



**REPUBLIC OF KENYA**

**NATIONAL ASSEMBLY**

**PARLIAMENTARY SERVICE COMMISSION**

**LOOKING IN THE FUTURE: BUDGET OPTIONS  
FOR 2010/11 AND MEDIUM TERM OUTLOOK**

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## **Foreword by Head of Parliamentary Budget Office**

*Budgeting is about making hard choices. These decisions can be made at a cost or avoided at far greater cost. The hard fact is that there is no free lunch anywhere – someone has to pay for it!*

The Fiscal Management Act mandates the Parliamentary Budget Office (PBO) to provide independent analysis on budgetary issues to the relevant parliamentary committee. In addition, the Office is also tasked to provide the National Assembly with timely and objective information and analysis in connection with the national budget and the economy.

Given the uncertainty of the current economic situation in the context of a global recession, it is more important than ever for parliamentarians and the public to have an up-to-date assessment of the economic conditions underpinning Kenya's finances. This will help to provide them with a planning environment for their debate and deliberations.

For this reason, and in meeting the commitments of PBO's mandate, this alternative scenario provides a detailed estimate of Kenya's near-term economic outlook for key macroeconomic variables including: real GDP, inflation, nominal GDP among other variables. The variables are then used to determine the overall resource envelop that is used to finance various government activities. However, it is important to note that the report provides various policy options that the Government could consider as it prepares the 2010/11 budget but does not in itself present an alternative budget since budget preparation solely lies under the purview of the Treasury.

PBO's baseline projections do not incorporate potential changes in policy. Thus, they serve as a neutral benchmark that legislators and other stakeholders can use to assess the potential effects of policy decisions.

PBO's outlook is based upon the analysis of high-frequency data using statistical models and professional judgment. Furthermore, all of the data PBO uses to monitor the current state of the economy is publicly available and the techniques employed are commonly used by both public and private sector economists.

It should be noted, however, that any economic outlook is subject to uncertainty, particularly given the current economic climate. In this context, the PBO's outlook should be seen as a data point, to be considered alongside other sources of analysis for parliamentarians.

## List of Abbreviations and Acronyms

BPS	Budget Policy Statement
BSP	Budget Strategy Paper
FMA	Fiscal Management Act
GDP	Gross Domestic Product
IMF	International Monetary Fund
MTEP	Medium Term Expenditure Framework
PEV	Post Election Violence
PBO	Parliamentary Budget Office
MDG	Millennium Development Goals
LPG	Liquefied Petroleum Gas
ASAL	Arid and Semi-Arid Lands
MTP	Medium Term Plan
EPAs	Economic Partnership Agreements
DRM	Domestic Resource Mobilization
KRA	Kenya Revenue Authority
PAYE	Pay As You Earn
AIA	Appropriations in Aid
IMF	International Monetary Fund

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## **1.0 Introduction**

### **1.1 Overview**

1. This document dubbed “*looking into the future: budget options for 2010/2011 and the medium term*”, the first of its kind, provides alternative insights and policy options on what the Government should do in order to achieve the various objectives of the vision 2030 of transforming Kenya into a newly industrialized, “middle-income country providing a high quality life to all its citizens by the year 2030”. One of the key targets of the first Medium Term Plan (MTP) 2008-2012 is to increase real GDP growth from 7 per cent in 2007 to 7.9-8.7 per cent by the years 2009-2010; and to 10 per cent by 2012. To achieve the high growth path, the plan envisions increasing savings and investment levels in order to support the high economic growth and employment creation.
2. In preparing the various alternatives, the analysis has been made bearing in mind the base year which is the expected outcome of 2009/2010 budget in particular the key variables such as GDP, inflation rate among others. The major effort of Government in 2009 of stimulating the economy through various packages is also reviewed.
3. The analysis attempts to gauge the progress made with regard to the Governments effort in addressing the current economic challenges and extent to which the various mitigation measures have been put in place amid post election violence hangover and the global economic crisis. The report will provide a critical analysis on the progress made on the Government’s commitment of aligning public resources with national strategic objectives under the Medium Term Expenditure Framework and Vision 2030.
4. The report also takes into consideration the fact that in 2009/10 – 2011/12 Budget Strategy Paper attempted to initiate programme based budgeting by reorienting the focus from input based financial programming to results based budget. For this reason this report also attempts to bring out the issues of prioritizing programmes towards specific outputs in a sequenced manner.

### **1.2 Organization of the report**

5. The report is organized as follows: Section II presents the state of the economy bearing in mind the developments from a global front as well as the global economic performance. Section III gives the macroeconomic forecasts underpinning the 2010/11 budget and the Medium Term, section IV highlights the key priority areas the Government needs to urgently address, while section V details the sectoral priority areas that should be the basis of resource allocation.

## **2.0 Slipping further or rebounding? The State of the Economy**

### **2.1 Impacts of the Global Economic Crisis and global Growth prospects**

6. Prosperity of any country is generally measured by a number of prevailing economic indicators namely; the citizens' standard of living, GDP growth rate, GDP per capita, general price levels, exchange rates, interest rates, balance of payments, general income levels and the country's indebtedness, among others. These economic fundamentals were globally threatened since 2008 due to the world's economic crisis emanating from United States and quickly spreading to the entire globe.
7. The devastating effects of the meltdown continued to the better part of 2009 leaving leading world economic institutions with no option but to focus even a grimmer picture for 2010. For instance, in January 2009 the IMF forecasted that advanced economies would not exit the recession until the mid2010. However the contrary to this expectation happened. These economies posted growth of about 2% in the third quarter of 2009, and growth in emerging economies accelerated to 8% in the second and third quarters; 2% higher than forecast. Additionally, global trade and industrial production are on a sharp recovery path. The hard question now is about the strength and sustainability of the recovery into the medium term. Most projections currently are mixed with some showing a continuation of positive growth for 2010 and others indicating that a pull out of some of the strategies of bailing out financial services in particular could quickly lead to a slow take off for leading economies. The seemingly stronger than expected recovery has been explained by several factors; most importantly unprecedented stimulus and financial rescue efforts in advanced economies largely worked.
8. Asia, where fundamentals like financial sectors and public budgets were healthy before the crisis, recovered rapidly, helping pull the rest of the world to recovery. The world succeeded in avoiding large-scale contagion effects, including sovereign debt crises, competitive exchange rate devaluations, and trade wars. Despite these improvements, production levels across the world remain 7-10% below pre-crisis levels, unemployment in many countries worsened and fiscal positions have deteriorated significantly. It is this situation that is raising concerns of the quick recovery.
9. From the foregoing, what lies ahead in terms of global economic performance is likely to be influenced by the policy mix being adopted by the economic policy makers in most countries. The type of fiscal policies (expansionary or contractionary), monetary policy, domestic borrowing levels, spending priorities, and private sector investment incentives will largely determine the recovery strength and time frame for different countries. For instance, China has already reached the same levels it was just prior to the crisis. Many countries are also quite optimistic as they identify capacities that had been idle due to the recession which could quickly be used. Meanwhile industrial production, for now, is underpinned mainly by stimulus measures. In advanced economies, the beginning of a turn in the inventory cycle and

the unexpected strength in U.S. consumption contributed to positive developments. Domestic demand was very strong in key emerging and developing economies, although the turn in the inventory cycle and the normalization of global trade also played an important role.

10. Growth in Sub Saharan Africa slowed markedly to below 1% from an average above 5% in the preceding five years, largely as a result of the collapse in global trade. The impact of the global crisis was initially most acutely felt by countries, such as South Africa, whose financial markets are more integrated into global financial markets as capital inflows reversed. Subsequently the impact spread to oil commodity exporters as trade collapsed. The region was also affected by lower tourism volumes, falling remittances, and lower levels of official development assistance. Indeed, it is forecasted that in most advanced economies, the recovery is expected to remain sluggish by past standards, whereas in many emerging and developing economies, activity is expected to be relatively vigorous, largely driven by buoyant internal demand. For example, emerging markets (fast recovery, strong growth) versus developed economies (slow/no recovery, low growth).
11. On global inflation, just as the sharp rise in food and fuel prices generated a rapid acceleration of overall inflation in both high-income and developing countries during 2008, the fall of commodity prices during the course of 2009 and unprecedented slowdown in the global economy has resulted in the overall inflation rate falling dramatically. For instance, inflation in low-income countries peaked at 15.4% in the middle of 2008, but as of July 2009 it had declined to 3.4% – below the levels observed prior to the food and fuel boom. However, food inflation in developing countries is not falling as rapidly as overall inflation
12. The behavior of inflation continues to play into how monetary and fiscal policy will evolve in 2010 and beyond, and it will be a challenge for policy makers to find the middle path. In the advanced economies, overall inflation is expected to pick up from zero in 2009 to 1.25% in 2010, as rebounding energy prices more than offset slowing labor costs. In emerging and developing economies, inflation is expected to edge up to 6.25% in 2010, as some of these economies may face growing upward pressures due to more limited economic slack and increased capital flows.

## **2.2 Expectations into the medium term; Optimists versus Pessimists**

13. The expectations and forecasts into the future has drawn economists in two schools of thought, namely, optimists and pessimists. The optimistic scenario is based on the assumption that many economies were largely unaffected and had some capacities in production that had not been fully utilized therefore they will be a quick launching pad for the recovery of the rest of other economies. The Optimistic camp cite several supporting factors among them the growing role of emerging economies (mainly in Asia) which did not suffer a financial crisis and remain fundamentally strong thus able to support the global recovery. They also argue that the corporate sector, particularly non-financial firms in the United States, reacted quickly and aggressively

to the crisis, registering better than expected earnings in 2009. As a result, a significant turnaround is expected soon in their labor, inventory, and investment demand, with employment expected to improve by the middle of 2010.

14. On the other hand, the pessimistic scenario is based on the assumption that recovery will be largely subdued with a possible return to recession in the leading economies such as the United States. They argue that the gas pedal (economic stimulus) may be pulled out too soon. Unemployment is being projected at close to 10% in advanced economies, low wage and income growth will depress consumption. The weak private sector will struggle to support the recovery while banks, still suffering from huge losses, will be forced to cut credit. Additionally, regional banks in particular will likely be hit by commercial property market weaknesses.
15. Impaired financial systems and housing markets or rising unemployment in key advanced economies may hold back the recovery in household spending more than expected. Some suggestions were that new regulations (such as higher capital requirements), if imposed too early, may hurt the banking sector, which still needs support. Premature and incoherent exit from supportive policies may undermine global growth and its rebalancing.
16. Other unfavorable concerns include worsening budgetary positions and fiscal sustainability that could unsettle financial markets and stifle the recovery by raising the cost of borrowing for households and companies. Rallying commodity prices may constrain the recovery in advanced economies. There are also worries about inflation. On monetary policy tightening, which will inevitably expose weaknesses, poses the biggest downside risk. Debt burdens will weigh on other major economies, including the United States and UK. Heavily indebted economies must consider all options, including tax increases, spending cuts, and structural changes to return to a more sustainable fiscal position. Protectionism also bears careful monitoring, especially if unemployment remains elevated.
17. On a regional front, the global financial crisis has had a marked, negative impact on economic performance in Sub-Saharan Africa, affecting trade, foreign direct investment, tourism, remittances (see annex 2 on remittances to Kenya in the last five years), and official assistance. GDP is estimated to have grown only 1.1 % for the region as a whole in 2009. Notwithstanding the severity of the shock, the improved macroeconomic fundamentals in place in many countries of the region as they entered the crisis meant that the impact was less pronounced than in other regions and relative to previous external shocks. As Sub-Saharan Africa is a major commodity exporting region, lower commodity prices, declining export volumes, as well as lower tourism revenues. Declining remittances have also undermined income and private consumption, which decelerated to 0.4 % growth in 2009, down from 3.5 % the previous year. Weak external demand for commodities, excess capacity, scarce credit, and tight liquidity all led to delays and scaling back of investment spending.
18. The contraction in both export and import volumes, as expected, was more severe in middle-income countries, which are more integrated into the global economy.

Because of the marked declines in oil prices, the deterioration in current account balances was most pronounced in oil-exporting countries, where it fell from 9.7 to 1.4 % of GDP. Meanwhile lower tourism revenues, remittances, and private current net transfers brought the current account balances in middle-income countries to a deficit of 1.2 % of GDP—down from a surplus of 3.3 % of GDP in 2008.

19. On the policy front, many countries in the region had only limited space for countercyclical measures, notwithstanding more prudent fiscal stances during the boom period. Automatic stabilizers worked in South Africa and the Seychelles, which were among the small number of countries that were able to implement significant countercyclical fiscal policies. A large part of the deterioration in fiscal balances in commodity exporters is linked to both lower volumes and lower export prices for commodities. For the region as a whole, the fiscal balance deteriorated from a surplus of 0.9 % of GDP in 2008 to a deficit of 4.2 % of GDP in 2009. Monetary policy remains ineffective in bolstering domestic demand in many countries owing to a lack of depth in the financial systems and weak transmission mechanisms.
20. Lower food and oil prices since mid-2008 contributed to a sharp decline in overall inflation, which has eased to low single-digit levels in many countries. By September 2009 several countries in the region were reporting falling overall prices. However, as a result of high food inflation related to recurrent droughts in East Africa, inflation remained stubbornly high in 2008 and better part of 2009. Currently, subdued inflation in many countries in the region has created room for lowering interest rates. Moreover, lower food and energy prices have relieved some of the pressure on fiscal balance although sharply lower trade volumes and lower export and import prices have slashed trade-related government revenues, which has - been particularly acute in the South African Development Community (SADC) and East African Community (EAC) member countries which have not been spared either.
21. They have witnessed negative growth resulting from the global financial crisis in three primary channels. The first of these is that external demand for goods and services has been tempered and this has been most adversely felt in the tourism and hospitality industry. Secondly, as a result of reduced income, commodity prices, terms of trade and the decline in remittances from Kenyans living in the Diaspora (Annex 5) have relatively strained domestic demand although this has not been to critical levels. Thirdly and finally, as a result of the adverse effects that the global financial crisis has had on the major economies of the world, and financial markets in particular, there have been severe constraints to capital flows in form of foreign direct investment thereby dampening growth prospects for the countries in the region.

### **2.3 Closer home; the Kenyan situation**

- 22.** The Kenya economy witnessed a remarkable growth trend since 2005 accelerating to 6.4% in 2006 and finally peaking at 7.1% in 2007. The growth however crumbled from 2008 when it registered a very low growth rate of 1.7%. This downturn was mainly due to the post 2007 election disturbances, the subsequent severe drought which badly affected local food production and worse still sky rocketing energy cost due to shortage of electricity as a result of depressed hydro electricity production. The recovery of the subdued GDP growth was further hampered by the global financial crisis whose impact was not only devastating to Kenya but also developing economies as well as developed economies the world over.
- 23.** Subsequently, it is expected that Kenya's growth only improved slightly from the 1.7% in 2008 to about 2.5% in 2009. It is further projected that the pace of the recovery will likely be slow and subject to uncertainty owing to factors from within and without. The Parliamentary Budget Office (PBO) forecasts the GDP of 2010 to stand at about 4.5 per cent. However, the recovery path remains fragile since it is dependent on positive and negative effect of the fiscal and monetary stance adopted by the Government in the course of the year.
- 24.** The accelerated growth in 2006 and 2007 could be attributed to formal sector friendly policies that were adopted by the government and which helped them grow fast. The policies were responsible for increase in production, enhanced trade, influx of tourists and improved business environment generally. The latest attempt by the Government to spur growth was the introduction of economic stimulus package targeting a number of sectors namely agriculture, education, health, and small scale industry. However the package seems to be facing challenges which may lead to dismal or less than expected impact on the economy.
- 25.** The whole stimulus package provided for in the fiscal year 2009/10 amounted to Kshs.22 billion with a whopping Kshs.9 billion directed towards education sector. Whereas successful economic stimulus packages in other countries (for instance United States targeted financial sector, in China targeted manufacturing), the Kenya stimulus was directed to many sectors and was largely recurrent in nature. As a result the impact of the package may be further needs and pressures in the budget as some become entitlements.

### **2.4 Kenya planning figures; illusion or mirage?**

- 26.** Kenya has a potential to grow at more than 5% just as its neighbors, Uganda and Tanzania, and Ethiopia which have managed to grow at over 5% for some time. Indeed it is upon this reality that the Vision 2030 was structured to look at the bright future due to the growth potential.

- 27.** The Vision 2030 and the Medium Term Plan (MTP) envisages GDP growth rate of 7.9 -8.7% by the year 2009 – 2010 and to 10% by 2012. Savings and investment levels were also targeted to increase at a high rate in order to support the high economic growth and employment creation. The planned tourism growth is to be tripled from 1.6 million to 3 million arrivals from 2008 to 2012 while increasing the spending per visitor from Kshs40,000 to kshs.70,000. In addition, 3.5 million Employment opportunities were to be created between 2008 and 2012.
- 28.** As of today, the reality is that these projections have been missed by big margins such as the GDP growth which only achieved 1.7% - 2.5% during the period 2008 – 2009. Tourists arrival is improving but at a lesser than targeted rate; in addition, the strive to increase visitors spending still faces major challenges. So long as the tourists continue paying in their mother countries before finally coming to Kenya the impact on the number of visitors may not be equaled to a similar impact on the economy as a whole. The missing links between the targeted drivers and the reality can only be corrected using well thought out and effective demand management policies.

## **2.5 Can budget policies turn around the economy to Vision 2030 path?**

- 29.** The budget is the single most important vehicle that enables a country to attain a sustainable growth pattern. For this reason fiscal and monetary policies must be tailored towards meeting the targets of the Vision 2030. It is a known fact that you cannot achieve much if the budget is more geared towards consumption spending than development and additionally where the leakage of resources is high. The Government needs to strive to reduce recurrent spending in order to create wealth for this country. On the monetary side the Government needs to fully implement necessary laws to combat any form of money laundering in the country. The policies should then be able to turn the country to the expected growth path immediately otherwise no growth will be realized as the country approaches the 2012 general elections and thereafter as is almost always the case.
- 30.** The first thing that the Government needs to consider is to create a viable climate for the private sector to thrive. Policies should be focused on productivity enhancing growth strategies starting from the forthcoming budget of fiscal year 2010/11 and the medium term. One easily remembers that when the Government implemented policies that were friendly to the formal sector in 2006 and 2007 the economy easily picked up and grew rapidly. Formal sector is the engine of development given that they easily pay their taxes which then are used to fund development priorities. This may involve simultaneously addressing underlying structural aspects such as dealing committed the governance issue which has bearing on the quality of institutions, and regulatory reform; all which are critical factors in promoting faster productivity growth.





### **3.0 Macroeconomic Forecasts Underpinning the 2010/11 Budget and the Medium Term**

#### **3.1 The forecast realities; will the future be like the past?**

**31.** Over the next few years, Kenya faces the related challenges of supporting the nascent economic recovery while transforming the economy in line with the vision 2030 goals. The most far-reaching economic crisis since the 1930s was precipitated by the collapse of the “subprime” housing market in the United States. When the bubble burst, the massive exposure of the financial system to bad debt led to a near collapse of the global financial system. However, a systemic collapse of banking systems in developed economies was only averted through large-scale, coordinated government intervention during the fourth quarter of 2008. These events brought on a global recession, sharply curtailing trade, investment and employment.

There are, however, growing signs that financial stabilization and economic recovery are taking root. The International Monetary Fund (IMF) expects world growth of 3.9 % in 2010, after a projected contraction of 1.1% in 2009. By 2014 the world is projected to grow by 4.5 %. In Africa, GDP growth rate is poised to stand at 4.0 % in 2010 and is likely to average 5.3 % by 2014.

**32.** The Parliamentary Budget Office forecasts a real GDP of 4.7 %, 5.1 %, and 5.4 % in 2010/11, 2011/12, and 2012/13, respectively<sup>1</sup>. The key drivers of the aforementioned growth are:

-  The imminent and ostensible recovery of the global environment,
-  Capital investment within the country resulting from the stabilization from the post 2007 election violence, and
-  The prospective increased lending by banks in line with the Central Bank incentives – the CBK has on several occasions acted to increase capital and liquidity in the country by lowering the Central Bank Rate (CBR) and this could bear fruit in 2010/11.
-  Renewed capital flows to emerging markets will have a positive effect on reducing the cost of capital and finance fixed investment.

**33.** However it is important to note that these growth patterns will be achieved if we get out the current mood which seems like election any time.

**34.** The reason for a lower projected GDP growth in 2012/13 and which may even be lower than projected is mainly on account of the following:

- Past trends: The economic and political history indicates that whenever there are elections the country gets into fever which leads to suppressed growth. In addition it has been observed over time that if the previous political regime continues then there is a time lag before the economic picks up. On the other hand, if there is a

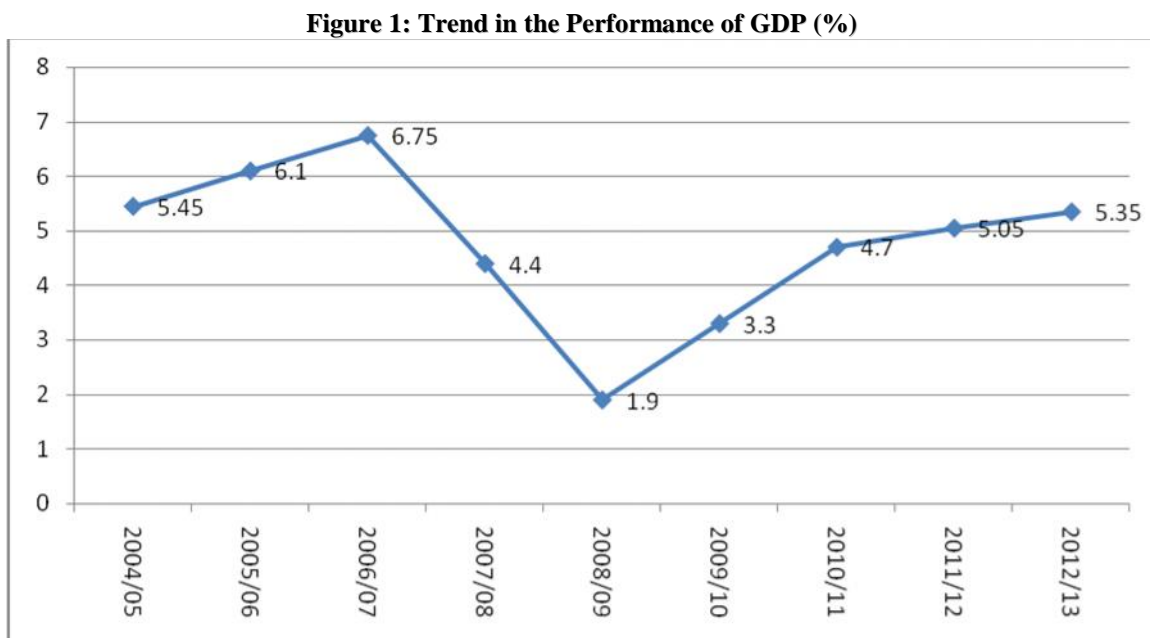
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<sup>1</sup> The detailed macroeconomic framework underpinning 2010/11 and the Medium Term is given in Annex.

change in political regime, most investors devise a wait and see attitude which also slows growth.

- Election related risks: This is due to the cyclical nature of suppressed growth immediately following a general election in the country resulting from a wait-and-see approach adopted by investors.
- Migration of people from post election (PEV) hotspots which form a cornerstone of the agricultural backbone of the economy. In fact not unless we move fast to deal with the perpetrators of 2008 skirmishes there will be a lot of suspicion especially in areas known to hotspots.
- Figure I gives the pattern of growth since independence and one will easily identify the behavior just before and immediately after elections

Figure 1 show past and forecast GDP growth rate.

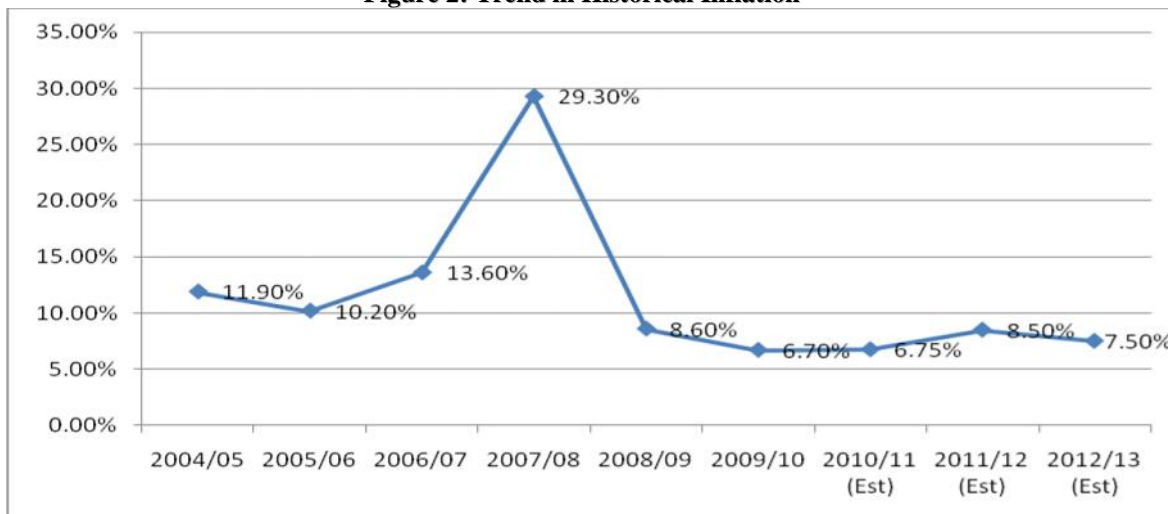


35. Over the medium to long term projection of the economic growth rainfall shortfalls will continue to significantly affect the growth of the economy since it has adverse effects on disposable incomes of the citizenry and this has a knock-on effect on the manufacturing and service sectors of the economy. It is also important to note that for the above growth to be sustained there is need for the Government to continually enhance public-sector investment in economic infrastructure which is crucial in supporting the recovery and is essential to reduce bottlenecks and draw in private-sector investment.

### 3.2 Is the general price level regime favorable?

- 36.** Low inflation, a more competitive real exchange rate, and rising private-sector investment and employment are important for a stronger recovery. The 2009/10 budget was prepared against a backdrop of reduced inflation levels to a tune of 5 % (from double digit figures in the financial year 2008/09). Inflation target of 5 % has been targeted by the Treasury for the past 3 financial years and has not yet been attained (see figure 2), even to date. More importantly, the overall inflation rate, which has a profound impact on purchasing power, has been on the rise in the last financial year, driven mainly by increase in food prices due to seasonal factors. It is important to appreciate that due globalization inflation becomes a key variable in the economy as high inflation rates in a country where its neighbors have low inflation can lead to re-location of firms to other countries.
- 37.** To this end the Parliamentary Budget Office projects that the level of inflation is likely to increase significantly in the medium term on account of a likely increase in money owing to the general election in 2012. This is in line with past trends seen in previous elections. Thus, inflation is expected to stand at 6.75 %, 8.5 %, and 7.5 % in 2010/11, 2011/12, and 2012/13.

**Figure 2: Trend in Historical Inflation**



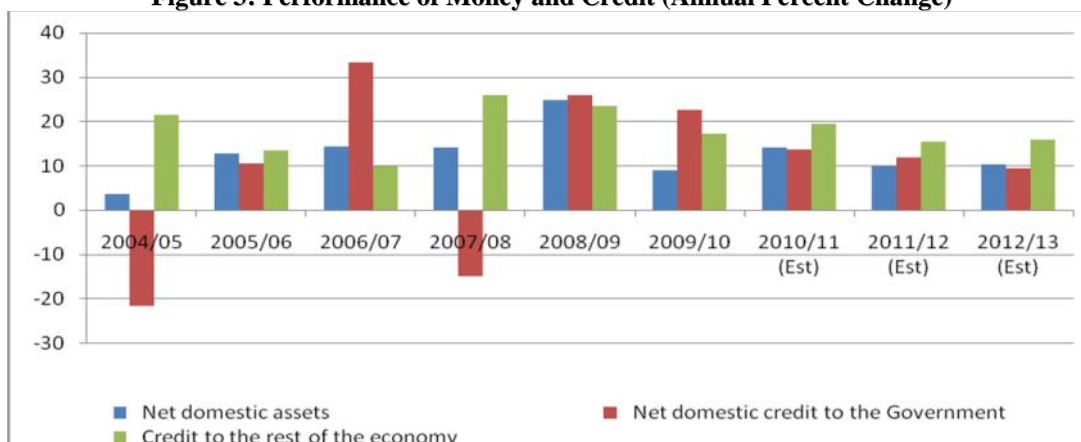
### 3.3 Taming the growth of money<sup>2</sup>

- 38.** The level of net domestic assets is expected to increase from 8.8 % in 2009/10 to 14.6 % in 2010/11 before stabilizing at about 10.2 % in 2011/12 and 2012/13. The driving factor for the huge build up in net domestic assets in 2010/11 should be due to an expansion in private sector credit which is necessary to support the higher envisaged growth. On the other hand, to free more resources for private sector led growth, net

<sup>2</sup> See Annex 2 for details

domestic credit to government is expected to decline from 22.5 % in 2009/2010 to 13.9 % in 2010/2011 while credit to the rest of the economy is expected to increase from 17.1 % in 2009/2010 to 19 % in 2010/2011. Broad money is poised to decrease slightly from 13.9 % to 13.4 % in 2010/2011.

**Figure 3: Performance of Money and Credit (Annual Percent Change)**

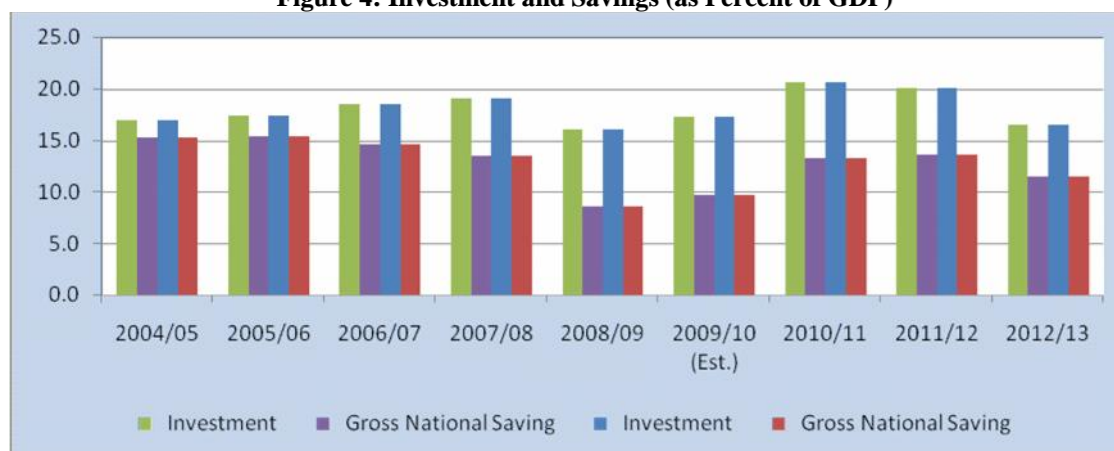


39. From the above figure, in line with the quest for private sector led growth, credit to the rest of the economy is envisaged to grow faster than credit to the Government. This therefore implies the need for a deliberate Government policy of reducing domestic borrowing. In so doing, we shall be able to achieve the twin advantage of lower interest rates coupled with a higher growth rate.

### 3.4 The panacea of Savings Investment gap?

40. To support the overall growth, the level of investment level is expected to increase from 17.3 % to 20.7 %. It expected that much of the investment will come from private sector which will contribute about 12.0 % (Figure 4).

**Figure 4: Investment and Savings (as Percent of GDP)**



### 3.5 Looking at the resource envelope<sup>3</sup>

#### 3.5.1 Total revenue

41. There is no adequate reason why the revenues cannot be more than 20% of GDP without instituting any new measures. Assuming that the target for FY 2009/10 will be met, the total revenue has a potential to grow at more than 10% i.e. from Kshs.571.7 billion in 2009/10 to more than Kshs.626.1 billion in 2010/2011 where if there is no policy change the ordinary revenue will comprise of 92.4% of the total revenue. AIA and investment income combined should contribute about 4.16% of the total Government revenue, while other revenues will comprise of 7.59%. Table 2 shows the details based on no policy change but with more efforts of collection.

*Table 2: PBO Revenue Estimates for FY 2009/10 – 2012/13 (In billion of Kshs.)*

	2008/09	2009/10	2010/11	2011/12	2012/13
<b>TOTAL REVENUE</b>	<b>487.9</b>	<b>571.7</b>	<b>626.1</b>	<b>685.5</b>	<b>745.3</b>
Ordinary Revenue (excl. LATF)	455.8	526.8	578.3	634.1	690.2
Income tax	184.4	211.9	233.0	259.1	286.3
Import duty (net)	36.2	40.6	44.5	48.8	52.7
Excise duty	69.9	78.1	91.5	97.3	102.6
Value Added Tax	126.9	148.4	161.9	177.5	192.9
Investment income	6.9	5.8	6.1	6.5	6.8
Other	31.5	47.8	47.5	51.4	55.7
LATF	9.2	11.2	12.3	13.6	15.1
Ministerial and Departmental fees (AiA)	22.9	33.8	35.5	37.7	40.0

42. Domestic revenue mobilization is one of the key pillars of Domestic Resource Mobilization (DRM). There are a number of constraints that hinder optimal and efficient revenue mobilization. These include the large informal sector, the high level of resource leakage, tax exemptions and exonerations, an unattractive business environment, trade liberalization, low economic growth and high level of poverty. As much as the Government has demonstrated that it is aware of the necessity to increase resource mobilization and a number of policy initiatives have been made, effective implementation and impact on DRM remains to be seen.
43. Indeed, the current ratio of revenue to GDP of about 20 % could be increased if the Government puts in deliberate revenue administrative measures. Thus, the following needs to be considered in the forthcoming budget:
- ***Address the issue of transfer pricing***  
Transfer pricing is a normal, legitimate, and a required activity. However transactions between related parties or associated enterprises are not always subject to the same market forces as transactions between independent actors. As a consequence, there is potential for manipulation, through under or over

<sup>3</sup> See Annex 3.

pricing, of the customs duties basis and allocation of taxable profits. Governments worry about transfer price manipulation because they are concerned with the loss of revenues through tax avoidance or evasion. Simulation results from the budget office indicate that in 2007, the Government lost US\$1,643,808.87 in value terms for the two sampled commodities (pharmaceuticals and petroleum). To this end there is need for a deliberate Government policy on how to enforce the transfer pricing guidelines. This may include but not limited to putting in place legislative mechanisms of curbing this menace. Several loopholes associated with the Transfer Pricing Rules in Kenya are prominent. Among them are that the rules are incomplete and not sufficient to deal with transfer pricing issues in the country; the Commissioner has no discretion powers of deciding the best arm's length pricing method a tax payer should choose and he may not challenge the arms length method used by the taxpayer; some sections of the transfer pricing guidelines conflict each other.

- ***Expansion of tax base***

The government should consider re-designing turnover tax regime. Its performance is currently down due to inherent weaknesses in its application making it unable to achieve the intended purpose. If well designed to be all inclusive it will be a good means of dealing with small businesses which don't qualify to pay VAT.

- ***Tax on rent income***

Tighten existing loopholes to bring more landlords into the tax net by linking KRA system with the wider government; especially the lands registry and urban council data on housing. This is a sure way to get all landlords on board. The current system put the burden of identifying the landlords on tenants through income tax returns by providing PINs of the landlords. This system is not good since most landlords do not give the tenants PINs as required. Thus, a number of landlords evade paying tax on rent.

- ***Strategies to bring to tax the 'bazaar type of traders'***

Most businesses especially in large urban cities are disintegrated into small business with a view to avoiding registration as formal business with tax obligations. In addition, there is possibility that goods that have not been subjected to tax easily find their way into these markets. In most cases these types of businesses camouflage in places like Eastleigh and Eastern side of Moi Avenue in Nairobi. The Government should research on best regimes to ensure that these businesses are enrolled into tax net.

- ***Widening of Personal Tax Brackets and Personal Relief***

It is appreciated that PAYE is the easiest tax to collect. However, the Government should at all times uphold the principle of 'flowers, bees, and honey' in collecting it. High income earnings should be encouraged in the economy so that the resulting increased disposable incomes are directed

towards more economic activities. By applying the highest PAYE rate of 30% at only Kshs.38,892 of income per month the Government seems to be sending the message that the amount is already a high income. We believe that there is a need to broaden the tax bands. The effect of this will be that individuals in the lower income groups will benefit most out of the amendment since it will also increase disposable income and hopefully stimulate spending.

- ***Conversion of Several Appropriations in Aid (AIA) into revenue***  
There are number services whose payments are made as user charges. Consideration should be made so that a number of these with high turnovers are converted to revenue. Some of these include immigration collections pertaining to documents such as passports, Court fees and fines, among others. We propose that these kind of charges should be collected as revenue through designated bank accounts through progressive application of law. This will reduce the leakage of resources and will also enhance the accountability in the mobilization of resources.
- ***Off set of Customs Duty Refunds to prevent cash flow constraints***  
Sections 145 to 153 of the Customs and Excise Act provide for refund, rebate and drawback of duty in specified circumstances. In practice however, KRA are slow in approving this thereby creating cash flow constraints to traders. Worst affected are petroleum products marketers. The Government should introduce a provision to allow taxpayers whose refunds have been verified by KRA to set-off against other taxes including PAYE and corporate tax.
- ***Economic Partnership Agreements***  
Trade liberalization (implying decline in international trade taxes) should be sequenced with corresponding increase in other forms of DRM. This is especially the case of Economic Partnership Agreements (EPAs).

### **3.3 What should drive fiscal policy (expenditure switching) in the 2010/11 and the medium term?**

44. Over the medium term, economic policy must strike a delicate balance, supporting the recovery through appropriate fiscal and monetary measures while avoiding the build-up of unsustainable debt that will impose costs on future generations. Indeed, achieving this balance requires sound economic policy, better coordination of policy between departments and well-functioning economic institutions.
45. Kenya faces a period of lower growth (below the MTP target) in the next few years, thus, this calls for the need to contain state expenditure as a share of GDP implies that the rate of growth in public spending will need to be moderate. Slower revenue growth and perhaps rising debt interest costs are expected to feature in the public finances for the foreseeable future. This means that government has to do more with less. Thus, the Government should focus on:

- ✚ Finding savings through reduced spending on non-core functions and activities, including shifting resources from administrative components to frontline services. This will include outsourcing non core functions of the various as opposed to the current practice of hiring additional staff.
  - ✚ Rationalizing public entities and agencies to save money and improve accountability. This should entail making public entities operate with a private sector culture and reduce overreliance to exchequer for their day to day operations
  - ✚ Reviewing public spending to weed out poorly performing programmes, low-priority activities and ineffective policies.
  - ✚ Reforming procurement systems to reduce corruption and obtain better value for money, including giving consideration to centralizing the procurement of selected goods and services
  - ✚ Changing the culture of the public service to reduce waste and to prevent extravagant spending, shoddy work and corruption.
  - ✚ Levering IT in most of the processes which will reduce administrative costs substantially and also reduce the leakage in resource mobilization
- 46.** Over the next several years the rate of growth in public spending needs to be moderate. Given the considerable pressures for delivery of more and better public services, the constrained fiscal environment places an obligation on government to do more with less. This implies the need for a new approach to the management of public resources and for spending to be reprioritized towards key targeted programmes and projects as opposed to the current practice whereby money is simply allocated to Ministries and often used for recurrent expenditure.
- 47.** From the Budget Office point of view, the Government has not yet reported on key details regarding implementation methods and output measurement; expected outcomes; and progress benchmarks towards achieving these elements. However, the limited information presented in the Government's report is believed to be accurate, timely and easily understood. A good example of good reporting is illustrated in the box below:

**Box 1: Good Reporting Practices by the Government**

Atypical example of a good reporting practice is illustrated below:

Kenyan Graduate Scholarships program:

- The amounts of funding allocation are identified (87.5 million over 3 years);
- The delivery mechanism is evident (Ministry of Higher Education);
- Tangible outputs are clearly described (500 doctoral scholarships and 1,000 masters'; and
- The inputs and outputs are aligned, and are directly linked to an outcome objective (developing a highly skilled workforce).

- 48.** Indeed, despite some effort to put resources in the social and economic sectors, the quality of many services has failed to meet the legitimate expectations of Kenyans. Judging by the lack of progress on many of the Millennium Development Goals, Kenya is falling short of its commitments. Too many children cannot get quality education; too many women die giving birth; too many people suffer from preventable diseases; too many households fall victim to crime; and too few people are reached by public employment programmes.

### **3.3 How does future expenditure composition look like: who pays the bill?**

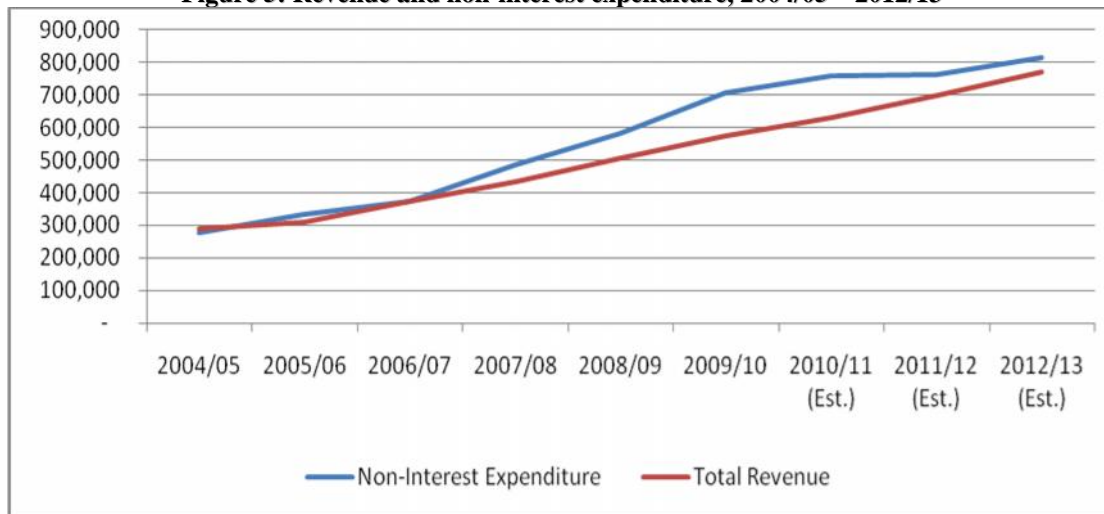
#### **3.3.1 Expenditure Net Lending**

- 49.** Total expenditure net lending in line with the thinking of contracting expenditures in order to achieve sustainable debt levels should reduce from 30.5 % in 2009/10 to lower than 29.3 % in 2010/2011. This should be mainly driven by containment of the public sector wage bill which will only occur if all salary adjustments are held on until the economy recovers fully. This will need to be supported by rationalization of the functions of government which should lead to lower recurrent expenditures.
- 50.** The level of recurrent therefore is forecasted to decline in proportion from 85% in 2004/05 to less than 63% in 2012/13. On the other hand, the level of development expenditure should be allowed to increase from 15 % to more than 40 % in 2012/13.

#### **3.3.2 Public Debt: Is Kenya's fiscal stance sustainable?**

- 51.** Sustainability – a core principle of fiscal policy – refers to the ability of government to finance its expenditure over a long period of time. A key indicator of sustainability is debt-service costs. If such costs are expected to rise as a percentage of GDP over the long term, the position is not sustainable. An unsustainable fiscal position can be financed in the short term through higher borrowing. However, pursuing an unsustainable fiscal stance for too long will result in spiraling debt costs – and eventually a costly adjustment through lower spending on service delivery and/or increases in tax rates.

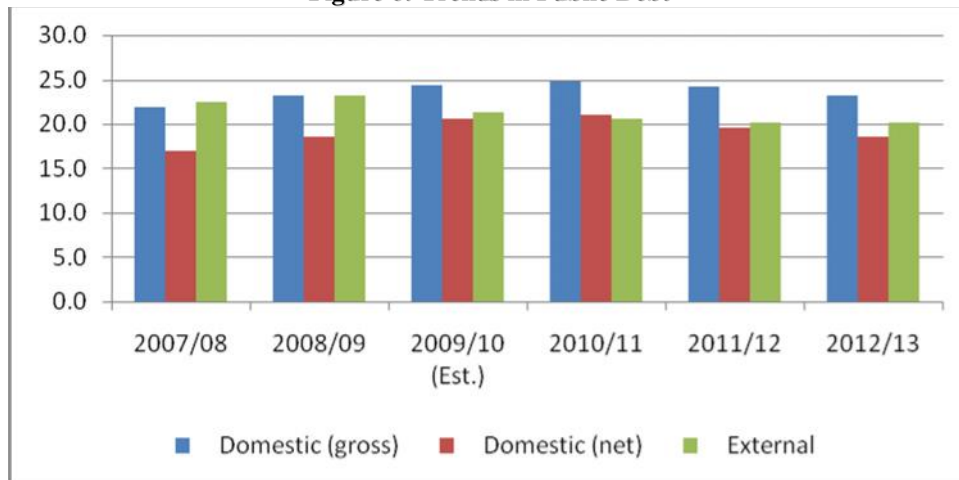
**Figure 5: Revenue and non-interest expenditure, 2004/05 – 2012/13**



- 52.** Figure 5 shows that strong growth in non-interest expenditure and a decline in budget revenue have resulted in a primary balance deficit. Over the medium term, there need for a clear policy for stabilization of growth in non-interest expenditure and rising tax revenue which should result in a narrowing of the primary balance deficit.
- 53.** According to IMF 2009<sup>4</sup>: *“Taking all public debt into account, however, the DSA shows greater risk of unfavorable debt developments, especially under a shock to GDP growth. Even temporarily lower GDP growth would set the NPV of public debt-to-GDP, the NPV of debt to revenue, and the ratio of debt service-to-revenue on a sharply increasing trend. Potentially large but unreported contingent liabilities also pose additional risks to the sustainability of public debt”.*
- 54.** Given the rule of Thumb of sustainable debt to GDP ratio being below 42%, overall level of public debt is should really be maintained below 41.7% in 2010/11 compared to an expectation of 41.9 % of GDP in 2009/10. Figure 6 shows the movement of domestic and external debt.

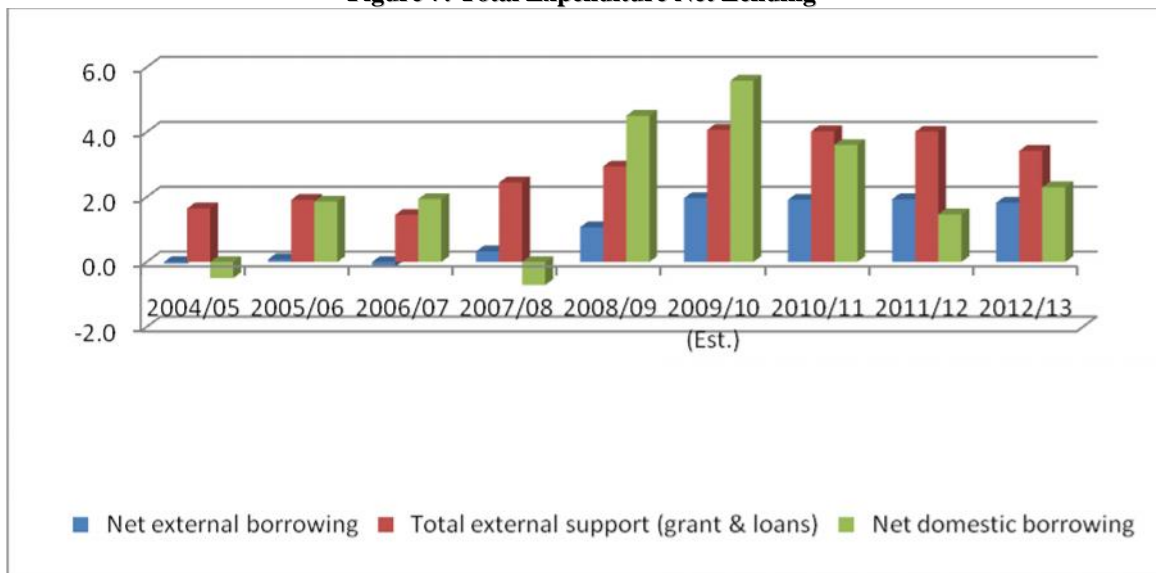
<sup>4</sup> Joint IMF/World Bank Debt Sustainability Analysis, May 2009.

**Figure 6: Trends in Public Debt**



55. It is important to note that extreme dependence on grants distorts the fiscal framework in times of sour relationship with the donor countries. To this end, the PBO maintains that donor grants and loans be retained at about 4% of GDP over the medium term (figure 6). One of the key issues surrounding donor funds in general is the lack of Government policy on the key priorities the funds are supposed to finance. Often external financing is supply driven rather than demand driven. There is therefore need to identify key areas that external financing needs to go. Overall, all modes of external financing should be based on our needs.

**Figure 7: Total Expenditure Net Lending**



56. On the other hand, interest payments are expected to increase by 10 basis points to 2.6% of GDP in 2010/11. In the near term, economic policies need to encourage a recovery in the domestic economy without burdening future generations with large public debts, high inflation and interest rates, and low growth. Thus, net external borrowing is expected to slightly drop from 2.0% of GDP in 2009/10 to 1.9% of GDP

in 2010/11. On the domestic front, given the high domestic debt which currently stands at about 20.5 % of GDP, domestic borrowing is expected to be curtailed from 4.3% of GDP in 2009/10 to 2.8% of GDP in 2010/2011.

### **3.4 Overall balance**

**57.** The overall balance including grants should shrink to less than 5.9% of GDP in 2010/11 from 6.6% of GDP in 2009/10. Lastly, in line with quest to pump substantial resources to the development related activities, development expenditure is expected to remain broadly at the 10.1 % level.

### **3.5 Balance of payments**

**58.** With the slight drop in Kenya's major export products, the value of exports is expected to increase from 12.1% of GDP in 2009/10 to 12.5% of GDP in 2010/11. On the other hand, the value of imports is also expected to trend downwards to 26.6% from 27.2%. The current account balance including official transfers is expected to narrow from 7.3 % of GDP in 2009/10 to 6.5 % of GDP in 2010/11.

## **4.0 Key priority areas and sectoral budget options**

### **4.1 Introduction**

- 59.** It is argued that if everything is a priority then nothing is really a priority. In order to spur the much needed economic growth of this country in line with the Vision 2030 the Government needs to move with speed to address some fundamental policy concerns to provide the necessary impetus for a higher growth trajectory. Hard times requires difficult decisions and as has been stated elsewhere in this document budget is about making decisions that are costly and delaying making the decisions is even more costly. The time to act is beginning with the financial year 2010/2011 which will be the basis for the medium term.
- 60.** At independence most African countries, Kenya included, identified ignorance, disease and poverty as the three major bottlenecks to development. Addressing these issues would in turn solve the major ills affecting standards of living and wealth creation. Achieving the aforementioned development challenges required giving priority to education, health and income generation. In order for the country to attain the high and sustainable economic growth that was envisaged in the vision 2030 it is important that expenditure priorities be re-oriented towards unlocking the economy.

### **4.2 Key Priority Areas**

- 61.** Given the above analogy, the following are the areas the PBO thinks the Government should focus on:
- Unlocking Governance Issues and its impact on the overall budget development of the country;
  - Delivery of better social services (Health, Education, Water)
  - Attaining food security;
  - Infrastructure development with more focus on diversity;
  - Energy and its role in opening up rural areas and affordability; and

#### **4.2.1 Governance Issues and its impact on National Development.**

- 62.** Unlocking the governance agenda is the master key to turning around the economy. Indeed the brimming number of Kenyans in prisons and remand homes is a governance issue. The long quest for birth certificate lately observed is all due to governance. The key and initial step on this priority should be to leverage on all processes related to governance law and order and ensuring that there are saving raised in this
- 63.** The country can account for many reasons why the economy is not growing as should be and why many of our people are living in poverty. However the most important reason as to why Kenya was having per capita income in the 1970's higher than Singapore is the crisis of governance of our times. Perhaps there is no adequate scientific measure or correlation between economic growth and governance, however

it is real and not unless the governance issues are sorted out upfront the vision 2030 and the aspirations of the people of Kenya will just be a mirage as it will be really difficult to overcome all other hindrances to faster economic growth that is so necessary if many of our people have to get out of poverty.

**64.** Bulk of the governance issues relate to the Governance sector which is composed of provincial administration (security issues), Home affairs (prisons and remand homes, Interim Electoral Commission (fair and free elections), Judiciary (Quick and relevant Justice), National assembly (policy commitment at political level and adequate legislation and oversight). Indeed this is a sector that can unlock a lot of resources for other sectors. Currently the prisons are overflowing and this could be due to slow court process or the fact that often there is no strategy to deter crime. Indeed the sector may not need additional resources but need enforcement of laws and may be creation of new ones. The new resources for the sector should be for leveraging IT in its process and elimination of human conduct in some of the processes starting with Judiciary and moving on to Immigration and eventually to security. How much can the country save if priority is given for faster justice, for better registration of persons, for use of alternative security measures e.g. surveillance cameras instead of security personnel etc. The security and development are for a long time been considered as inter- related and mutually reinforcing. Wars in poor countries have left the countries even poorer and less politically stable. It is from the foregoing that long term security and stability requires generation of sustainable economic growth. For a country to achieve the planned economic growth and ensure a suitable investment atmosphere, the investors both local and international need to be assured of their security and the security of their ventures.

**65.** To ensure improved security, it is important that corrective institutions nurture reducing Opportunities for recurring offences. Again, there is need to look into the process of detecting crime, charging those guilty, rehabilitation, and integration back into society. Aspects of this process (or loop) do not link adequately to the others and need to be well coordinated. In addition, a working judicial system while at the same time dispensing all backlog cases pending on courts with speedy administration of justice will address the issues of lawlessness and mob justices that are inherent in society today.

#### **4.2.2 Delivery of better social services (Health, Education, Water)**

**66.** In the provision of basic social services the preference of the beneficiaries should be factored in and demand driven approach always considered. Since independence, the delivery of social services have been the key priority in the budget it is for this reason that among other ministries the Education, and Health Ministries have been commanding a fair share of total resources. As indicated elsewhere the Government will need to contract expenditures in particular those related to recurrent. It is also a known fact whenever expenditure contracts the social sectors are adversely affected.

In addition the stimulus package had substantial resources that were ploughed into these sectors and this will definitely now become annual requirements hence it will be difficult to this sector to live within the same levels as previous years.

67. The rapid population growth which is currently outstripping the economic growth rate implies that the provision of basic social services will be constrained. It is imperative that provision of basic goods and services match the ever growing population. In addition, there is need to put come up with deliberate measures to check the population growth rate otherwise we risk losing the fight for the quest of improving the quality of life.
68. **Education:** There is concern from Kenyans about the growing need for more teachers particularly in ASALs as well as quality amenities within schools. Whereas the Education sector's proposals to reduce transfers to public universities, increase bursary allocation, improve targeting of needy students, provide basic equipment to targeted schools and needy areas, expand capacity at secondary schools and promote private sector participation in provision of secondary school are commendable and in line with KESSP, there is need to consider raising the transition rates from one level of education to the next. It is also important to streamline the delivery of services in this sector by ensuring that there is less leakage and that the country will not talk of having implemented successfully free primary education when their children playing outside the school gate for he cannot afford to be in school due to other charges often absurd to imagine.
69. **Health:** Under health, the major concerns revolve around the high costs of both in and out patient care, the quality/standards of health care and medication is low, and the access to specialized care and diagnosis is limited to Nairobi and major towns The major challenges have been improving the delivery of health care service and enhancing accessibility of health by majority of the citizen. Despite an increase in investment in the health sector over the past recent years, Kenya continues to experience a high disease burden; most people especially the poor are unable to access basic health care. Key indicators in health have declined relatively with wide regional variations.
70. Other countries e.g. South Africa has encouraged for the higher class and middle class to seek medical services from the private sector. Yet in Kenya in the referral hospitals a large number of those seeking services are from the middle class. Where governance issues are high the poor may even be completely locked from some these services. Indeed we still report cases of women that deliver in the house for lack of a health centre /dispensary. This calls for the adoption and implementation of clear government policy on a health financing policy. Thus there is need to enact legislation that establishes a health regulatory authority to harmonize efforts in the health sector, ensure standards and quality provision of services and a level playing field. It is important to revisit the Health Insurance policy and support the need to enrollment of all Kenyans including private sector irrespective of whether they seek for these services. This should be complemented by ensuring there is more surveillance and reduction in leakage and wastage of resources in this sector.

**71. Clean Water:** The provision of clean water in the country faces challenges of sustainability despite the concerted efforts by government to ensure access of clean water to all people in line with the MDGs. In the recent past substantial resources have been given to this subsector and there are still shortages of water. There is need to consider the strategies identified in the vision 2030 and enhance rain water harvesting by providing cheaper credit to household to engage in the activities of water harvesting.

**72.** A closer linkage between addressing the issues of water and environment should be addressed.

#### **4.2.3 Attaining Food Security**

**73.** A nation that cannot feed its population can hardly achieve any meaningful development and is dependent on other nations. A healthy Nation is wealthy nation and builds on its credibility which in turn fosters national development besides improving on living standards. Kenya has experienced a cyclical drought and severe famine every 4 to 5 years. As a result, food poverty is a common phenomenon in every poverty report. Once Kenya experiences this food shortage, the immediate response has been erratic food relief services The Government has often reacted in uncoordinated manner with piecemeal allocation for strategic grain reserves in the ensuing financial year.

**74.** To curb this recurring problem there is an urgent need to address the issue of food security that in turn will address the issue of food poverty by establishing feasible mitigation mechanism. This entails an integrated food security strategy that prioritizes the issue of food for all Kenyans after taking into consideration the diversity of Kenyans. This should be an all round the farm activity and the proceeds be channeled towards a long-term solution. The current food glut and milk glut are an example of unplanned post harvest.

- To effectively address the twin problem of food poverty and cyclical famine particularly in rural areas the following should be considered as matter of urgency. Encourage use of modern farm implements and inputs including quality seeds. . Increasing acreage under irrigation

Access to credit and micro-finance,

- Ensure a vibrant livestock production where there is a strategy for destocking and restocking depending on the cyclical nature of the Kenyan weather. This also includes support to introduction of small harbatours that supplement the KMC alternatively expand KMC to have branches in areas where livestock is mainstay.
- . Revitalize the cooperative movement in order to mobilize domestic savings and to streamline the marketing function in the sector.

#### 4.2.4 Infrastructure Development

- 75.** Infrastructure is the capital stock that provides public goods and services. It generates far reaching implications on production activities and quality of life of households which in turn permeate the entire social fabric. Infrastructure development is the basis for economic growth which plays a pivotal role in poverty reduction. In addition, the growing infrastructure increases employment opportunities in a country as well as facilitating the access to markets.
- 76.** Infrastructure must be designed and constructed so that it balances the need for growth, development and change with the equally critical requirement for sustainability and a palpable improvement in the overall quality of people's lives.
- 77.** Infrastructure sustainability poses a challenge due to the large size of expenditures needed considering that even a marginal productivity improvements leads to significant savings in national budgets. In financing the infrastructure the government needs to consider programmes of user- pricing, wide spread reliance on earmarked taxes, up – front capital contributions by land developers and joint capital participation with the private sector.
- 78.** Whereas it is important to recognize efforts in the development of infrastructure especially the road network it is equally important to note that while mass transport is by road functional light railway line would ease traffic congestion in our roads and even the lifespan of the road built. Decongest areas close to the Central Business District.
- 79. Energy:** With growing industrialization, household and industry consumption levels of energy are far outstripping our domestic generation capacity. Additionally, global supply of some forms of energy such as petroleum is limited and costly. Kenyans are concerned that with these issues as well as the present wood fuel supply deficit, the harmful effect of coal on the ozone layer, the non-reliability of hydroelectric power and the limited availability of LPG, immediate and long term intervention measures are required. There is great potential for alternative sources of energy such as solar, wind and biomass (waste), not just for domestic use but for exportation as well.
- 80.** For a country to develop, provision of affordable, reliable, secure and sustainable energy services for national development is essential. As a country, Kenya relies heavily on hydroelectricity as a source of energy. Currently Kenya does not generate enough energy for her usage but it also imports power from Uganda and geothermal power generation is also done. Diversification of energy generation in the country by harnessing the wind and solar power in the country will go a mile ahead to curb the energy gap in the country.

## **5.0 Summary, Way forward and Policy Options**

### **5.1 Summary**

- 81.** Financial Years 2008/09 and 2009/10 were characterized by economic shocks both from within and without. The country has a twin challenge of getting the balance right between supporting jobs and economic activity, and ensuring that the Government's longer-term finances remain sound and constrain debt accumulation.
- 82.** The evidence to date indicates that the Government has made some progress with regard to the above balance. The severity of the downturn in Kenya has been significant owing its position and the role it plays in the regional economy (EAC). Growth is expected to slowly rebound over the next two Financial Years. However, there are eminent risks of falling back to a lower economic growth level due political uncertainty especially with regard to the prevailing enactment of a Constitution and forthcoming 2012 elections.

### **5.2 Way forward and Policy Options**

- 83.** One thing that is certain is the fact that policy makers are faced with myriads of challenges in the coming year into the medium term. In endeavoring to achieve growth prospects, fiscal policy should remain stimulative in the near term. Also, the Government needs to sort out, as a matter of urgency; governance issues in terms of rule of law, justice system, resource leakage and improving flow of information, among others.
- 84.** There is need to re-engineer policy changes to bring about a shift in demand from public to private sources. In terms of fiscal policies, it should however be stressed that while fiscal stimulus can provide a short term boost, it is not an effective growth strategy in the long term. Similarly, monetary policy should remain supportive and more should be done to promote credit to the private sector for more investment.
- 85.** There is need to strive to align its development priorities to the flagship projects identified in the Vision 2030 especially those meant to spur and kick start the economy in the medium term. Policies adopted should accommodate the permanent shift in the structure of the world economy caused by the crisis, and support demand moving from traditional industrial powers to emerging markets. Economists believe that if these shifts are well managed with long-term considerations (like climate change in mind) have the potential to create new sectors, such as "green industries," that will help drive future growth.
- 86.** There is need to increasingly embrace innovation and capacity of the private sector and the discipline of the markets, in an attempt to ensure that the population had access not just to a service, but to services of decent quality. This should eventually see many people probably being accommodated in the private health care system and

in private schools. What about if private security is properly regulated and encouraged to outnumber the police and private contractors recruited to run all prisons in Kenya? This may help in the long run to check the ever ballooning Government expenditure. The obvious fact is that Government regulation and oversight has to be tightened considerably and keeping tender processes fair and incorruptible.

- 87.** There is need to move away from perpetuating the ‘handout syndrome’ and reconsider any attempts to introduce socialism in distribution of economic goods. Citizens must be prevailed and encouraged to work hard for there is no free lunch – someone has to pay. In the modern times such strategies are difficult for any nation that is at the take off stage in development and encourages idleness and less effort and attitude to work. For instance the subsidized ‘unga’ project failed in 2008 as it could not be sustained neither could it adequately targeted in our form of societal structure beliefs and attitudes. More recently attempts to give certain sections of the population ‘free monthly salaries’ as social protection is also failing for the same reason of identification and dealing with the Kenyan perception of a public good “mali ya uma”.
- 88.** The better option is to look for ways of engaging all the citizens to be productive in whatever way. Attempts to give free monies will only work to let productive people abandon their law paying labor to seek for free monies. This has the effect of slowing down production outputs thus endangering the GDP growth prospects further. As we move towards 2010/11 budget and the medium term, Kenyans would expect more bold moves to entice the people to be more productive through well thought out programmes targeted to the productive sectors of the economy.

<b>Annex 1: Main macroeconomic indicators underpinning the Medium-Term Fiscal Framework, 2007/08-2012/13</b>						
	2007/08	2008/09	Medium-Term			
			2009/10	2010/11	2011/12	2012/13
		Prov.	PBO	PBO	PBO	PBO
<i>Annual percentage change, unless otherwise indicated</i>						
<b>National account and prices</b>						
Real GDP	4.4	1.9	3.3	4.7	5.1	5.4
Real GDP per capita	1.4	-1.0	0.4	1.8	2.2	2.5
GDP deflator/1	9.1	11.9	10.0	6.7	8.2	8.7
CPI Index (eop)/1	29.3	8.6	6.7	6.8	8.5	7.5
CPI Index (avg)/1	18.5	12.6	8.4	5.0	8.5	8.5
Terms of trade (-deterioration)	-3.5	1.8	1.2	-4.9	-3.1	-0.1
<b>Money and credit (end of period)</b>						
Net domestic assets	14.0	24.9	8.6	14.2	9.5	10.5
Net domestic credit to the Government	-15.1	25.8	22.5	15.2	13.0	10.6
Credit to the rest of the economy	26.0	23.4	17.1	18.8	14.7	15.9
Broad Money, M3 (percent change)	18.7	13.0	13.7	12.8	14.8	15.7
Reserve money (percent change)	18.2	4.7	13.3	13.9	14.8	15.7
<i>In percentage of GDP, unless otherwise indicated</i>						
<b>Investment and saving</b>						
Investment	19.1	15.0	16.3	18.8	17.2	18.0
Central Government	6.6	7.6	9.0	8.8	8.7	8.7
Other	12.5	7.4	7.3	10.0	8.5	9.3
Gross National Saving	13.5	7.6	8.9	11.7	11.1	13.3
Central Government	1.7	1.7	2.3	6.4	5.5	5.3
Other	11.8	5.9	6.6	5.3	5.6	8.0
<b>Central government budget</b>						
Total revenue	22.0	22.6	22.5	22.2	21.6	20.9
Total expenditure and net lending	27.2	28.6	30.6	28.8	26.3	25.8
of which : wages and salaries	7.4	7.1	6.8	6.5	6.4	6.4
Interest payments	2.4	2.4	2.5	2.6	3.5	3.4
Development expenditures	6.7	7.7	10.3	10.2	10.1	9.4
Overall balance (commitment basis) excl. grants	-5.2	-6.0	-8.0	-6.7	-4.7	-4.9
Overall balance (commitment basis) incl. grants	-3.5	-4.9	-6.6	-5.3	-3.3	-3.5
Net external borrowing	0.3	1.1	2.0	1.9	1.9	1.8
Infrastructure bonds	0.0	0.8	1.3	0.9	0.4	1.0
Net domestic borrowing	-0.7	3.7	4.3	3.1	1.4	1.7
Total external support (grant & loans)	2.4	2.9	4.1	4.0	4.0	3.4
<b>Balance of payments</b>						
Exports value, goods and services	25.9	24.4	21.0	20.6	21.2	22.4
Imports value, goods and services	38.1	37.8	33.4	32.1	31.4	31.0
Current external balance, including official transfers	-5.6	-7.4	-7.4	-7.1	-6.0	-4.7
Current external balance, excluding official transfers	-5.7	-7.3	-7.4	-7.0	-6.0	-4.6
Gross international reserve coverage in months of next year imports (end of period)	3.4	2.7	2.9	3.1	3.6	4.0
<b>Public debt</b>						
Nominal central government debt (eop), net	39.3	41.7	42.0	42.3	40.8	39.8
Domestic (net)	16.9	18.5	20.6	21.5	20.3	19.4
External	22.4	23.2	21.4	20.8	20.4	20.4
<b>Memorandum items:</b>						
Nominal GDP (in Ksh billions)	1,963	2,237	2,541	2,838	3,224	3,693
Nominal GDP (in US\$ millions)	29,885	32,181	37,023	41,497	45,239	49,337
Per capita income (US\$)	792	829	927	1,010	1,071	1,136
Source: PBO Forecasts						

Annex 2: Central Government Operations 2008/09 - 2012/13 (in billions of Kenya Shillings)					
	2008/09	2009/10	2010/11	2011/12	2012/13
	Prel.	PBO	PBO	PBO	PBO
<b>TOTAL REVENUE</b>	<b>487.9</b>	<b>571.7</b>	<b>626.1</b>	<b>685.5</b>	<b>745.3</b>
Ordinary Revenue (excl. LATF)	455.8	526.8	578.3	634.1	690.2
Income tax	184.4	211.9	233.0	259.1	286.3
Import duty (net)	36.2	40.6	44.5	48.8	52.7
Excise duty	69.9	78.1	91.5	97.3	102.6
Value Added Tax	126.9	148.4	161.9	177.5	192.9
Investment income	6.9	5.8	6.1	6.5	6.8
Other	31.5	47.8	47.5	51.4	55.7
LATF	9.2	11.2	12.3	13.6	15.1
Ministerial and Departmental fees (AiA)	22.9	33.8	35.5	37.7	40.0
<b>EXPENDITURE AND NET LENDING</b>	<b>601.9</b>	<b>776.7</b>	<b>837.4</b>	<b>885.9</b>	<b>951.7</b>
Recurrent expenditure	431.2	509.3	544.5	558.4	600.2
Interest payments	52.1	64.3	75.0	112.6	127.4
Domestic interest	45.9	58.0	67.7	103.4	114.9
Foreign interest	6.1	6.3	7.3	9.3	12.5
Wages and benefits(civil service)	155.2	173.5	183.6	205.8	237.6
Contribution to civil service pension fund	6.1	0.0	11.4	12.4	14.7
Civil service reform	0.1	0.1	0.1	0.2	0.2
Pensions etc	27.2	26.1	23.5	22.7	25.0
Other	148.2	191.4	196.6	149.8	138.3
O/W internal security interventions	0.0	0.0	2.5	3.0	2.0
Defense and NSIS	48.5	53.9	54.3	54.9	57.1
Pending bills change	0.0	0.0	0.0	0.0	0.0
Development and Net lending	166.3	261.3	290.0	324.5	348.5
Domestically financed	112.0	155.1	172.7	191.4	200.0
Foreign financed	52.0	103.8	114.8	130.4	145.6
Net lending	2.4	2.4	2.5	2.7	2.9
Drought Expenditures	4.3	6.1	1.0	1.0	1.0
Contingencies	0.0	0.0	2.0	2.0	2.0
<b>Balance (commitment basis excl. grants)</b>	<b>-114.0</b>	<b>-205.0</b>	<b>-211.3</b>	<b>-200.4</b>	<b>-206.4</b>
Adjustment to cash basis	12.8	-0.6	0.0	0.0	0.0
Project grants	19.7	35.3	38.8	44.3	53.2
<b>Balance (cash basis including grants)</b>	<b>-81.5</b>	<b>-170.3</b>	<b>-172.5</b>	<b>-156.1</b>	<b>-153.1</b>
Statistical discrepancy	7.2	-2.1	0.0	0.0	0.0
<b>FINANCING</b>	<b>88.7</b>	<b>168.2</b>	<b>141.6</b>	<b>107.0</b>	<b>109.7</b>
Net foreign financing	16.8	50.2	54.4	62.3	48.5
Project loans	32.3	68.5	76.0	86.1	73.9
Commercial Fin./Sovereign bond	0.0	0.0	0.0	0.0	0.0
Repayments due	-17.5	-18.7	-21.5	-23.8	-25.4
Change in arrears	1.5	0.0	0.0	0.0	0.0
Rescheduling/Debt swap	0.5	0.5	0.0	0.0	0.0
Privatization proceeds	0.0	6.0	0.0	0.0	0.0
Net domestic borrowing	69.4	109.5	87.2	44.7	61.1
Financing gap	0.0	-2.1	-30.9	-49.2	-43.5
<b>Memo items</b>					
Domestic Debt (gross)	518.3	621.8	716.3	809.3	895.5
Domestic Debt (net)	404.1	524.0	611.2	655.8	717.0
Infrastructure bonds	18.6	32.9	26.2	13.4	18.3
Nominal GDP	2,307.7	2,541.1	2,837.9	3,224.4	3,693.1
Source: PBO Forecast ,Ministry of Finance for historical data					

Annex 3: Central Government Financial Operations, 2007/08 - 2011/12 (% of GDP)					
	Prel.	BOPA'10	BOPA'10	BOPA'10	BOPA'10
<b>TOTAL REVENUE</b>	<b>21.1%</b>	<b>22.5%</b>	<b>22.1%</b>	<b>21.3%</b>	<b>20.2%</b>
Ordinary Revenue (excl. LATF)	19.8%	20.7%	20.4%	19.7%	18.7%
Income tax	8.0%	8.3%	8.2%	8.0%	7.8%
Import duty (net)	1.6%	1.6%	1.6%	1.5%	1.4%
Excise duty	3.0%	3.1%	3.2%	3.0%	2.8%
Value Added Tax	5.5%	5.8%	5.7%	5.5%	5.2%
Investment income	0.3%	0.2%	0.2%	0.2%	0.2%
Other	1.4%	1.9%	1.7%	1.6%	1.5%
LATF	0.4%	0.4%	0.4%	0.4%	0.4%
Ministerial and Departmental fees (AiA)	1.0%	1.3%	1.3%	1.2%	1.1%
<b>EXPENDITURE AND NET LENDING</b>	<b>26.1%</b>	<b>30.6%</b>	<b>29.5%</b>	<b>27.5%</b>	<b>25.8%</b>
Recurrent expenditure	18.7%	20.0%	19.2%	17.3%	16.3%
Interest payments	2.3%	2.5%	2.6%	3.5%	3.4%
Domestic interest	2.0%	2.3%	2.4%	3.2%	3.1%
Foreign interest	0.3%	0.2%	0.3%	0.3%	0.3%
Wages and benefits(civil service)	6.7%	6.8%	6.5%	6.4%	6.4%
Civil service reform	0.0%	0.0%	0.0%	0.0%	0.0%
Pensions etc	1.2%	1.0%	0.8%	0.7%	0.7%
Other	6.4%	7.5%	6.9%	4.6%	3.7%
Defense and NSIS	2.1%	2.1%	1.9%	1.7%	1.5%
Pending bills change	0.0%	0.0%	0.0%	0.0%	0.0%
Development and Net lending	7.2%	10.3%	10.2%	10.1%	9.4%
Domestically financed	4.9%	6.1%	6.1%	5.9%	5.4%
Domestically financed Ministerial	4.9%	5.0%	4.7%	4.6%	4.7%
Domestically FinancedSpecial interventions	0.0%	1.1%	1.3%	1.3%	0.7%
Foreign financed	2.3%	4.1%	4.0%	4.0%	3.9%
Net lending	0.1%	0.1%	0.1%	0.1%	0.1%
Pending bills (change)	0.0%	0.0%	0.0%	0.0%	0.0%
Drought Expenditures	0.2%	0.2%	0.0%	0.0%	0.0%
Contingencies	0.0%	0.0%	0.1%	0.1%	0.1%
<b>Balance (commitment basis excl. grants)</b>	<b>-4.9%</b>	<b>-8.1%</b>	<b>-7.4%</b>	<b>-6.2%</b>	<b>-5.6%</b>
Adjustment to cash basis	0.6%	0.0%	0.0%	0.0%	0.0%
Project grants	0.9%	1.4%	1.4%	1.4%	1.4%
<b>Balance (cash basis including grants)</b>	<b>-3.5%</b>	<b>-6.7%</b>	<b>-6.1%</b>	<b>-4.8%</b>	<b>-4.1%</b>
Statistical discrepancy	0.3%	-0.1%	0.0%	0.0%	0.0%
<b>FINANCING</b>	<b>3.8%</b>	<b>6.6%</b>	<b>5.0%</b>	<b>3.3%</b>	<b>3.0%</b>
Net foreign financing	0.7%	2.0%	1.9%	1.9%	1.3%
Project loans	1.4%	2.7%	2.7%	2.7%	2.0%
Programme loans	0.0%	0.0%	0.0%	0.0%	0.0%
Commercial Fin./Sovereign bond	0.0%	0.0%	0.0%	0.0%	0.0%
Repayments due	-0.8%	-0.7%	-0.8%	-0.7%	-0.7%
Change in arrears	0.1%	0.0%	0.0%	0.0%	0.0%
Rescheduling/Debt swap	0.0%	0.0%	0.0%	0.0%	0.0%
Privatization proceeds	0.0%	0.2%	0.0%	0.0%	0.0%
Net domestic borrowing	3.0%	4.3%	3.1%	1.4%	1.7%
Financing gap	0.0%	-0.1%	-1.1%	-1.5%	-1.2%
<b>Memo items</b>					
Domestic Debt (gross)	22.5%	24.5%	25.2%	25.1%	24.2%
Domestic Debt (net)	17.5%	20.6%	21.5%	20.3%	19.4%
Infrastructure bonds	0.8%	1.3%	0.9%	0.4%	0.5%
Nominal GDP	100.0%	100.0%	100%	100.0%	100.0%

Annex 4: Monetary Survey 2007/08 - 2011/12 (exp. in billions of Kshs)						
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	<i>Act.</i>	<i>Proj.</i>	<i>Medium term projection</i>		<i>Proj.</i>	
<b>Central Bank of Kenya (CBK)</b>						
Net Foreign Assets 1/	202.6	208.3	262.5	229.9	307.7	397.5
Net Domestic Assets	-49.6	-48.2	-81.1	-21.9	-67.0	-120.0
Net credit extended	-23.1	-82.4	-17.2	62.5	47.2	28.8
Net claims on Government	-27.7	-17.5	-12.1	-7.7	-3.5	0.4
Claims on banks	4.5	-64.9	-5.1	70.3	50.6	28.5
Other assets, net	-28.9	-52.8	-64.0	-84.5	-114.1	-148.8
Reserve money (RM)	152.9	160.2	181.4	207.9	240.8	277.5
<b>Monetary Survey</b>						
Net Foreign Assets (NFA) 1/	291.3	276.8	349.2	387.4	494.4	617.2
Central Bank (CBK)	202.6	208.3	262.5	229.9	307.7	397.5
Banks	88.7	68.5	86.7	157.5	186.7	219.8
Net Domestic Assets (NDA)	539.3	673.4	733.0	839.6	926.3	1,020.4
Domestic Credit	691.7	850.2	1,006.3	1,200.9	1,381.2	1,584.4
Claims on Government (net)	133.4	167.9	205.8	234.3	262.5	287.9
Central Bank	-27.7	-16.6	-20.3	-7.7	-3.5	0.4
Banks	161.1	184.6	226.0	242.1	266.0	287.5
Claims on Private Sector	558.3	689.0	807.0	966.5	1,118.7	1,296.5
Other items (net)	-152.4	-176.8	-273.3	-361.2	-454.9	-564.0
Broad Money (MB)	840.7	950.2	1,082.2	1,227.0	1,420.7	1,637.6
of which:						
Residents' foreign-currency deposits	124.7	138.2	173.1	196.3	227.3	262.0
(ratio of FX deposits/MB)	14.8%	14.5%	16.0%	16.0%	16.0%	16.0%
<b>Memorandum items:</b>						
Reserve money annual percentage change	18.2	4.7	13.3	14.6	15.8	15.3
MB Annual percentage change	18.7	13.0	13.9	13.4	15.8	15.3
Velocity (GDP/MBexp)	2.3	2.4	2.4	2.3	2.3	2.3
Velocity (GDP/MBavg)	2.5	2.5	2.5	2.5	2.5	2.4
Multiplier (MB/RM)	5.5	5.8	5.9	5.9	5.9	5.9
Credit to private sector	26.0	23.4	17.1	19.8	15.7	15.9
Resident FX deposits (billions of US\$)	1.9	2.0	2.5	2.8	3.1	3.4
Net Government borrowing	335.3	395.7	496.0	582.6	668.0	744.8
Banking sector	133.4	167.9	205.8	234.3	262.5	287.9
Non-banking sector	201.8	227.7	290.3	348.3	405.5	457.0
1/ At current exchange rate						

<b>Annex 5: Balance of Payments, 2007/08-2011/12</b>						
<i>In millions of US dollars, unless otherwise indicated</i>						
	<b>2007/08</b>	<b>2008/09</b>	<b>2009/10</b>	<b>2010/11</b>	<b>2011/12</b>	<b>2012/13</b>
	<i>Est.</i>	<i>Proj.</i>	<i>Medium term</i>			<i>Proj.</i>
<b>Trade balance</b>	<b>-4,982</b>	<b>-5,629</b>	<b>-5,894</b>	<b>-6,323</b>	<b>-6,512</b>	<b>-6,409</b>
Exports, f.o.b.	4,615	4,705	4,591	5,055	5,747	6,750
Imports, fob	9,597	10,334	10,485	11,378	12,258	13,159
Services (net)	1,329	1,289	1,271	1,423	1,636	1,945
Credits	3,111	3,148	3,192	3,490	3,863	4,327
Freight and other transport	1,215	1,199	1,170	1,289	1,465	1,721
Travel	841	715	728	817	908	1,017
Other credits	1,055	1,234	1,294	1,384	1,490	1,589
Debits	1,782	1,859	1,921	2,067	2,227	2,382
Freight and other transport	824	831	843	915	986	1,058
Travel	267	270	283	303	326	348
Other credits	692	757	794	849	915	975
Net investment income	-96	-142	-264	-323	-368	-416
Credits	170	105	39	89	183	258
Debits	265	247	303	412	551	674
of which: official interest payments	87	86	93	103	112	125
Unrequited transfers (net)	2,070	2,087	2,091	2,164	2,253	2,344
Private (net)	2,037	2,107	2,111	2,184	2,273	2,364
Official (net)	34	-20	-20	-20	-20	-20
Credits	58	0	0	0	0	0
Debits	-24	-20	-20	-20	-20	-20
<b>Current Account</b>	<b>-1,678</b>	<b>-2,394</b>	<b>-2,796</b>	<b>-3,059</b>	<b>-2,990</b>	<b>-2,536</b>
<i>Excluding official transfers</i>	<i>-1,736</i>	<i>-2,394</i>	<i>-2,796</i>	<i>-3,059</i>	<i>-2,990</i>	<i>-2,536</i>
<b>Capital Account</b>	<b>512</b>	<b>391</b>	<b>489</b>	<b>568</b>	<b>630</b>	<b>709</b>
<b>Financial Account, net</b>	<b>1,841</b>	<b>1,158</b>	<b>2,791</b>	<b>3,012</b>	<b>3,280</b>	<b>2,845</b>
Direct investment	527	364	476	605	668	731
Portfolio investment (equity)	74	129	193	315	344	373

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Other Long-Term Capital	182	406	851	597	659	983
Government	96	345	790	522	586	912
Inflows	348	596	1,063	837	921	1,251
Program loans	20	0	0	0	0	0
Project loans	328	596	1,063	837	921	1,001
Commercial financing	0	0	0	0	0	250
Amortization	252	252	273	315	334	339
Private (net)	86	62	62	75	73	71
Inflows	154	140	162	204	223	242
Amortization	69	78	101	129	150	170
Other depository corporations	-385	-73	-527	-284	-300	-336
Short-term capital (net) and NEO	1,443	332	1,797	1,779	1,909	1,095
<b>Overall Balance</b>	<b>675</b>	<b>-845</b>	<b>484</b>	<b>521</b>	<b>920</b>	<b>1,018</b>
Financing	-675	845	-484	-521	-920	-1,018
Change in gross reserves (- = increase)	-722	650	-462	-497	-894	-986
Use of Fund credit, net	47	195	-22	-24	-26	-32
Change in arrears	0	0	0	0	0	0
Financing gap	0	0	0	0	0	0
<u>Memorandum items:</u>						
Gross official reserves (end period)	3,445	2,795	3,257	3,754	4,648	5,634
(in months of next year's imports of G&S)	3.4	2.7	2.9	3.1	3.6	4.1
Export of goods and services	7,726	7,853	7,783	8,545	9,610	11,076
Imports of goods and services	11,379	12,193	12,405	13,445	14,485	15,540
<b>In percent of GDP</b>						
Current account incl. official transfers	-5.6	-7.4	-7.5	-7.3	-6.5	-5.1
Current account excl. official transfers	-5.6	-7.4	-7.5	-7.3	-6.5	-5.1
Import volume growth, goods (percent)	8.0	5.2	5.3	4.0	5.6	5.6
Import value growth, goods (percent)	23.9	7.1	2.2	8.5	7.7	7.3
Export volume growth, goods (percent)	7.9	-2.0	-0.3	11.1	14.8	15.6
Export value growth, goods (percent)	19.8	1.9	-2.4	10.1	13.7	17.5

**Annex 6: Monthly Remittances Inflow 2004 to 2009 in US\$ '000**

Year	2004	2005	2006	2007	2008	2009
January	25,154	28,564	31,506	40,930	53,925	39,535
February	27,676	26,056	30,283	39,533	50,382	53,353
March	29,944	31,219	36,354	48,562	59,344	55,361
April	27,773	29,216	35,369	38,251	67,872	48,117
May	26,931	32,358	42,427	41,163	48,538	49,180
June	30,047	34,360	35,667	48,643	49,490	46,347
July	33,187	29,133	41,065	53,350	44,137	50,372
August	28,894	31,759	30,587	58,803	43,388	55,947
September	28,894	31,616	28,841	60,575	48,953	53,347
October	25,223	33,037	29,633	46,848	61,113	53,037
November	25,473	34,282	31,403	55,564	43,970	48,231
December	29,130	40,557	34,459	41,421	40,129	56,329
<b>Annual Total</b>	<b>338,326</b>	<b>382,153</b>	<b>407,593</b>	<b>573,643</b>	<b>611,241</b>	<b>609,156</b>

Source: Central Bank of Kenya