | 1.8 |
| All industries excluding agriculture | 62 | -1 | 4 | 4 | 3 | 5.7 | 3.0 |
| Taxes on products | -14 | 3 | 2 | 8 | 6 | 4.0 | 4.8 |
| GDP at market prices | 100 | -1 | 3 | 2 | 0 | 4.0 | 2.1 |

*Sources*: KNBS data; Oloo (2009).

Starting with the third quarter of 2008, which coincides with the onset of global financial crisis, real GDP grew by 2%, compared with 3% in 2008Q2 and -1% in 2008Q1. The worst performance in 2008Q3 was in hotels and restaurants, because of the poor performance of the tourism sector (-35%), followed by agriculture (which is rain fed, -5%) and manufacturing (-1%), which registered negative growth. The best performers were construction (33%), mining and quarrying (26%), wholesale and retail trade (9%) and financial intermediation (5%), which registered a growth of at least 5% compared with 2007Q3.

This is repeated in 2008Q4, with poorer performance. Real GDP grew by 0%, with the worst performance being in hotels and restaurants (-29%), followed by agriculture (-10%), which registered negative growth. The best performers were mining and quarrying (7%) and wholesale and retail trade (6%), which registered a growth of at least 5% compared with 2007Q4.

After attaining an impressive revised growth of 4.0% in 2009Q1, the economy grew by a provisional estimate of 2.1% in 2009Q2, remaining at almost the same level as in 2008Q3. Sectoral performances varied considerably, with hotels and restaurants achieving the highest growth, of 24% to 59%, reflecting a recovery in tourism, while the drought caused electricity and water to record the largest contraction (1.7% to 5.0%). Hotels and restaurants, construction, transport and communications and financial intermediation were the key drivers of growth during these two quarters. On the other hand, agriculture and forestry, manufacturing, electricity and water and fishing saw slowed growth. The economy grew by 0% in 2009Q3. Persistent drought and the current crisis are the main factors restraining the economy from attaining its growth potential (KNBS data, 2009).

## 3.3 Fiscal effects

The global financial crisis and other crises have aggravated Kenya's budget deficits. Implementation of the 2008/09 budget was faced with numerous challenges, including inability to achieve revenue targets because of the slowdown of the economy and additional drought-related expenditures and famine relief. The overall budget deficit (including grants) in 2008/09 was projected at KSh127.0 billion (5.3% of GDP). The deficit was to be financed through net external borrowing of KSh25.2 billion (1.1% of GDP); net domestic borrowing of KSh54.5 billion (2.3% of GDP), including KSh18.8 billion in long-term domestic infrastructure bonds; privatisation receipts totalling KSh8 billion (0.3% of GDP); KSh33.6 billion from issuance of a sovereign bond to finance infrastructure development; and KSh5.7 billion additional financing from Telkom Kenya and Kenya Petroleum Refineries.

These projections were adversely affected by the crises. For example, the government was unable to sell off parastatals such as the National Bank of Kenya and Kenya Wine Agencies, and the $500 million sovereign bond was suspended. The Kenya Revenue Authority (KRA) was also unable to achieve its target for the first quarter of the financial year (KSh10 billion), although it was able to do so in the second quarter.[28] For 2008/09 overall, the KRA missed its revenue target by KSh12.3 billion although, compared with 2007/08, revenue grew by KSh61.7 billion. The KRA collected KSh480.6 billion against a target of KSh492.9 billion, representing revenue growth of 14.7%. It attributed the missing of its targets to rising inflation, the volatile exchange rate, mixed performance of the NSE and the waiver of KSh6.9 billion of import duty on maize, which were directly and indirectly influenced by the global financial crisis (Nyabiage, 2009b).

Faced with a gaping hole in its finances, the government revised the budget several times by instituting massive cuts in the original spending plans and freezing expenditure on key infrastructure projects. In April 2009, for example, the budget for 2008/09 was cut by a massive KSh23 billion, implemented across all ministries. The recurrent budget was cut by KSh6.6 billion and the development budget by KSh16.7 billion. Those hit hardest by the cuts were the Ministries of Public Health, Energy and Roads and the Office of the President, losing more than KSh1 billion each. However, Finance, Agriculture, Water and Irrigation were offered extra funding of at least KSh2 billion each.

This was the second austerity measure in early 2009 to be implemented by the government, the first having been unveiled in February, as it tried to adjust its spending plans in line with deteriorating economic conditions. The measures in February 2009 targeted cuts in expenses on training, foreign travel and purchases of furniture. Although the government was negotiating to borrow from the IMF ($209 million was approved in May 2009), the borrowed money was to be utilised specifically to boost the country's dwindling foreign exchange reserves and was, therefore, not available for discretionary spending. The World Bank was seen to be reluctant to discuss budget support, citing governance concerns (Kisero, 2009).

In April 2009, Kenya signed agreements with two advisors who were to study and recommend the best way of selling its stake in the National Bank of Kenya and Kenya Wine Agencies. The plans were part of

28 The financial year runs from July to June. The development budget finances capital expenditures.

a privatisation drive aimed at raising KSh8 billion shillings ($88 million) that the government needed to help tackle the KSh127 billion deficit. It was noted, however, that the process might extend beyond the end of the 2008/09 fiscal year, as it would take four to seven months to complete the sale. The government was also planning to sell shares in other firms, including five sugar factories, Kenya Pipeline Company, hotels, manufacturing concerns and some power stations (Reuters, 2009e).

In the 2009/10 fiscal year, the government rolled out an expansionary budget. The KRA revenue target was set at KSh545.2 billion, a growth of 13.5% over what was collected in 2008/09 (Nyabiage, 2009b).[29] The budget read on 11 June 2009 had a deficit of KSh109 billion. A major concern is that the large budget deficit (about 6% of GDP) will crowd out lending to the private sector. This is aggravated by the fact that at least five companies (including Safaricom, KenGen, Stanbic Centum and Shelter Afrique) have announced plans to borrow more than KSh20 billion over the same period. The government was already spending more than half of the money it was borrowing to pay interest on the ballooning domestic debt, putting the sustainability of its borrowing plan into question.

CBK data show that, between June 2008 and June 2009, the government took about KSh88 billion in new borrowing from the public and paid KSh46 billion in interest and other charges. The accumulated domestic debt as at 30 June 2009 stood at KSh518.3 billion, accounting for 21.7% of GDP. However, according to the IMF/World Bank, under the proposed monetary programme and considering the flight to safety by commercial banks, there is limited risk that increased government borrowing will crowd out credit to the private sector, which is likely to remain weak in the short run. They note that additional funds are necessary to mitigate the impact of the drought (see Wahome, 2009c). According to CBK, the KSh109 billion that the government intended to raise from the domestic market would not hurt the economy. Borrowing, among other measures announced in the 2009/10 budget, will drive up private consumption, employment and economic growth. The programmes and tax measures contained in the budget will crowd in rather than crowd out private sector activity (Ondari, 2009b). This is because the projects targeted, mainly infrastructure, such as roads and energy, will lower transaction costs and enhance the profitability of the private sector. As well, private sector credit to the public sector is four to one, so for every shilling available for domestic credit, 80 cents goes to the private sector with the government borrowing 20 cents.

Compounding the problem, the KRA missed the target for the first quarter of the 2009/10 fiscal year by KSh3.8 billion, as we have seen, collecting KSh124 billion.

## 3.4 Poverty and distributional effects

Growth reductions in developing countries can be associated with increases in poverty, with a high correlation between growth, poverty and social tension indicators. Decomposition analysis of changes in poverty by Ali and Elbadawi (1999) for Kenya (among other countries), based on a poverty line that was permitted to change with mean consumption, found high responsiveness of poverty to growth. The elasticity of the headcount index to mean income was -0.74. The impact of reduced growth is therefore to increase the headcount poverty ratio, which had reduced from 56% in 2000 to 46% in 2006 by 2% to 3%, compared to what it would otherwise had been, this in turn affecting other human indicators.

The structure of the population suggests who can be expected to be afflicted by increased poverty. According to CBK, 7 million Kenyan adults are engaged in pastoral, non-commercial agricultural pursuits. A further 9.5 million are employed or in self-employment. Of these 9.5 million in employment, 1.9 million are engaged in the informal sector and about 0.5 million are employed by the public sector (in teaching, civil service and parastatals). While the crisis itself may not have any effects, the other problems that have affected Kenya in the past two years are likely to affect those employed outside the

29 The composition of ordinary revenue in 2008/09 was income tax 35.9%, VAT 26.1%, excise duty 14.2%, import duty 7.1%, other taxes 7.9% and appropriations in aid 8.7%.

informal and public sectors, in commercial agriculture, manufacturing and tourism, who interact directly with the global financial system.

Increased poverty in turn is likely to affect other human development indicators adversely. Indeed, according to Devarajan, the impacts of growth reductions on these indicators of human development are often asymmetric.[30] Child mortality, primary school enrolments and life expectancy, for instance, rise during growth reductions but barely fall during accelerations, although there is no evidence yet that this has happened in Kenya.

30 See a series of articles at Shanta Devarajan's blog, http://blogs.worldbank.org/africacan/.

# 4. Policy responses: A critical review

## 4.1 Macroeconomic policies to manage the impact of the crisis

### 4.1.1 Monetary policies

A debate occurred as to whether the country needed a monetary stimulus. The argument was that this would release resources that would eventually be channelled to the real sector. The counterargument was that, given the high subscription to weekly treasury bills and the impressive performance of the infrastructure bond that the government floated in February 2009, there was already large liquidity in the system. Reduction in interest rates might also encourage capital outflows, with implications for the exchange rate, although Kenya's trading partners had also reduced their interest rates. Indeed, low interest rates could permit the government to spend more on infrastructure without crowding out the private sector.

Among some of the monetary policies implemented at the onset of the global financial crisis, CBK lowered the cash ratio from 6% to 5% and the Central Bank Rate (CBR) from 9% to 8.25%, in order to lower interest rates and enhance credit supply in the economy, although some observers contended that these actions were not enough to significantly achieve these objectives. On 22 July 2009, the cash ratio was reduced further, from 5% to 4.5%, releasing about KSh5 billion for banks to lend; the CBR was reduced from 8% to 7.75% and further to 7% in November 2009. CBK continues to complain that, despite cutting the cash ratio and the CBR, lending rates have remained unchanged, limiting uptake of credit by the private sector. Indeed, lending interest rates increased from 13.7% in September 2008 to 14.7% in September 2009. This was attributed by CBK to higher risk perception by commercial banks.[31]

According to CBK, the main areas of focus for the monetary authorities in dealing with the global crisis are to: 1) continuously strengthen regulation and supervision of the financial sector, including enhancing capital requirements and the role of credit rating agencies; 2) undertake reforms in the capital market to restore investor trust and confidence; and 3) strengthen coordination of the various regulatory authorities through creation of a Financial Services Authority.[32] With the country increasingly moving into universal banking, CBK and the various regulatory agencies across the capital market, insurance and pensions have signed a memorandum of understanding (MoU) for collaboration among themselves in the supervision of financial institutions and other matters of mutual interest. A technical committee comprising representatives from each of the four regulators will oversee implementation of the MoU.

### 4.1.2 Fiscal policies

Besides actions by CBK, the government has initiated a number of other programmes, although these may not be linked directly to the global crisis. Some have been initiated to mitigate the effects of the post-election violence, the escalation of oil prices in the first half of 2008 and the continuing food crisis. The food crisis in particular has dominated domestic economic debate and has moved it to the forefront of policymaking, by severely affecting the balance of payments and the budget (CBK, 2009b). For example, the government initiated the KSh15 billion Kazi Kwa Vijana programme in March 2009 to mitigate the rampant youth unemployment in the country. Besides providing employment, such a

31 The evolution of the short-term interest rates (i.e. the repo rate, the interbank rate and the 91-day and 182-day treasury bill rates) has reflected the tightness of liquidity in various market segments. The liquidity build-up before allotment of the Safaricom shares, for example, was largely locked up in the leading transactions bank, which led to skewed liquidity distribution in the interbank market in mid-2008. To ease the resultant liquidity shortfall, CBK undertook repo sales to mop up the excess liquidity in the lead bank and reverse repo purchases to provide liquidity to banks that were short of liquidity. CBK data show the interbank rate falling from 8.1% in July 2008 to 3.1% in June 2009. The decline was a reflection of increased liquidity availability in the economy and thus lowered cost of credit.

32 Nyangito (2009). See Kilonzo (2008) for a discussion of the reforms required in the capital market.

programme is vital in boosting the private consumption necessary to stimulate economic growth in the country. The programme is dovetailed into the Economic Stimulus Programme (ESP, see below) and aims to create 300,000 jobs for youth by December 2009 through country-wide projects distributed as follows: water and irrigation projects (50,000); forestry sector (100,000); Ministry of Youth Affairs (105,000); road construction (50,000); and urban garbage collection and waste management projects (15,000). By June 2009, KSh3.4 billion had been disbursed to the various ministries for the programme, with an additional KSh6.6 billion allocated in 2009/10 (Barasa and Muindi, 2009).[33]

In August 2009, the government launched the ESP, defined as a 'short to medium term, high intensity, high impact programme aimed at jumpstarting the economy towards long-term growth and development, securing the livelihoods of Kenya and addressing the challenges of regional and inter-generational inequity' (Kenyatta, 2009a). The ESP was to be anchored within the principles of the government's blueprint Vision 2030 and recognition of global concerns on environmental sustainability. In the 2009/10 budget speech, (Kenyatta, 2009b), one of the objectives of the ESP was to enable Kenyans to 'emerge with strength when the global economy recovers, and enhance their capabilities and competitiveness for the long term'.

The ESP was to cover a six-month period, officially starting on 1 July and ending on 31 December, 2009. Under the package, the government would spend KSh22 billion in 210 constituencies in the country with the aim of injecting money into rural areas to stimulate consumption and offer employment to youth. Besides reviving irrigation schemes, farmers in 180 constituencies would benefit from newly built wholesale and fresh produce markets, *jua kali* (informal) artisans would benefit from the construction of sheds and purchase of equipment and 140 constituencies were marked for the construction of 200 fish ponds at a cost of KSh1 billion.

The Kenyan ESP raises a number of issues (see Shaw, 2009). Do the proposal and activities duplicate what is already being done? Within the tight budgetary constraint, would the money actually get to these far-flung places? How much of it has been disbursed? Who will oversee and implement the projects? There is also the issue of the criteria for deciding, for example, which two primary schools in each constituency should be chosen to be upgraded to centres of excellence. On duration, even if the funds are there and the implementation capacity is available, was it really realistic to attempt to do so much in just six months?[34] It is too early in the ESP to answer these questions.

## 4.2 Social policies to respond to the impact of the crisis

In the 2009/10 budget speech (Kenyatta, 2009b), it was reported that the government was in the process of developing a national social protection policy. Kenya as a developing country does not rely much on cash transfer programmes. A recent exception is the paying of KSh10,000 to internally displaced families to facilitate their return to their homes after the 2007 post-election violence; some were provided with KSh25,000 to rebuild their homes. Similarly, the government does not provide many subsidies outside the education and health sectors. A recent exception is maize flour, a stable food in the country. The government was to subsidise milling (KSh200 per bag) and the price of the final product (KSh52 per 2kg bag compared with a market price of more than KSh72 per 2kg bag). The subsided maize flour was to be distributed by the National Cereals and Produce Board, which has only a few branches in the country, so the sale of the subsidised products would not widespread. This initiative eventually collapsed and has been described as a political gimmick.

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33 A food for work programme was suspended in July 2009 following an order by the Minister for Special Programmes. Under the scheme, those in need of relief food were required to work before being given supplies. The Minister said that, as a result of hunger, some people were unable to get relief food because they had no strength to work (WFP, 2009).

34 Tenders for the construction of *jua kali* sheds were floated only in September 2009. Tenders for revamping schools of excellence were floated in December 2009.

The Ministry of Gender, Children and Social Development has attempted to design several cash transfer programmes. Beneficiaries of a proposed plan to feed and provide social protection for the extremely poor, for example, were approved at a stakeholders' sensitisation workshop in May 2009 (Ngirachu, 2009). This plan would use initial benchmarks from the 2005/06 Integrated Household and Budget Survey, which found 19% of Kenyans to be extremely poor and set the poverty line for the extremely poor at KSh988 in rural areas and KSh1474 in urban areas. The plan was to be ready for a cabinet memorandum by June 2009 which, if approved, would guide the preparation of a sessional paper to be presented to Parliament.[35]

In July 2009, the Ministry further announced that people aged over 65 not on any pension would be paid a monthly stipend of KSh1000 from the state. The Ministry would cater for payments from its budget and was waiting only for District Commissioners to provide the number of beneficiaries, estimated at 1.026 million, about 2.5% of the population (Manyindo, 2009). This initiative was allocated KSh200 million in the 2009/10 budget.

A social welfare programme involving a cash transfer to targeted orphans and vulnerable children (OVC) was also set to be strengthened in some 50 districts. The Cash Transfer Programme for Orphans and Vulnerable Children (CT-OVC), which had been running on a pilot basis for four years, was disbursing payments to households with OVC through the Postal Corporation of Kenya, expected to cater to 100,000 households by 2012. The number of orphans has increased, estimated at about 2.4 million. Payments are made every two months, at KSh3000 per household. The programme has received support from the UN Children's Fund (UNICEF), the UK Department for International Development (DFID) and the World Bank (see World Bank, 2009a).

The social security items in the social security expenditures apply mainly to formal sector workers. The government provides a non-contributory pension to its workers, although there are plans to make it contributory.[36] Other formal sector workers are covered by the contributory National Social Security Fund (NSSF). Membership is mandatory unless a worker is covered under another industry or occupation-specific scheme. Coverage on social security is therefore quite narrow, with formal sector workers comprising about one in eight of the labour force. There are, however, efforts to encourage the self-employed to join the NSSF or other insurance schemes.

The general approach taken in the country is to define core poverty programmes (CPPs). These are programmes/projects that purportedly impact positively on the lives of the poor by: 1) increasing their incomes or improving their quality of life or enhancing security; 2) empowering them or improving governance; and 3) promoting equity and equality in society. These programmes are supposed to be given high priority by the government and are cushioned against budget cuts to ensure that goals are achieved as planned.

The budget for CPPs has expanded significantly over time. In nominal terms, only KSh20.3 million, or 7.6% of actual expenditure, was approved in 2000/01. About KSh78 billion, or 16% of total expenditure, was approved for these programmes in 2007/08, although only 67% had been spent or committed by September 2008. In 2008/09, this component of the budget was reduced to KSh62.9 billion. These and other programmes are likely to be affected severely by the budgetary crunch facing the country as a result of the post-election violence, the fuel crisis in late 2008, the food shortage and the global financial crisis, which have all reinforced one another in increasing government expenditure and undermining revenue generation, particularly because of reduced economic growth.

35 This had not been done by the end of 2009.

36 The contributory scheme, which was set to be launched on 1 July 2009, was later suspended to await a law that would guide its implementation. It was to cover 400,000 civil servants and teachers in the country. See Siringi (2009).

## 4.3 Multilateral and bilateral donor responses in Kenya

Several donors have come to assist the country during the global crisis, although some support was planned earlier. For example, the World Bank announced in May 2009 support for Kenya of KSh33 billion in a soft loan. Funds were for projects in four sectors, with the loan intended to help cushion the country from the adverse effects of the crisis, although financing of these projects was actually proposed in 2007 and delayed by the post-election violence that rocked the country in early 2008 (Bonyo, 2009). Among these are: 1) Northern Corridor transport improvements (KSh19.7 billion); 2) energy sector recovery, mainly involving increasing the number of households connected to the national grid as well as distribution facilities to reduce outages (KSh6.2 billion); 3) the CT-OVC (KSh3.9 billion); and 4) Phase 2 of the Lake Victoria Environment Management Programme to improve the livelihoods of communities by reducing environmental stress (KSh2.4 billion). The latest round of lending by the World Bank brought its Kenya portfolio to KSh127.4 billion.

The World Bank also approved a $90 million loan in June 2009 to strengthen agricultural productivity through technology in East Africa. Funds were to benefit Ethiopia, Kenya and Tanzania, with an allocation of $30 million each.

Similarly, funding under the IMF Poverty Reduction and Growth Facility ended in January 2009, and in May 2009 Kenya signed a new $209 million loan deal through the IMF's Exogenous Shocks Facility to revamp the country's foreign exchange reserves and provide import credit. The endorsement would also open doors for more international lending. Another example is of China, which in August 2009 donated KSh3.2 billion to alleviate the food crisis in the country. The country also received a KSh340 million grant from Japan in September 2009.

It is not clear to what extent donor policies have changed as a result of the global financial crisis (te Velde and Massa (2009) analyse this issue at the global level). A statement attributed to IMF directors when discussing Article IV consultations in September 2008 points to a change in attitude. The directors noted that some aspects of past engagement were disappointing, in particular the protracted focus on governance issues and insufficient attention to programme ownership, indicating some break with the IMF's lending practices (IMF, 2008b). China has pledged that its aid policies will not change.

# 5. Conclusions

## 5.1 The impact of the crisis: An update

The objective of this paper has been to update and extend an examination of the effects (so far) of the global financial crisis, possible impacts (economic, financial and social) and the scope and limitations of current policy responses. Table 20 summarises the transmission mechanisms of and policy responses to the global crisis in Kenya. It should be noted that the country faced a number of other crises in 2008 and 2009, and it has been difficult to disentangle their effects from each other.

**Table 20: Summary of crisis transmission mechanisms and policy responses**

| Transmission mechanisms | Status 2009 | Outlook 2010 |
|---|---|---|
| Banks | The banking system remains well capitalised and stable (IMF, 2009b). Bank supervision has been stepped up to detect any emerging issues.<br><br>No contagion. Among other indicators, total NPLs remain low at 6.9% of advances in Oct 2009 vs. 6.6% in Oct 2008; capital adequacy is 33.5% against a statutory requirement of 12%. | Increased lending and other financial services to the real sector as the economy recovers. |
| Trade | Current account deficit at 6.7% of GDP. Recovery in tourism helped (partly) to stabilise the services account. | Current account deficit projected to decline to below 6% of GDP. |
| Financial flows (remittances, FDI, other flows) | Remittances projected to grow by 3% (higher than expected but below pre-crisis growth rates).<br><br>Net FDI expected to drop (but 'other financial flows' have increased).<br><br>NSE 20-Share Index mirrors Dow Jones and remains more than 50% below mid-2008 levels. | Remittances expected to recover in line with global trends; reduced transaction costs with expansion of 'mobile money' can trigger additional transfers.<br><br>FDI remains subdued until the global economy recovers; it is dependent on IPOs, particularly in services. |
| **Policy responses** | **Status 2000** | **Outlook 2010** |
| Monetary easing and debt management | Reverse repos to inject liquidity in the market and keep broad money aggregates on target. CBR reduced by 175 basis points to 7%.<br><br>Sharp decline of inflation to 5% by end-2009; average inflation for 2009 10.2%.<br><br>Drawing down of external reserves, from 4 months to 2.7 months of import cover. Exogenous Shocks Facility from the IMF injected $209 million. | Ensure price stability and maintain inflation at 5%.<br><br>Reserves build up to 4 months of import cover.<br><br>Expected improvements in debt management and increased liquidity in government bond markets. |
| Fiscal stimulus | Supplemental budget for 2008/09 increased deficit to 5.9% of GDP, but realisation at 3.7% owing to difficulties in absorption.<br><br>2009/10 increased deficit to 6% of GDP; additional ESP spending for rural infrastructure and social safety nets. | Debt to GDP ratio remains the fiscal anchor. Debt sustainability and interest rate impact of additional government borrowing will determine the size of stimulus if still required. |

*Source*: Adapted from World Bank (2009b).

This paper has addressed a whole range of issues. On the banking system, for example, it looks at a number of indicators to conclude that, as in Phase 1, the banking system seems poised to withstand the global financial and economic crisis, as the fundamentals seem quite sound and have not been affected substantially. However, financial statements for the first half of 2009 show a sharp decline in banks' profitability. In a study of the banking system's balance sheet to gauge the impact of the global financial crisis, the IMF (2009b) concludes that 'after a period of instability, the central bank position is generally sound; the deterioration of the public sector net financial position puts it at greater risk of interest rate shock; reduction in foreign currency loans and liability has resulted in an improvements in the banking sector's net foreign currency position; and households and firms have increased their liability in foreign currency'.

In the capital market, by March 2009 the NSE 20-Share Index had fallen to a near seven-year low. The index improved between March and June 2009, but slumped in July-September 2009. The index increased marginally by about 5% between end-September and December 2009 (by 0.8% in October, 4.1% in November and -0.1% in December 2009) as investors focused on the bond market. Financial statements by stockbrokers and investment banks for the first half of 2009, however, show that these institutions made substantial losses, questioning their ability to survive if conditions were to continue. Data on FDI show a substantial decline in 2008 to a more normal level ($50 million) following an upsurge in 2007 attributable to the entrance of a new mobile telephone operator and the privatisation of Telkom Kenya. It is not clear to what extent these changes can be attributed to the global crisis relative to the other crises that the country faced in 2008 and 2009.

On trade, there was a major decline in 2008 of the tourism sector, although there was some recovery in 2009. By November 2009, tourism arrivals and earnings were up 90% from 2008. Tea exports increased by 5.4% and earnings by 36.2% in 2008. Despite the overall production shortfall in 2009, Kenya's income from tea exports increased by 17% in the first half of 2009, amounting to KSh30.8 billion. In addition, horticultural exports increased by 4.5% and earnings by 24.6% in 2008. Between January and August 2009, however, horticultural output declined by 7.4%, to 123.9 million kilograms, attributed mainly to a decline in flower production, which had dropped 30% by October 2009, with exports moving in the same direction. Coffee production peaked at 130,000 metric tonnes in the 1988/89 crop year and has declined systematically since then. Volume of coffee exports declined by 24.5% in 2008, with coffee earnings roughly unchanged. Less than 54,000 metric tonnes of coffee exports is expected in 2009. Overall, volume of aggregate exports expanded by 23.3% and the price index by 18.9%, with the terms of trade increasing by 10%.

Remittances from the Kenyan diaspora increased by 6.6% in 2008. In the first 10 months of 2009, remittances declined slightly, to $451.6 million compared with $466 million in the same period in 2008, although remittances through informal channels are not captured by these CBK data. The OECD-DAC database shows a substantial increase in foreign aid to the country in 2008. Kenya received $1523 million in 2008 (compared with $1345 million in 2007), with committed funds fully disbursed in 2009, compared with only 53% in 2008.

With the global financial crisis and other crises, the current account deficit has widened, continuing an earlier trend. It rose from $1.10 billion in 2007 to $2.12 billion in 2008, attributed mainly to the huge increase in the value of oil imports. The current account deficit increased further to $2.388 billion in the year to August 2009, affecting the exchange rate and foreign exchange reserves.

All the transmission mechanisms discussed above have affected growth. In 2008, the growth rate declined to 2.1%. Growth in the first quarter of 2009 was 4%, declining to 2.1% in the second quarter. Reduced economic growth has led to reduced employment in the country.

The global financial crisis and other crises have also aggravated the country's budget deficits. Implementation of the 2008/09 budget faced numerous challenges, which included inability to achieve revenue targets and additional expenditures arising from drought and famine reliefs. The overall budget deficit (including grants) in 2008/09 was projected at KSh127.0 billion (5.3% of GDP). Faced

with a gaping hole in its finances, the government revised the budget several times by instituting massive cuts in the original spending plans and freezing expenditure on key infrastructure projects in February and April 2009. In the 2009/10 fiscal year, the government adopted an expansionary fiscal stance, with the target for KRA being KSh545.2 billion, a growth of 13.5% over what was collected in 2008/09. A budget deficit of KSh109 billion (about 6% of GDP) is envisaged, with concerns that domestic borrowing to finance the deficit will crowd out lending to the private sector. Among some of the macroeconomics policies implemented to manage the crisis, CBK has so far lowered the cash ratio from 6% to 4.5% and the CBR from 9% to 7%. Lending interest rates have actually increased, however, from 13.7% in September 2008 to 14.7% in September 2009. Besides actions by CBK, the government has initiated a number of programmes, which may not be directly linked to the global financial crisis. In August 2009, for example, the government launched the KSh22 billion ESP to fund various activities.

Kenya as a developing country does not rely much on cash transfer programmes. However, there have been attempts to design and implement several cash transfer programmes to target the very poor, the elderly and OVC. The latter has received support from UNICEF, DFID and the World Bank. Several donors have come to assist the country during the global crisis and other crises, including the World Bank, the IMF through its Exogenous Shocks Facility, China and Japan. It is not clear to what extent donor policies have changed as a result of the crisis, although China has pledged that its aid policies will not change.

## 5.2 Looking ahead: How well is the country positioned to gain from a future recovery and grow sustainably?

At its onset, there was a big debate on the likely impacts of the global financial crisis on Kenya. Different views were expressed. According to the Prime Minister, the Kenyan economy would be badly affected. On the other hand, Ministry of Finance and CBK officials postulated that the impacts would be indirect and most likely small. According to the latter, the potential impacts on Kenya were not so much from the financial crisis but more from the recession in the global economy, with the contagion felt through a decline in commodity prices, contraction of markets for export products and decline in ODA and other capital flows, including remittances. According to CBK (2009c):

> 'Kenya is primarily a rural agro-based economy with only a small minority of the population directly interfacing with the developed world. The main sectors likely to feel any significant impact [are] tourism and commercially-oriented agriculture such as horticulture, tea and coffee. Other effects might be felt through foreign exchange volatility, inputs (cost and availability) and also the credit and trade restrictions. Strategies by the world economies affecting relative interest rates will affect the flow of short-term capital (hot money) internationally.'

Given the above policy differences, Kenya did not (at least initially) articulate a strong view on how to handle the global crisis. A taskforce was set up to look into ways of cushioning Kenya's economy from the adverse effects, comprised of officials of the Ministries of Finance and Planning and National Development, as well as CBK, but this has been moribund.

On optimal response, the IMF, for example, advises developed countries to: 1) stabilise financial markets through continued liquidity support and further capital injections; 2) provide global fiscal stimulus, on the order of magnitude of 2% of world GDP, which would raise growth by two percentage points, with the onus on countries with space to expand without jeopardising medium-term sustainability; 3) ease monetary policy; and 4) avoid beggar-my-neighbour policies (see Bredenkamp, 2008).

For poor countries like Kenya, the IMF advises that: 1) they should leave the stimulus task to larger more developed countries; 2) those with scope to undertake countercyclical policies should do so, depending on their debt situation and availability of financing; 3) they continue strengthening social safety nets; 4) they restore inflation control; and 5) they allow exchange rates to adjust. With a serious budget constraint arising from financing the various crises that the country experienced in 2008 and

2009, and hence limited ability either to provide stimulus packages or to enhance social safety nets, the government seemed to be following the IMF advice and left the matter to CBK to undertake a countercyclical monetary policy.

A widespread consensus has now emerged that the global financial crisis will have had a major impact on the economy. This induced the policy actions discussed above and mainly articulated in the 2009/10 budget, with the country positioned to gain from a future recovery from the crisis. According to the Kenya Institute for Public Policy Research and Analysis (KIPPRA), the economy has survived the triple assault of the post-election violence, prolonged drought and global recession, and is now showing signs of recovery (Menya, 2009).[37] According to the World Bank, Kenya's economic prospects are 'quite' good, despite the various challenges facing the country, with favourable foundations for rapid economic growth already in place. These include the country's geographic location and fairly established manufacturing and services sectors. The microeconomic management and the business environment are good for economic growth and the ongoing investments in roads, power and water would be expected to pay off. Policies should therefore focus on macroeconomic management, regulatory reforms and the fight against corruption (Ondari, 2009c).

According to the IMF (2009b), the key lessons that would reduce future risks and vulnerabilities to financial crisis are recognising the importance of the credibility of the exchange policy, adequacy of reserves, sound debt management, proactive bank supervision and regulation and sound macroeconomic policies in response to cyclical developments.

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37 Because of drought, for example, Masinga Dam was shut because of low water levels caused by poor rains in the Mt Kenya catchment area, leading to power rationing in the country from early August 2009 to October 2009. Masinga Dam is the fourth-largest hydropower station on Tana River, with an installed capacity of 40 MW, after Gitaru (225 MW), Kiambere (154 MW) and Kamburu (96 MW).

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# Annex 1: Capital held by commercial banks in Kenya, 2006-2008

| Bank | Core capital (Ksh.m) | | | Core capital/total deposit liabilities (%) | | | Core capital/TRWA (%) | | | *Total capital/TRWA (%)* | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | 2006 | 2007 | 2008 | 2006 | 2007 | 2008 | 2006 | 2007 | 2008 |
| ABC Bank | 670 | 808 | 959 | 16.41 | 15.89 | 17.97 | 17.34 | 17.08 | 21.27 | 17.52 | 17.16 | 21.36 |
| Bank of Africa | 746 | 800 | 1009 | 15.12 | 14.49 | 11.59 | 16.05 | 13.59 | 12.42 | 16.9 | 14.41 | 13.19 |
| Bank of Baroda | 1263 | 1466 | 1658 | 12.48 | 11.57 | 11.13 | 27.53 | 18.94 | 18.53 | 27.53 | 18.94 | 19.71 |
| Bank of India | 941 | 1168 | 1690 | 13.16 | 13.56 | 16.55 | 25.14 | 28.48 | 22.09 | 25.14 | 28.48 | 32.09 |
| Barclays Bank of Kenya | 12375 | 17019 | 19980 | 13.19 | 15.6 | 15.8 | 12.12 | 13.03 | 15.02 | 12.12 | 13.03 | 18.75 |
| CFC Bank | 2765 | 3107 | 5952 | 15.42 | 15.46 | 9.67 | 14.28 | 15.56 | 11.41 | 18.29 | 19.13 | 14.65 |
| Chase Bank | 622 | 665 | 763 | 19.24 | 15.56 | 10.68 | 23.18 | 15.67 | 11.32 | 23.18 | 16.24 | 12.62 |
| City Bank | 5651 | 7112 | 8898 | 22.31 | 24.02 | 28.53 | 26 | 26.54 | 25.29 | 26.6 | 27.14 | 26 |
| City Finance Bank | 354 | 325 | 321 | 280.99 | 140.52 | 195.45 | 75.71 | 77.73 | 77.91 | 75.71 | 77.93 | 78.27 |
| Commercial Bank of Africa | 3030 | 3459 | 4295 | 9.32 | 9.93 | 9.59 | 14.84 | 13.47 | 12.44 | 15.29 | 14.1 | 13.02 |
| Consolidated Bank | 516 | 543 | 668 | 20.96 | 19.03 | 20.33 | 19.23 | 16.87 | 17.09 | 21.47 | 18.87 | 18.65 |
| Co-operative Bank of Kenya | 4361 | 5882 | 12613 | 9.05 | 10.74 | 19.15 | 13.29 | 14.22 | 22.01 | 14.56 | 14.51 | 23.48 |
| Credit Bank | 458 | 521 | 646 | 23.35 | 19.62 | 23.3 | 22.56 | 28.92 | 28 | 23.23 | 30.02 | 28.85 |
| Development Bank of Kenya | 1033 | 1109 | 1229 | 78.42 | 69.69 | 55.83 | 53.21 | 39.58 | 31.58 | 53.21 | 39.58 | 31.58 |
| Diamond Trust | 2531 | 4279 | 4457 | 15.13 | 14.7 | 9.9 | 17.29 | 19.1 | 15.62 | 20.65 | 19.14 | 19.77 |
| Dubai Bank | 397 | 403 | 396 | 49.63 | 40.35 | 38.39 | 35.54 | 30.15 | 25.53 | 35.54 | 30.15 | 26.48 |
| EABS Bank (now Ecobank) | 1300 | 1171 | 1026 | 18.54 | 15.51 | 12.3 | 20.11 | 16.98 | 14.27 | 20.55 | 18.23 | 15.52 |
| Equatorial Commercial Bank | 617 | 670 | 648 | 18.8 | 16.28 | 17.68 | 21.02 | 20.29 | 20.21 | 21.02 | 20.29 | 21.07 |
| Equity Bank | 2201 | 13666 | 14272 | 13.47 | 43.34 | 28.35 | 13.85 | 45.68 | 29.23 | 13.85 | 58.92 | 40.77 |
| Family Bank | | 1146 | 1409 | | 19.03 | 12.29 | | 22.05 | 19 | | 22.23 | 19.12 |
| Fidelity Commercial Bank | 274 | 290 | 391 | 13.84 | 10.55 | 10.36 | 16.21 | 13.22 | 12.96 | 16.21 | 14.15 | 14.04 |
| Fina Bank | 779 | 852 | 913 | 9.8 | 9.25 | 7.96 | 16.97 | 13.8 | 12.31 | 17.75 | 14.52 | 13.16 |
| Giro Commercial Bank | 446 | 484 | 564 | 9.92 | 9.85 | 10.99 | 15.95 | 15.83 | 17.53 | 17.2 | 17.08 | 18.78 |
| Guardian Bank | 788 | 805 | 835 | 19.73 | 17.72 | 18.2 | 22.61 | 23.75 | 23.34 | 22.61 | 23.75 | 23.34 |
| Habib A.G. Zurich | 648 | 741 | 752 | 14.9 | 14.79 | 14.04 | 38.82 | 35.73 | 29.1 | 38.82 | 35.73 | 29.1 |
| Habib Bank Ltd | 446 | 522 | 613 | 18.35 | 19.11 | 20.27 | 57.58 | 46.29 | 47.13 | 57.58 | 46.29 | 47.65 |
| HFCK | 706 | 740 | 286 | 9.27 | 8.43 | 28.49 | 13.1 | 13.12 | 40.52 | 16.19 | 16.12 | 43.17 |
| I&M | 2424 | 3750 | 3933 | 13.3 | 15.87 | 13.87 | 12.82 | 14.4 | 10.95 | 12.86 | 14.44 | 12.62 |
| Imperial Bank | 1249 | 1455 | 1725 | 17.66 | 16.95 | 16.56 | 19.78 | 17.9 | 19.01 | 19.78 | 18.9 | 20.14 |
| Kenya Commercial Bank | 9169 | 10046 | 16127 | 11.88 | 10.64 | 12.78 | 15.75 | 13.61 | 15.45 | 15.75 | 13.61 | 15.45 |
| K-Rep Bank | 849 | 977 | 1084 | 25.66 | 21.79 | 24.07 | 18.95 | 17.38 | 17.66 | 19.82 | 18.1 | 18.41 |
| Middle East Bank | 809 | 841 | 861 | 34.62 | 44.16 | 42.59 | 30.93 | 38.61 | 42.96 | 31.33 | 39.43 | 43.25 |
| National Bank of Kenya | 3368 | 4442 | 5672 | 11.41 | 12.79 | 16.55 | 11.47 | 37.22 | 38.58 | 11.88 | 38.67 | 39.91 |
| NIC Bank | 2700 | 4058 | 5070 | 12.28 | 16.36 | 14.39 | 13.3 | 15.78 | 14.21 | 14.16 | 16.66 | 15.13 |

| Bank | Core capital (Ksh.m) | | | Core capital/total deposit liabilities (%) | | | Core capital/TRWA (%) | | | *Total capital/TRWA (%)* | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Oriental Commercial Bank | 673 | 819 | **791** | 91.81 | 99.54 | **60.15** | 59.8 | 60.34 | **53.01** | 59.8 | 60.34 | ***54.26*** |
| Paramount Universal Bank | 415 | 449 | **483** | 23.78 | 23.94 | **22.91** | 32.46 | 40.84 | **41.18** | 32.46 | 40.84 | ***41.97*** |
| Prime Bank | 800 | 1089 | **1697** | 9.66 | 10.51 | **10.84** | 13 | 14.94 | **17.05** | 13 | 14.94 | ***17.05*** |
| Prime Capital & Credit | 856 | 861 | | 38.73 | 40.54 | | 28.89 | 26.44 | | 28.89 | 26.44 | |
| Southern Credit Bank | 526 | 534 | **452** | 14.05 | 12.35 | **11.01** | 20.93 | 16.08 | **14.59** | 21.94 | 16.86 | ***15.6*** |
| Stanbic Bank | 2658 | 3164 | | 13.45 | 13.94 | | 17.01 | 13.37 | | 17.73 | 14.11 | |
| Standard Chartered Bank | 8367 | 8967 | **9332** | 12.9 | 12.14 | **12.13** | 18.32 | 16.29 | **15.74** | 18.88 | 16.71 | ***16.2*** |
| Trans-National Bank | 1104 | 1062 | **1216** | 87.36 | 59.01 | **64.3** | 65.43 | 59.61 | **64.28** | 66.49 | 60.8 | ***65.31*** |
| Victoria Commercial Bank | 567 | 629 | **739** | 15.52 | 18.33 | **20.64** | 22.52 | 23.48 | **23.92** | 23.09 | 24.53 | ***22.94*** |
| | | | | | | | | | | | | |
| ***Total/average*** | *82452* | *112896* | ***141145*** | *13.83* | *15.62* | ***15.75*** | *16.35* | *18.06* | ***29.51*** | *16.96* | *19.13* | ***33.11*** |

*Sources*: Oloo (2007, 2008, 2009).

# Annex 2: Kenya's top commodity exports at HS-6 digit level

| HS6 | Description | Exports 2007 | | | | | Change 2006-2007 | |
|---|---|---|---|---|---|---|---|---|
| | | Total (US$m) | Total (1000kg) | Share | Top 5 markets & share | (%) | Value (%) | Volume (%) |
| 090240 | Black fermented tea and partly fermented tea, whether or not flavoured, in immediate packings of >3kg | 698 | 374,218 | 17% | | | 6 | 16 |
| | | | | | Pakistan | 28 | 2 | 14 |
| | | | | | Egypt | 18 | -1 | 9 |
| | | | | | UK | 16 | -6 | 13 |
| | | | | | Sudan | 6 | 32 | 26 |
| | | | | | Afghanistan | 5 | 70 | 84 |
| | | | | | Total these market | 72 | | |
| 060310 | Fresh cut flowers and flower buds, for bouquets or for ornamental purposes | 259 | 81,722 | 6% | | | -5 | -15 |
| | | | | | Netherlands | 71 | 4 | -9 |
| | | | | | UK | 16 | -32 | -35 |
| | | | | | Germany | 4 | 1 | 4 |
| | | | | | Switzerland | 2 | -4 | -9 |
| | | | | | Japan | 2 | -15 | -40 |
| | | | | | Total these markets | 95 | | |
| 070990 | Fresh or chilled vegetables | 169 | 51,464 | 4% | | | 21 | 16 |
| | | | | | UK | 76 | 28 | 21 |
| | | | | | Netherlands | 14 | -6 | -8 |
| | | | | | Belgium | 3 | 49 | 23 |
| | | | | | South Africa | 1 | -13 | 3 |
| | | | | | Germany | 1 | 24 | 15 |
| | | | | | Total these markets | 95 | | |
| 090111 | Coffee (excluding roasted and decaffeinated) | 155 | 55,086 | 4% | | | 22 | 21 |
| | | | | | Germany | 19 | 19 | 11 |
| | | | | | US | 14 | 17 | 25 |
| | | | | | Switzerland | 14 | -8 | -13 |
| | | | | | Sweden | 13 | 48 | 42 |
| | | | | | UK | 7 | 32 | 31 |
| | | | | | Total these markets | 67 | | |
| 271019 | Medium oils and preparations of petroleum or bituminous minerals, nes | 136 | 152,537 | 3% | | | -42 | -68 |
| | | | | | Uganda | 31 | 8 | -41 |
| | | | | | Tanzania | 14 | -8 | -50 |
| | | | | | Singapore | 7 | n/a | n/a |
| | | | | | Rwanda | 6 | -8 | -50 |
| | | | | | DRC | 4 | -13 | -52 |
| | | | | | Total these markets | 62 | | |
| | **Total 5 products** | 1147 | 715,027 | 35% | | | | |
| | **Total trade** | 4081 | | | | | | |

*Source*: te Velde (2008).

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