

Executive Briefing Book



Will the Kenyan economy fulfill its longer-term potential?

Kenya/Economic Promise

Kenya's promise is clouded by impending elections and the threat of terrorism from Somalia.

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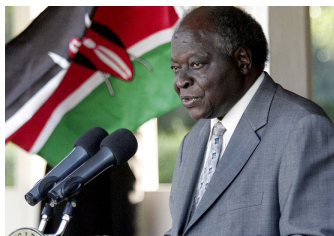
Key Judgments

- Kenya's ambition to achieve middle-income status by 2030 has been jolted, with economic policy errors and political uncertainty pointing to a troubled period.
- Two former ministers, indicted in connection with the ethnic violence of 2007-08, plan to run for the presidency in an election that may be deferred until March next year.
- Kenyan businesses are reeling from a savage hike in interest rates after the central bank had delayed action for too long, triggering high inflation and currency depreciation.
- The monetary policy missteps have also impacted the government's finances, and spending may have to be cut -- an unwelcome option in the runup to elections.
- Kenya's military campaign in Somalia incurs the significant risk of a backlash from Islamist militants, who retaliated against Uganda in 2010 by bombing Kampala.
- Rapidly expanding trade with East African neighbors and an intensifying search for oil and natural gas hold out promise for the future -- provided Kenya is stable.

Analysis

Kenya's political and economic outlook is dominated by the impending presidential and legislative elections. Although due before the end of the year, these could be delayed until March 2013. The last elections, in 2007, triggered a wave of ethnic violence in which more than 1,200 people were killed, shattering Kenya's long-standing reputation for stability.

Following the International Criminal Court's (ICC) decision last month to issue indictments against four prominent individuals for allegedly directing the unrest -- they include Uhuru Kenyatta, the former finance minister, and William Ruto, the former education minister -- no repetition of the 2007-08 violence is anticipated. The indictments have made the political elites realize that the eyes of the world are on them.



Kibaki, nearing the end of his presidency

Economic growth is expected to rise to 5% in 2012, and to 6% in 2013, after last year's disappointing outturn of 4.5%. This was due largely to the impact of the regional



drought which depressed food and electricity production. Weak demand for Kenyan exports from traditional trading partners in more mature economies also impaired the growth rate. Improved rains, rising food and power output, together with robust cross-border trade with fellow member states in the East African Community (EAC), are likely to be the main drivers of growth in the year ahead.

The more promising economic outlook remains overshadowed, however, by three distinct risks: the threat of an abrupt breakup of the grand coalition established in the wake of the 2007-08 violence between the Kikuyu, Luo and Kalenjin ethnic groups; the tightening squeeze on government finances; and the potential fallout from Kenya's military incursion into neighboring Somalia.

How fluid is the political scene?

Kenya's fractious politicians are already positioning themselves for the forthcoming elections, which are expected to bring an end to the coalition government. President Mwai Kibaki is



Odinga, favorite to become next president

constitutionally bound to step down at the end of his second five-year term, while the post of prime minister -- specifically created to accommodate opposition leader Raila Odinga in the coalition -- will be abolished.

Odinga is favorite to replace Kibaki as president. However, he will face competition from George Saitoti, the internal security minister, and Moses Wetangula, the foreign minister, as well as Kenyatta and Ruto, neither of whom has abandoned his presidential ambition, despite the ICC indictments. The risk of a coalition breakup before the elections is not high; but if the government were to collapse, the toll on business and consumer confidence would be heavy. Such an eventuality would also dampen prospects for an orderly ballot.

How troubled are the government's finances?

While much of the weakening in Kenya's economic performance last year has been attributed to external factors, the government's own contribution has not been insignificant. As finance minister, Kenyatta was responsible for overseeing a 22 billion shilling (\$224 million) stimulus package in 2009, in an effort to boost growth

and employment. The stimulus was deemed to be an overriding priority in the wake of the ethnic violence and the global economic downturn. It was energetically supported by the Central Bank of Kenya (CBK), which implemented highly accommodative monetary policy, fostering growth at the expense of its primary mandate to safeguard price stability.

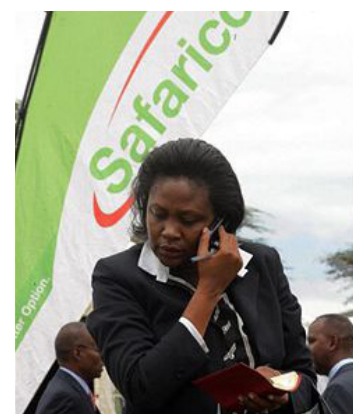


Currency slide thwarted bond issuance

The fiscal stimulus and the loose monetary policy should have been rolled back in 2010, when it was clear that growth was recovering -- as happened in neighboring Uganda. The CBK, however, took far too long to raise interest rates, a delay that spurred rapidly rising, double-digit inflation and sharp currency depreciation. When the CBK finally took action in the fourth quarter of 2011, inflation was approaching 20% -- four times the official target -- while the shilling had lost nearly 25% of its value since the beginning of the year.

Credit squeeze. Four successive rate hikes followed, bringing the base rate up from 6.25% in September to 18% by November. While the abrupt tightening of monetary policy has already helped the shilling to recover most of its earlier losses, and inflation is now expected to head towards single digits by mid-2012, the commercial banks have been forced to cap rates on existing loans at 20%, and extend repayment periods, in order to avoid the threat of mass defaults. Although the commercial banks are expected to be able to withstand the shock, demand for credit is likely to remain muted for some time, while the need to make even greater provision for non-performing loans can be expected to put a downward pressure on banking sector margins for the foreseeable future.

Business impact. The failure of the CBK to act earlier has had a marked impact on the performance of most Kenyan businesses. Half-yearly results at Safaricom, Kenya's biggest corporate -- which accounts for half the market capitalization of the newly renamed Kenyan Securities Exchange



Safaricom profits dialed down

-- showed net profits were down 48.3% to 5.4 billion shillings. Although Safaricom's revenues were up 5%, and its customer base expanded by 8%, the mobile telecoms corporation blamed the 'unprecedented devaluation' for driving up its operating costs, and for greatly reducing consumer spending power.

The impact on the government's finances was even more pronounced. A planned \$500 million eurobond issuance was put on hold for fear that it would be under-subscribed due to the falling shilling. Domestic bond issuance was suspended as a result of the government's reluctance to lock in higher borrowing costs. The budget deficit for 2011-12 is forecast to be 7.4% of GDP, but is likely to be significantly higher.

Public spending. Unless the shortfall can be bridged by increased foreign borrowing, the government may be forced to trim its spending plans -- an unattractive option in the runup to an election. These pressures are likely to be eased somewhat by an additional \$250 million loan from the IMF, the resort to a \$500 million syndicated loan from a consortium of international banks, and the government's return to the domestic bond market as interest rates begin to fall. But while additional foreign loans may ease the present financial squeeze in the short term, they come at the cost of an ever higher debt-to-GDP profile over the longer term.

How high is the risk of a backlash from Somalia?

Kenya's military incursion into neighboring Somalia, although undertaken to protect its lucrative foreign currency earnings from the tourism sector, further tarnishes the country's fiscal outlook. The intervention began last October, and appears designed to create a buffer zone between Kenya's northern coastal beaches and al-Shabaab Islamist militants who control much of central and southern Somalia. Of critical importance is the southern port of Kismayu, which generates tens of millions of dollars a year in taxes on trade for the militants.

The war is popular in Kenya, although the 2.4 million ethnic Somalis living in the country, particularly in the Somali-dominated Eastleigh neighborhood of the capital, Nairobi, fear the attendant counter-terrorist crackdown.



Kenya's thrust into Somalia risks backlash

Financing the military operation is a considerable burden on the budget, but the Kenyan government expects a brief conflict and is confident of exiting Somalia before the elections. However, the goal of breaking al-Shabaab's hold on the region, especially Kismayu, is unlikely to be achieved rapidly. While the US is providing support, in part with drone attacks, the prospect of anything that could be described as a victory looks slim. Apart from a vague hope that the war will be financed by increased donor funding, Kenya has no credible plan for a sustained conflict.

Terrorism threat. Al-Shabaab's ability to launch retaliatory terrorist attacks, especially on soft targets inside Kenya, is of paramount concern. The Somali militants, some of whom have links with Al Qaeda, have mounted suicide bombings to devastating effect in Somalia and Uganda: the July 2010 bombings in Kampala killed more than 70 people. Amid intelligence reports that al-Shabaab plans mass-casualty attacks in Kenya, the Nairobi authorities are braced for the worst.

Where is the economic silver lining?

There has been a marked upturn in the economic prospects for the EAC, which groups Kenya, Tanzania, Uganda, Rwanda and Burundi into a regional common market. Ke-



The search for oil is just beginning

nya, which is home to one of Africa's most dynamic and innovative business communities, remains the industrial heart of the EAC, and is expected to benefit greatly from continued regional integration. Intra-regional trade is expanding rapidly, and Kenyan exports to all EAC members are recording strong growth, more than offsetting stagnant or declining trade with traditional partners in Europe. Uganda has replaced the United Kingdom as Kenya's single biggest trading partner.

Foreign investment. China has stepped in to help ameliorate Kenya's growing infrastructure deficit, including construction of a new super highway between Nairobi and Thika, a nearby industrial and market town. Egyptian private equity firm Citadel Capital has brought in new management to run the under-performing Rift Valley Railway. Tullow Oil is due to begin drilling for onshore oil in the first quarter of 2012, while US oil explorer, Apache, is expected to join French rival, Total, in the search for offshore oil and natural gas reserves.

Construction of one of the world's biggest wind farms, the 300 MW Lake Turkana project, is due to begin later this year, and plans to boost the country's electricity from geothermal resources have gathered momentum.

Outlook

Kenyan policy-makers and the business community face a potentially difficult year or so. Astute monetary policy management will be one of the keys to reviving

the economy and enhancing its attraction to foreign investors. If, also, Kenya can engineer a smooth exit from Somalia, and if it can stage a credible presidential election, there is every prospect that the country can set itself back on the path towards realizing the goal of middle-income status by 2030.

In the short term, however, the risks to this outlook -- in particular those of political discord or a major terrorist attack -- are considerable.