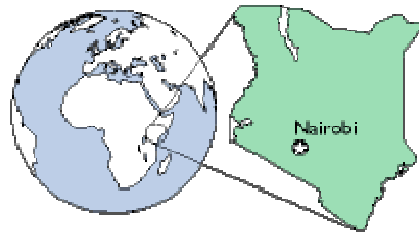


# COUNTRY REVIEW

## Kenya



26 February 2010

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**EULER HERMES COUNTRY RISK GRADE: D**

Country Risk Grades are on a scale of AA, A, BB, B, C, D  
where AA is the lowest and D the highest risk.

## Strengths

- The political system has shown evidence of some systemic resilience, despite intense party and individual rivalries and ethnic and religious divides
- Although flawed, an electoral system is in operation and proved more robust than had been considered likely in the aftermath of President Moi's term of office
- Although further government commitment is required to eradicate rampant corruption, some international financial support has been renewed
- Strategically important as economic hub of East Africa
- Vibrant horticultural and tourism sectors

## Weaknesses

- Tribal and personality-based politics lead to fragile coalitions
- Endemic corruption, which has reduced IFI and donor financing, has proved extremely difficult to eradicate, or even reduce
- Vulnerable to acts of international terrorism, particularly in terms of tourism flows
- Low income, primary commodity dependent economy
- Weak long-term growth and policy record
- Weak structural business environment

## Key Risks

- **Further weak global commodity demand because of subdued growth in the world economy/world trade, with potential for an associated reduction in aid funding**

## Country Risk Assessment

Ratings	Kenya		Median Grade D	Nigeria	Peers	
	Latest	Previous			Uganda	Tanzania
<b>Systemic Political Risk:</b>	<b>P4</b>	<b>P4</b>	<b>P3-</b>	<b>P3-</b>	<b>P3-</b>	<b>P2-</b>
<b>Systemic Economic Risk:</b>	<b>E5</b>	<b>E5</b>	<b>E6</b>	<b>E6</b>	<b>E5</b>	<b>E5</b>
ME rating:	ME5	ME5	ME6	ME4	ME4	ME5
<i>Structure</i>	6.0	6.0	6.0	6.0	6.0	6.0
<i>Policy</i>	6.0	6.0	5.6	6.0	4.2	6.0
<i>Solvency</i>	2.8	3.5	4.3	1.9	2.0	4.6
<i>External Liquidity</i>	4.8	4.8	4.3	1.9	4.2	3.3
SBE rating:	SBE5	SBE5	SBE6	SBE6	SBE5	SBE5
<b>COUNTRY GRADE:</b>	<b>D</b>	<b>D</b>	<b>D</b>	<b>D</b>	<b>C</b>	<b>C</b>

**Nomenclature:**

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

## ECONOMIC STRUCTURE

<b>Country Profile</b>	
Capital city:	Nairobi
Population:	38.77 mn (2008)
GDP:	USD 30354 mn (2008)
Currency:	Shilling (KES)
Form of state:	Republic
Head of government:	President Mwai Kibaki PM Raila Odinga
Next elections:	Presidential and legislative by December 2012

<b>Major Industries (% of GDP at market prices, 2008)</b>	<b>Global Assumptions</b>	<b>2009e</b>	<b>2010f</b>	
Agriculture	22.0%	Real GDP grth (% yr/yr) *	-3.9	0.9
Industry	16.0%	Inflation (% , av) *	-0.1	1.3
Services	62.0%	Dated Brent (USD/b)	61.0	72.0
		* major economies		

<b>Main Exports (% of total, 2008)</b>		<b>Main Imports (% of total, 2008)</b>	
Tea	19.0%	Industrial goods	28.0%
Horticultural products	16.0%	Machinery & equipment	11.0%
Coffee	3.0%	Consumer items	6.0%
Fish & related products	1.0%	Food, drink & tobacco	5.0%
<b>Lead Export Markets (% of total exports, 2007)</b>		<b>Lead Import Markets (% of total imports, 2007)</b>	
Uganda	16.9%	UAE	11.4%
UK	9.3%	China	9.9%
Tanzania	8.2%	India	8.7%
Netherlands	8.2%	Saudi Arabia	8.0%

## Basic indicators

<b>Selected economic indicators</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009f</b>	<b>2010f</b>
Nominal GDP (USD mn)	22,779	27,124	30,355	28,695	32,354
Population (mn)	36.77	37.76	38.77	39.82	40.89
GDP per capita (USD)	620	718	783	721	791
Real GDP growth (% yr/yr)	6.1	7.0	1.5	2.5	4.0
Inflation (% , average)	14.5	9.7	26.3	20.0	11.5
Fiscal balance (% of GDP)	-1.8	-3.7	-3.9	-6.9	-6.1
Current account balance (% of GDP)	-2.2	-3.8	-6.5	-7.0	-5.9
External debt/GDP (%)	28.7	27.1	25.9	28.3	26.0
External debt/Exports of goods & services (%)	83.0	78.5	72.3	87.1	81.6
Debt-service ratio (%)	7.0	8.3	5.1	5.5	5.0
Foreign exchange reserves (USD mn)	2,396	3,335	2,856	3,500	2,700
Import cover (months)	3.4	3.8	2.7	3.8	2.7
Exchange rate assumption, KES:USD (av)	72.1	67.3	69.2	77.3	76.0
f: CRU central forecast					

Sources: Central Bank, IMF, World Bank, Euler Hermes Country Risk Unit

## Political Stability

In April 2008, a government of national unity was formed around a broad-based coalition led by President Mwai Kibaki's Party of National Unity (PNU) and the Orange Democratic Movement (ODM), which is led by Raila Odinga, who became prime minister. The government is an uneasy alliance of parties and individuals but its formation, following international mediation, pulled Kenya back from the brink of violence that threatened the sovereign unity of the country. Although some limited political progress has been achieved, **political stability remains fragile and ethnic and tribal harmony is not guaranteed under the new compromise**. This background needs to be set against a severe deterioration in the global economy, with associated negative effects on the domestic economy and businesses, and **political risks and uncertainties will continue this year and into 2011**.

As expected, the Waki report, which is the outcome of an official investigation into the post-election violence, is critical of both the PNU and the ODM. The report suggests that the main parties organised violent attacks on opposition supporters and must take an equal share in responsibility for the breakdown in law and order. The report is also critical of the electoral system and some of the country's institutions. Although the investigation and subsequent report have allowed some frustrations and pressures to dissipate, it is difficult to envisage a quick return to relative political and social stability. **Tribal and regional divisions, as well as political and personal animosities, are likely to engender an environment of suspicion and uncertainty, with risks weighted on the downside**.

Events of the last two years are in stark contrast to the apparent success following elections in 2002 that marked a peaceful hand-over of power following over 20 years of rule by President Daniel arap Moi and the Kenya African National Union (KANU) party. The smooth transition offered hopes that democracy had become entrenched and that Kenya would act as a benchmark for political evolution elsewhere in Sub-Saharan Africa. This was particularly the case as President Mwai Kibaki—who campaigned on an anti-corruption, pro-economic reform platform—pledged to review constitutional changes and reduce presidential powers within 100 days. After eight years there is a distinct lack of meaningful progress. This is particularly significant as only **with positive developments on political reform and anti-corruption measures will the international donor community become fully supportive**, a necessity for promoting economic advancement.

Regional relations focus on the Common Market for Eastern and Southern Africa (COMESA) and the East African Community (EAC). Within the latter grouping, a customs union was launched in 2005 and full political federation is proposed by 2013, although the timing of this seems unlikely. International relations have improved marginally following the **re-activation of IMF facilities in December 2004** and a donor consultative group meeting in April 2005. However, continuing IFI and international donor relations are dependent on progress in curbing the perceived endemic corruption in the country. In this respect, frustrations continue to be evident.

Kenya has been subject to high profile international terrorist activity (the US embassy in Nairobi was bombed in 1998 and an Israeli-owned hotel in Mombasa attacked in 2002). Such incidents have an adverse effect on tourism and investment. The government has increased attempts to deter terrorism but **Kenya will remain vulnerable because of its porous borders**, particularly with Somalia.

## Economic Stability

Kenya is a low-income, moderately indebted and **primary commodity dependent** economy. Its **principal exports are horticultural products (primarily for European markets—**an estimated 25% of Europe's imports of cut flowers come from Kenya), **tea and coffee**, whereas the manufacturing base is relatively under-developed. Services now account for around 62% of GDP and, in addition to a large government sector (over 14% of GDP), there is a **growing tourism industry** based on the country's twin-resort holiday trade (beaches and game parks). However, tourism is a fickle industry and increases vulnerability through rapid swings in revenue generation, depending on prevailing security conditions. Kenya itself has been targeted by terrorists.

Real GDP growth registered an annual average 1.9% in 1991-2003, compared with annual population growth of over 3%, thereby indicating declining per capita incomes over that period. This weak economic background was caused partly by **dependence on rain-fed agricultural production** (agriculture contributes around 22% of overall GDP and 40% of export receipts), but largely through **poor economic management** at business, sectoral and macro-economic levels. Real GDP growth was relatively strong in 2004-07 (averaging around 6% each year), partly reflecting the vibrancy of the global economy and, in particular, strong demand for commodities and associated high prices of some

Kenyan exports. However, the political- and ethnic-related violence severely disrupted the economy in 2008, with overall GDP growth of only 1.5%, and this coincided with the onset of the global financial crisis and recession so that **economic expansion was a subdued 2.5% in 2009 and is forecast at 4% for this year, as the global recovery is expected to move forward slowly.**

The two main political factions within the power-sharing government, the ODM and PNU, **espouse similar free-market principles** and this should aid policy formulation and, in theory, implementation. However, other political differences and personal animosities have led to **some policy paralysis**, although the power-sharing government's principal aim of regaining macro-economic stability following the violence and serious disruption to economic life in Q1 2008 has been achieved—with significant input from international agencies. Inflationary pressures built up through most of 2008 (partly reflecting oil and other commodity price increases) and consumer price inflation averaged over 25% yr/yr. The **focus of policy now requires further structural economic reforms** (including privatisation and increased market liberalisation) in order to promote sustainable growth and make meaningful inroads into poverty alleviation.

Shilling weakness stemming from high inflation, reduced FX earnings from the important tourist sector because of violence early in 2008 and general risk aversion in the foreign exchange markets have been compounded by the global financial turmoil. The **central bank is likely to continue its policy of attempting to prevent large slippage in the currency and a modest shilling appreciation is forecast this year**, although this largely reflects some correction from the large depreciation in 2009. We forecast an average of USD1=KES76 this year, compared with KES77 in 2009 and KES69 in 2008.

Tourism provides a substantial part of FX generation in most years but the violence and uncertainties in 2008-09 reduced such inflows and this was exacerbated by the global recession, with associated reduced spending power in key markets of tourist provenance. With only a slow recovery in disposable income expenditures in those markets, growth in Kenyan tourism earnings this year is also likely to be muted and overall, we **forecast that the current account deficit will remain high at almost 6% of GDP, after 7% in 2009.** With some further central bank intervention to support the shilling, net FX accumulation is unlikely and we **forecast that import cover will be under three months** this year—the internationally-accepted minimum level of comfort. On a positive note, given Kenya's strategic position in East Africa and, in particular, its border with Somalia, the international community is likely to provide timely assistance to Kenya, in need, although the donor community will want to see firm evidence that domestic stability and security have improved and that the government is committed to act positively in limiting corruption at all levels.

External debt ratios are manageable—debt/GDP 28% and debt/XGS 87% in 2009 are much improved from 50% and over 200% in 2000, respectively—and the debt service ratio is only around 5% because of the high proportion of lending conducted on concessional terms. Kenya does not qualify for enhanced-HIPC debt relief.

## Structural Business Environment

The structural **business environment is well below the average** of the countries we assess. The Heritage Foundation 2010 Index of Economic Freedom categorises Kenya as 'Mostly Unfree' and assigns it a ranking of 101 out of 183 countries surveyed, below Tanzania, Honduras and Zambia but above Swaziland, Serbia and Algeria. Trade policy, bureaucracy and regulation, lax property rights, a judiciary that is subject to political influence and corruption are areas perceived as particular weaknesses. Transparency International's Corruption Perception Index 2009 gives Kenya a lowly ranking of 146= (with Cameroon, Ecuador and Russia) out of 180, below Pakistan, Philippines and Nepal but above Côte d'Ivoire, Papua New Guinea and Yemen. According to the World Bank's Doing Business Survey 2010, Kenya ranks 95 out of 183 countries in terms of the ease of doing business, although enforcing contracts takes less time and is less complex than the average for the region. Effectiveness of insolvency legislation is much better than the regional average, although well behind that of the OECD, in terms of recovery rate (although not in relation to the time taken to resolve bankruptcies).

**The financial sector is generally under-developed and is subject to political influence.** Five organisations account for just over 50% of the banking sector total assets. NPLs, although improving, remain high, particularly in relation to state-owned banks lending to state-owned enterprises.

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## Charts

