Implications of the Global Financial Crisis on the Kenyan Economy

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Kenya Institute for Public Policy
Research and Analysis

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Abstract

The Global Financial Crisis (GFC) has been traced back to the late 1990s when the United State (US)'s interest rates on the federal funds were considerably low, leading to liberal lending practices by commercial banks to clients. Because of increased liquidity from the low federal rates, loans were given to sub-prime clients (clients who ordinarily would not have qualified for the loans), without adequate collateral and without due consideration to their ability to repay the loans. Mortgage lenders invented new ways of stimulating activity in the property market by securitization, where banks pooled various loans into sellable assets, thus offloading risky loans to other investors. This meant that bad loans were now a problem of those who bought the securities. When the housing bubble burst, confidence quickly fell. Lending began to slow down and in some cases ceased completely as loan defaults increased. The combined deterioration of the credit market and liquidity strains precipitated the financial crisis, and the collapse of America's largest mortgage institutions and other global investment banks. Given that most banks outside the US held the US mortgage-backed securities, the busting of the US housing boom spelt doom on the bank's balance sheets. They encountered bad debts that led to liquidity problems. Businesses and individuals could not obtain credit easily as banks shied away from lending, thus reducing domestic demand in the respective countries, which spilled over to the global markets as imports demand reduced. This had serious implications for global economic growth prospects as countries' exports declined significantly.

In Kenya, the effects of the crisis were limited due to the fact that the country does not hold much of the "toxic" securities and debts that spread the crisis in the international financial system. However, to a limited extent, exposure to the crisis affected some key sectors that trade with nations in the developed world. During the crisis, economic growth in Kenya dipped from 7 per cent in 2007 to 1.7 per cent in 2008, though this drop was largely attributed to internal shocks such as the post-election violence of 2008, and drought. Exchange rates also depreciated following a dip in net capital and financial inflows in the period, foreign reserves reduced as donor flows dropped and as Central Bank used the available reserves to defend the weakening shilling. At the sectoral level, the crisis contributed to a decline in tourist arrivals, manufacturing and in stock market activity.

Policy options to mitigate against the crisis include: sustaining macroeconomic stability, eliminating unnecessary public expenditures, tighter and closer financial sector regulation and supervision, export diversification, and the need for banks to intensify portfolio oversight and continuous improvement of the investment climate.

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Abbreviations and Acronyms

CBK	Central Bank of Kenya
CBR	Central Bank Rate
CDO	Collateralized Debt Obligation
COMESA	Common Market for Eastern and Central Africa
EAC	East Africa Community
FDI	Foreign Direct Investment
FSB	Financial Stability Board
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IMF	International Monetary Fund
IPO	Initial Public Offer
JKIA	Jomo Kenyatta International Airport
KNBS	Kenya National Bureau of Statistics
MBS	Mortgage Backed Securities
MIA	Moi International Airport
NBEPA	Netherlands Bureau for Economic Policy Analysis
NSE	Nairobi Stock Exchange
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
UNCTAD	United Nations Conference on Trade and Development
WEO	World Economic Outlook

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1. Introduction

1.1 Background

The current global economic downturn traces its roots to what has been termed "the worst financial meltdown since the great depression" (Crotty, 2008). It started with a housing market bubble, which begun in the late 1990s in the United States of America (USA) and accelerated in the early to mid 2000s. Banks earned large fees securitizing mortgages, selling them to capital markets in the form of mortgage-backed securities (MBS) and collateralized debt obligations (CDOs) and servicing them after they were sold.

The financial bubble was further spread and took a global scope. Other developed economies also experienced a housing boom before the bubble burst.

A collapse of the US sub-prime mortgage market and the reversal of the housing boom in other industrialized economies have had a ripple effect around the world. African countries are particularly vulnerable to these crises. Kenya is thus not spared.

This paper addresses the following:

- Explaining the causes of the Global Financial Crisis (GFC)
- Assessing the effects of the Global Financial Crisis on Kenya's economy
- Suggesting strategies that can be used in a bid to mitigate the effects of the Global Financial Crisis

1.2 Explaining the Causes of the Current Financial Crisis

The origin of the current international financial crisis could be traced back to the year 2000 with the bursting of the Internet bubble (Mama and Nanfosso, 2009). The Internet promoted many business ventures and companies through worldwide marketing, thus making huge profits. However, this was not sustainable. In 2000, the Federal Reserve responded to the bursting of the Internet bubble by bringing down the interest rate on federal funds (the rate at which American banks lend to each other) from 6.5 per cent to 3.5 per cent within only a few months.

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The terrorist attack of 11 September 2001 did not make things any better. The attacks led to the continuation of Federal Reserve lowering the interest rate until it reached 1 per cent in 2003, the lowest rate for half a century. This low rate of interest led to very cheap loans, which were available to house buyers. This brought about the real estate bubble.

Mortgage lenders relaxed their lending conditions and invented new ways of stimulating activity. This went on well and between 2000 and 2005, the monetary value of existing housing rose by more than 50 per cent. At the same time, the construction sector raced out of control due to the sky high demand. An increase in the prices of housing led to speculation. There was a rush for mortgage loans, which were granted with the maximum complicity of brokers to borrowers, whose credit-worthiness was not guaranteed. In this regard, the extreme case was that of loans granted to people with no income, job, and assets. This ultimately led to the the sub-prime crisis that hit the USA.

The sub-prime crisis came about because of financial instruments such as securitization, where banks would pool various loans into sellable assets, thus off-loading risky loans[1] onto others. Most banks in the USA turned long term loans into securities. The security buyer got regular payments from all those mortgages (while the banker off loaded the risk). Securitization was therefore seen as the greatest financial innovation in the 20th century (Anup, 2008). Rating agencies were paid to rate these products and invariably the products got good ratings. This encouraged people to take them up. These products were commonly referred to as Mortgage-backed securities (MBS) traded through.

MBS were traded through capital markets. This started in Wall Street and others followed quickly. With soaring profits, all financial institutions wanted a share of the returns even if it meant going beyond their area of expertise. Banks borrowed even more money to lend out so that they could create more securitization. Some banks did not need to rely on savers as much then, as long as they could borrow from other banks and sell those loans as securities. Bad loans would be the problem of whoever bought the securities. Some banks even started buying securities from others.

[1] Banks made large profits by giving out loans that were payable with time (for example 3, 5 or 10 years). Some loans ran into decades, especially mortgage loans.

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Respected commercial banks such as Citigroup and Merill Lynch got into a form of investment banking, buying, selling and trading risk. Investment banks, not content with buying, selling and trading risk, got into home loans and mortgages without the right controls and management. Many banks and other financial institutions were taking on huge risks, increasing their exposure to problems. These financial products were complex but they helped to spread risk. Their complexity always helped to hide the bad debts (Davis, 2008). Banks were actually trying to minimize losses by transferring bad debts.

The complexity of these securities was a problem because people did not fully understand them. This meant that when small problems started to eventually come up in the financial market, confidence fell quickly. Lending slowed and in some cases, ceased completely. Currently, there is a crisis of confidence; no one seems to trust any financial institution.

Some investment banks were sitting on the riskiest loans that other financial institutions did not want. Assets were plummeting in value and therefore lenders (security buyers) wanted to take their money back. However, investment banks had little in deposits and no secure retail funding. This led to some collapsing quickly and dramatically.

Large banks with capital reserves ran out of liquidity. They had to turn to governments for bail out. New capital was injected into banks to allow them to lose more money without going under. That still was not enough and confidence was not restored.

An alternative explanation to the cause of financial crisis was the swaps. A credit default swap is an insurance contract between a security buyer and a security seller covering a corporation's specific bond or loan. A security buyer pays an upfront amount and yearly premiums to the security seller to cover any loss on the face amount of the referenced bond or loan. This is the same as saying that if individual A owns a house, individual B can actually insure the house (owned by individual A) so that when a calamity comes on the house, it is individual B who is to be paid by the insurance company.

If the party providing the insurance protection (once it has collected its upfront payment and premiums) does not have the money to pay the insured buyer in the case of a default affecting the referenced bond or loan (or if the "insurer" goes bankrupt), then the buyer is not covered. The premium payments are gone, as is the insurance against default.

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The most risky part is that credit default swaps are not standardized instruments. They are not true securities. They are not transparent, not traded on any exchange, are not subject to present securities laws in the USA, and they are not regulated. They are risky instruments.

Many companies in the USA are not doing well. Their bond prices are very low. Giant insurance companies such as AIG have paid claims and now they are not liquid enough to meet further claims. They have to be bailed out by the government to remain afloat. Insurance corporations that went under disappeared with clients' claims that they could not meet. This further created a confidence crisis in the financial system, thus resulting to the present financial crisis.

1.3 Transmission of the Crisis

At the current global market, the international financial system is effectively an indirect US Government Bond Standard, in which the USD acts as a standard of value for all other currencies, and is held because it is directly convertible into US Government Bonds (Toporowski, 2005). The nearest alternative international currency, the Euro, cannot take over as a reserve currency because a more or less balanced trade account does not allow the Euro-zone to supply the rest of the world with the amounts of 'free' Euros necessary to finance trade.

A second key feature of the international financial system is the means of payment for debt acquired in international transactions. International banking has its counterpart in an international debt system, mostly in USD.

Finally, crucial to the current structure of international trade and finance is the fact that the US is the main market for the commodity exports on which foreign trade of most developed and developing countries depends. Export commodities are therefore priced in USD.

As the USA cuts down its expenditure, other industrial countries, which are the main suppliers to the USA market, are greatly affected. Imports to the USA are reduced, and with that the supply of 'free' dollars to the rest of the world declines (Toporowski, 2009). This demonstrates why the crisis spread to Europe faster than other countries. For the African countries, the effects are reduced remittances and trade, and less capital inflows.

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1.4 From Financial to an Economic Crisis

Shrinking banks drain money out of the economy as they try to build their capital and are nervous about loaning. Businesses and individuals that rely on credit find it harder to get the funds. A spiral of problems is created.

Banks with little confidence to lend will lend with higher interest rates. People will find their mortgages harder to pay and re-mortgaging will become expensive. For any recent home buyers, the value of their homes is likely to fall, leaving them in negative equity.

Using this analogue, in the wider economy, many sectors will experience credit crunch, and higher costs of borrowing will lead to job cuts. People will cut back on consumption in a bid to cushion this economic storm. Other businesses will struggle to survive, leading to further fears of job losses.

1.5 Previous Financial Crisis

The Wall Street Stock Market crash of 1929 is the earliest financial crisis to be documented. It occurred during a period of declining real estate values in America. In the early and mid 1920s, just before the Crash, real estate values had gone up with a peak. The pre-crash period was also a time of prosperity and surpluses, which led to high price levels in USA, despite warnings against speculation.

Commercial banks were too speculative in the pre-depression era. They invested their assets and bought new securities issues for resale to the public. They also issued unsound loans to companies in which the bank had invested in and encouraged its bank clients to invest in those same stocks. When the stock market went down, people lost confidence in the financial system. Dow Jones Industrial Average (DJIA) took 25 years thereafter to attain pre-1929 levels.

This called for tight financial sector regulation and the introduction of fiscal and monetary policy controls, which replaced the 'free' invisible hand economics. Latin American countries began borrowing huge sums of foreign money to develop domestic industries in the 1960s. Their foreign debt exceeded US$ 300 billion in the early 1980s (China view, 2009). In 1982, Mexico declared its inability to repay the debt, triggering a world shaking debt crisis. During the crisis, GDP per capita of Latin American countries dropped by 10 per cent (China view,

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2009). Most Latin American countries are still trapped in these debts (Soederberg and Taylor, 2004).

In 1990, a stock market crash followed by a real estate crisis put an end to Japan's era of 'miracle years' (CPB)[2] . During the second half of the 1980s, GDP growth averaged 5 per cent per year. However, this growth was increasingly driven by capital expenditure of a speculative nature. Skyrocketing share prices and land prices encouraged a credit and building boom of unprecedented proportion as banks were guided by the seemingly unlimited availability of collateral. During the 1980s, land prices rose by 400 per cent and share prices went up by 600 per cent. In the 1990s, after the bubble had burst, GDP growth was only 1 per cent per year on average. In 1995, consumer prices went down. The nineties are now routinely labeled as Japan's 'lost decade'.

Although growth recovered slightly after 2000, the Japanese economy has been on the verge of deflation since then. Between 1999 and 2005, consumer prices fell nearly constantly. The mitigation measures have been criticized firmly. The consensus view is that during the nineties, monetary and financial policy in Japan failed in two important respects. First, after the bursting of the bubble, monetary policy was and continues to be too restrictive and tight. Second, the need to purge non-performing debt and to reform industry was insufficiently recognized. After the Crash, much collateralized debt had become worthless. However, banks still went on to extend credit to inefficient and insolvent firms (called zombie firms). There was widespread reluctance to let established firms go bankrupt. In 2002, the OECD reported that Japanese banks had taken losses amounting to 10 per cent of 1995 GDP. Ten years after the Crash, the Japanese government was still struggling to move banks to greater transparency (CPB[1]).

At the backdrop of the USD appreciation and the devaluation of the Thai currency in July 1997, there were severe attacks on East Asian stocks and currencies. This led to the Asian Financial Crisis, whose effects were: widening current account deficit resulting from falling export performance due to exchange rate appreciation, rising capital inflows encouraging excessive imports, insufficient foreign exchange reserves resulting in devaluation of Asian currencies, and increased interest rates (CMA)[3]. Indonesia, Thailand and South Korea were the

[2] Netherlands Bureau for Economic Policy Analysis.
[3] Capital Markets Authority, Kenya.

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countries most affected. Their GDPs shrank by 83.4 per cent, 40.4 per cent and 34.2 per cent, respectively. The mitigation measures employed included the provision of emergency official liquidity support designed to cushion the flow of capital outflows, financial sector and structural reforms to help boost investor confidence, and monetary and fiscal policy controls (Berg, 1999).

Many developed nations are experiencing these effects and are sliding into recession, while others are already there. Developing countries have also started feeling the impact, which is spreading gradually.

1.6 Financial Linkages

It is argued that in general, African banking sectors are insulated from foreign finance (Mwega, 2009). The sectors rely on domestic deposits and lending and do not have derivatives or asset-based securities in their portfolio. Even though some banks have significant foreign ownership, the parent banks are typically not from the US, and the foreign ownership share is relatively small (Mwega, 2009).

In Kenya, foreign banks comprise about a quarter of all banks in the country, with 11 foreign banks out of 42 commercial banks in 2007. There are five foreign banks that are not locally incorporated. These accounted for 9.2 per cent of the core capital of the banking system in 2007. There are six foreign but locally incorporated banks. These are therefore partially owned by the locals, and they accounted for 31.7 per cent of the core capital of the banking system in 2007. In general, foreign banks account for about 40 per cent of commercial banks core capital, which is not alarming. It is also important to note that toxic assets are not held by Kenyan banks (Nyangito, 2009).

Overall, the banking sector performance in Kenya is stable (Nyangito, 2009). According to the Central Bank of Kenya figures, deposits increased by 25 per cent to Ksh 935.6 billion in December 2008, and the asset base of the sector also expanded by 24 per cent as at December 2008 to stand at Ksh 1.2 trillion. Gross non-performing loans decreased from 10.6 per cent in December 2007, to 9 per cent by December 2008. The sector's profit before tax stood at Ksh 41.8 billion in 2008 or 17.7 per cent higher than the Ksh 35.5 billion registered in 2007.

The stock market in Kenya has not been spared from the crisis. The NSE index declined from a high of over 6,000 in January 2007 to a

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low of below 2,700 in April 2009. Market capitalization also declined significantly from a high of Ksh 1,230 billion in June 2008 to a low of Ksh 680 billion in April 2009.

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2. Global Impact of the Crisis

2.1 Impact on the Developed and Middle Income Countries

The world trade volume has declined greatly since 2006. This can mainly be attributed to the fall in global demand as consumers in the key markets face lean budgets as the Global Financial Crisis (GFC) persists. The developed and emerging countries are worst affected. The situation is not likely to be any better in year 2009. Table 2.1 gives key economic indicators for selected developed and middle income countries.

From the financial perspective, Anup (2008) observed that the extent of the problems has been so severe that some of the world's largest financial institutions, with bases in developed countries, have collapsed. Others have been bought out by their competitors at low prices, and in other cases, the governments of the wealthiest nations in the world have resorted to extensive bail-out and rescue packages. The value of the world's companies has been wiped out by the crisis. The UK and other European countries have also spent around 2 trillion

Table 2.1: Key data for selected economies

	2006	2007	2008	2009
GDP volume				
Europe	2.9	2.7	0.8	-3.25
United States	2.8	2.0	1.1	-3.50
Japan	2.1	2.4	-0.7	-5.25
Asia (Excluding Japan)	9.2	9.7	6.7	2.25
World	5.1	5.0	3.1	-1.25
World trade volume (goods)				
Import volume (EU)	8.4	4.7	-0.8	-10.50
World trade volume	9.5	7.2	2.3	-12.50
World consumer prices (harmonized)				
Consumer prices	2.2	2.1	3.3	0.25
World trade price (Euro)	4.3	-1.7	4.2	-5.0

NB: All data is given in annual percentage changes

Source: Netherlands Bureau for Economic Policy Analysis

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on rescues and bailout packages. The crisis is still going on and more is expected.

In most advanced and emerging economies, security markets have been affected significantly. Table 2.2 shows market index trends in selected stock exchanges. From the table, a declining trend of share values in the four exchange markets is depicted. This demonstrates that in developed and emerging economies, the stock markets have not been performing well since the emergence of the financial crisis.

Apart from declining stock prices and thus diminishing company capital values, many firms have gone under and many workers lost their jobs. This has resulted in reduced domestic and global demand. However, the most serious aspect is the loss of confidence in the financial system by many economic units in developed countries.

2.2 Impact on the Developing World

In developing economies, the banking sector has so far proved resilient to the ongoing financial turmoil. However, the capital markets have not been able to withstand. Appendix 1 shows the monthly trends of security indices in four African Stock markets (South Africa, Kenya, Egypt and Nigeria). The graphs indicate that in all the four stock markets, the performance has been on the decline since May 2008. This shows that trading of financial instruments has been affected negatively by the global financial situation.

Table 2.2: Share indices in selected countries

	USA - NYSE composite index	Thailand stock exchange index	Tokyo stock exchange (weighted stock price average)	TAIWAN TAIEX index
Jan 2007	9,255	654	390	7,815
June 2007	9,873	777	397	8,580
Dec 2007	9,740	858	323	8,309
Jan 2008	9,126	784	286	7,923
June 2008	8,660	769	292	8,180
Dec 2008	5,757	450	238	4,496
Jan 2009	5,196	438	163	4,475
Mar 2009	4,979	432	148	4,926

Source: Statistics from respective security exchanges

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Naude (2009) argues that there are three other ways through which the financial crisis is affecting the economies of developing countries:

a) Banking failures and reductions in domestic lending: Naude (2009) observes that financial institutions in developing countries could be negatively affected depending on the extent to which they hold assets contaminated by sub-prime mortgages. Currently, this does not appear to be a significant concern, although many developing economies seem to unreasonably imitate the innovations of the west. It is only a matter of time before securitized assets are traded in these countries. However, there is a more serious indirect threat through declines in stock market prices and housing prices. These reduce the capital of banks and of other big firms, which in particular causes problems where they do not hold sufficient levels of their capital in cash. In such cases, it is likely that banks will reduce lending in order to shore up their capital. Reductions in bank lending will reduce investment, lower growth and increase unemployment.

b) A reduction in export earnings: Even if most developing countries are spared from significant damage to their financial systems, the advanced economies are entering a recession which is hurting them. The impact will eventually be significant, given that most developing countries have been basing their economic growth in recent years on exports. The International Monetary Fund (IMF) expects growth in world trade to decline from 9.4 per cent in 2006 to 2.1 per cent in 2009. The expected declines will come through a combination of lower commodity prices, a reduction in demand for goods from advanced economies and less tourism.

c) Financial inflows from the rest of the world to developing countries, including official development assistance (ODA), investment flows–both portfolio and foreign direct investment (FDI)–trade credits and flows of remittances are reducing and this has started having a negative impact on the economies of developing countries.

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3. Global Response to the Crisis

3.1 Developing Economies

Developing countries are considering a combination of short and long-term measures to mitigate the effects of the crisis. Most governments are planning and some are already implementing fiscal and credit stimulus to counter the current slow down in production.

In designing a fiscal stimulus, policy makers should be mindful of how different types of expenditure will affect the country's external position and economic activity. Given that developing countries heavily rely on commodity exports, an expansionary fiscal policy cannot be a substitute for the decline in external demand. Some countries may have scope for discretionary fiscal easing to sustain aggregate demand depending on the availability of domestic and external financing. All this must be done carefully, so as not to crowd out the private sector through excessive domestic borrowing in the often thin financial markets (International Monetary Fund–IMF, 2009)

According to Velde (2008) of Overseas Development Institute, there is also need for developing countries to:

- Better understand what can provide financial stability, how cross-border cooperation can help to provide the public good of international financial rules and systems, and what the most appropriate rules are with respect to development;
- Understand how to minimize financial contagion; and
- Use fiscal and monetary polices constructively. Developing countries need to understand the social outcomes and provide appropriate social protection schemes.

Various calls have also been made for official development assistance (ODA) to developing countries to remain at existing levels despite the crisis. Following the recent Doha Declaration on Finance for Development, most developed countries recommitted themselves to maintaining, and even accelerating where possible, their aid commitments.

3.2 Developed and Emerging Economies

Most advanced economies are adopting immediate and short-term policy responses to ensure that the financial crisis is contained and

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confidence in financial systems is restored by providing guarantees, strengthening the balance sheets of banks, and sharpening bank supervision.

The G-20 Leaders' Summit on Financial Markets and the World Economy held in April 2009 resolved to implement the following measures to counter the negative impacts of the global financial crisis:

- Triple resources available to the IMF to US$ 750 billion.
- Undertake an unprecedented and concerted fiscal expansion, which will save or create millions of jobs.
- Continue cutting interest rates aggressively.
- Central banks to maintain expansionary policies for as long as needed and to use the full range of monetary policy instruments, including unconventional instruments, consistent with price stability.
- Restore domestic lending and international capital flows and establish a new Financial Stability Board (FSB) with a strengthened mandate that will include all G20 countries.
- Provide significant and comprehensive support to banking systems to provide liquidity, recapitalize financial institutions, and address decisively the problem of impaired assets. This will restore the normal flow of credit through the financial system.
- Avail over US$ 1 trillion of additional resources for the world economy through the international financial institutions and trade finance.
- Conduct all economic policies cooperatively and responsibly with regard to the impact on other countries and refrain from competitive devaluation of their currencies.
- Promote a stable and well-functioning international monetary system.

Governments in developed countries have enacted large fiscal stimulus packages to offset the reduction in private sector demand caused by the crisis; in addition, governments have bailed-out some of the firms that have been adversely affected by the crisis. A variety of regulatory changes have also been proposed to prevent recurrence of a crisis of this nature.

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4. Implications of the Financial Crisis on the Kenyan Economy

4.1 Macroeconomic Implications

4.1.1 Economic growth

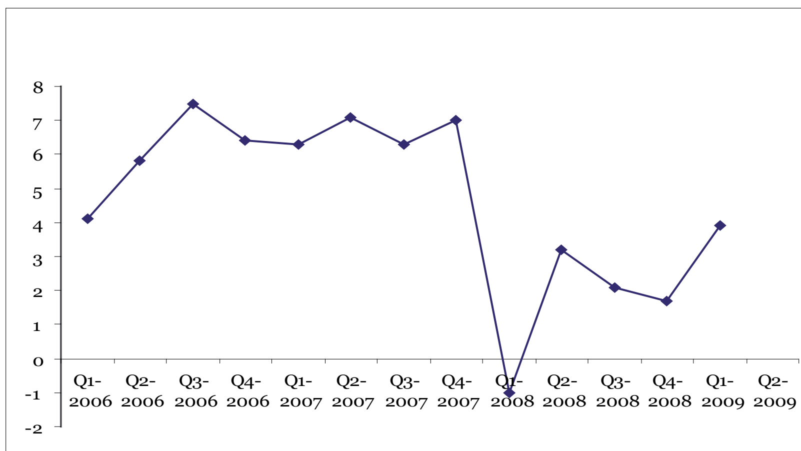
The Kenyan economy was on a steady growth path prior to the post-election violence, recording an average growth rate of 6.7 per cent in 2007. Following the post-election violence, Kenya's economic growth rate dipped to negative 1 per cent in the first quarter of 2008. In 2008, the country experienced both internal and external shocks, including the post-election violence, unprecedented rise in fuel prices, high food prices due to shortages, and the global financial crisis, which led to a global economic slowdown. The economy started to recover in the second quarter of 2008, but again fell in the third quarter (Figure 4.1).

4.1.2 Foreign exchange

Most countries have experienced increased volatility of their currencies as a result of the GFC. In most cases, countries have recorded rapid depreciation of their currencies due to:

- Reduced global demand, which has led to falling exports in most countries. When a country is not able to export as much as it did before, the supply of foreign currency is reduced, leading to currency depreciation.

Figure 4.1: Quarterly economic report



Kenya National Bureau of Statistics

- The tightening of global credit as a result of the crisis has reduced capital inflows in the form of trade credit and foreign direct investments to most developing countries, with the effect of depreciating exchange rates.
- Foreign investors unsure of the resilience of domestic economies, pull out their investments particularly in securities to invest back home. This has increased capital outflows, depreciating the exchange rates.
- Massive bailouts in donor countries may reduce donor aid flows to recipient countries. The reduced donor aid flows is likely to depreciate the exchange rates. Kenya's reliance on foreign aid is minimal, hence the effect is not expected to be huge.

The exchange rate could depreciate as a result of developments in other countries. For instance, Figure 4.2 shows the trends in net capital outflows in Kenya between January 2007 and February 2009.

Net capital and financial inflows dropped significantly in February 2008, reaching its lowest in April 2008 (Figure 4.2). This could partly explain the depreciation of exchange rates. The trends of exchanges in Kenya are given in Figure 4.3.

As seen in Figure 4.3, the Kenyan Shilling has been depreciating since February 2008. In 2008, the Kenya Shilling depreciated by 22.6 per cent against the US$ and by 15.6 per cent since July 2008. This depreciation trend cannot be explained by the trends of the net capital flows. The depreciation can be attributed to the developments

Figure 4.2: Total capital and financial flows (net) January 2007 to January 2009

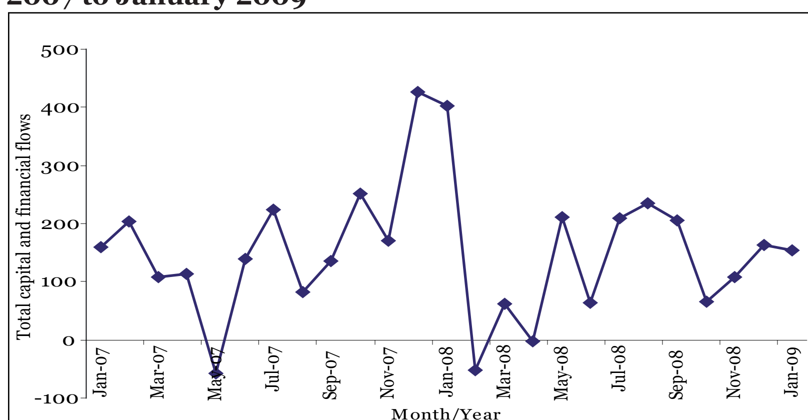


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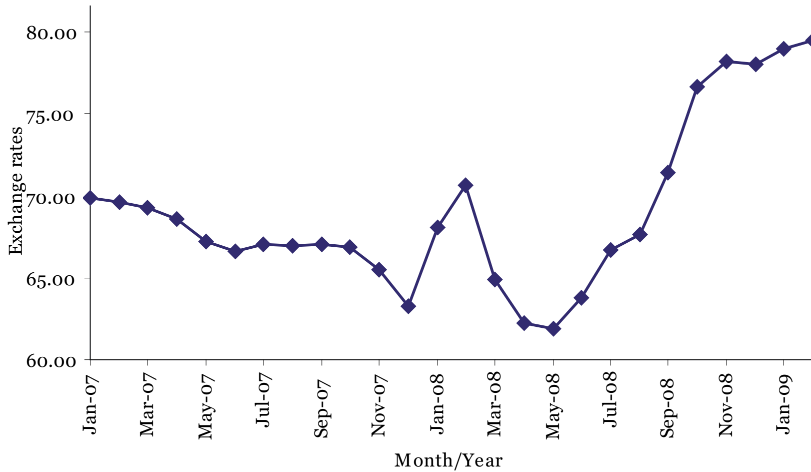
Figure 4.3: Average exchange rate Ksh/US$



in the US. In particular, the strengthening of US$ against other currencies has resulted in depreciation of the Kenya shilling.

4.1.3 Interest rates

Following the crisis, banks globally either have cut back on new loans or are cautious in their lending policies, leading to liquidity constraints in the global markets, hence increased lending rates. Figure 4.4 shows the trend of lending rates over the last two years.

On the other hand, confidence is critical for the economic and financial systems. This has been a casualty of the crisis. The loss of confidence has led to reduced interbank lending, as banks are not sure whether such lending is secure after several banks crashed. An immediate result of the reduced interbank lending activity is a reduction in the interbank lending rate. Government, through the Central Bank of Kenya, has already lowered the cash ratio from 6 per cent to 5 per cent and the Central Bank Rate from 9 per cent to 8.5 per cent. Figure 4.5 confirms this expectation. The average interbank rate had been on an upward trend since early 2007, reaching a peak of 8 per cent in July 2008. It then started to reduce as the CBK used the Central Bank Rate to cool it down.

The rise in the interbank rates, however, is likely to bring little impact as business confidence is absent. Keynes argued that investment in this circumstance can be likened to “pushing on a string”.

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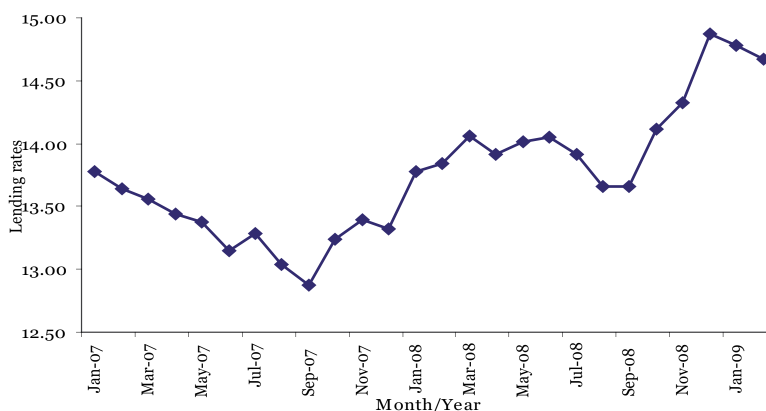
Figure 4.4: Average weighted lending rates (Jan. 2007-Feb. 2009)



4.1.4 Foreign reserves

The global financial crisis may affect the level of reserves that the Central Bank holds through its effects on donor aid. When donor governments commit their funds to stimulate their economies, for instance through fiscal stimulus packages, the amount of money they will avail to the recipient governments as donor aid will reduce. When the Government of Kenya for instance records a reduction in donor funds, the reserves at the Central Bank also reduce. This is because donor aid receipts are normally kept at the Central Bank as foreign reserves. In most developing countries, including Kenya, there is almost always excess liquidity in the economy. When the Central Bank runs low on securities to use to mop up excess liquidity in the economy and is forced to use forex reserves, the level of reserves at the Central Bank is reduced. This has the effect of depreciating the exchange rates as the amount of reserves available to take care of import bills is reduced. In addition, when commercial banks feel that the Central Bank is using the reserves to mop up, they may panic and hoard foreign currency, which will push the price of foreign currency (foreign exchange) up, hence depreciating the exchange rates. This is more serious when donor funds are not forthcoming to replenish the reserves used to mop up the excess liquidity. The crisis, therefore, is likely to reduce donor funds flow, reduce the amount of foreign reserves at the Central Bank and depreciate exchange rates.

A look at the trends of foreign reserves in the past few months (Figure 4.6) shows that foreign reserves declined from 4.94 months of

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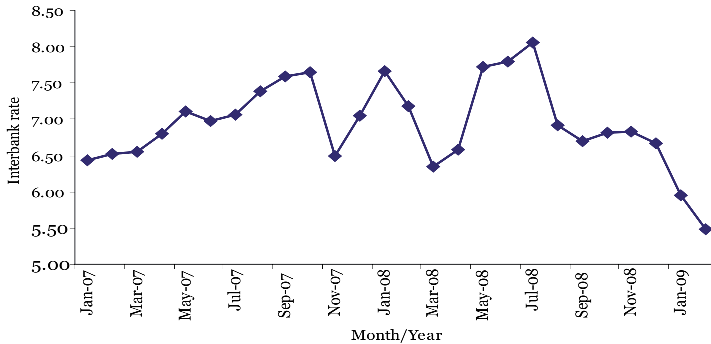
Figure 4.5: Average interbank rate (Jan 2007-Feb 2009)



import covers as at 15 January 2008, to 3.26 months of import cover as at 15 January 2009. This may be attributable to reduced donor fund flows, while at the same time the CBK uses the available reserves to intervene in the market to mop up excess liquidity in the money market.

4.1.5 Remittances

There are mixed feelings on what effect the financial crisis will have on remittances to developing countries. While some expect a slowdown in remittances as they see them to be pro-cyclical (increasing during economic booms and decreasing during recessions), others see them as counter-cyclical. It is important to consider the sectors in which immigrants from Kenya are working in, as not all sectors have experienced job cuts. Such disaggregated data is not available and it will be difficult to establish if Kenyans in the affected sectors have reduced their remittances.

It is expected that remittances from the US will decline, since it is the origin of the crisis and, as the economy recedes, the capacity of immigrants to send money home will reduce. With the spread of the crisis to other developed countries, moreso in Europe, China and Japan, the effects are expected to be the same.

The cost of remitting cash to Kenya is very expensive (Mwega, 2008) and there are possibilities that the figures provided by CBK may not truly reflect the actual remittances. It is difficult to obtain data on other informal cash transfer avenues that migrants could be using. For this study, we rely on data obtained from CBK. However, disaggregated data on the country of origin of remittances will hinder us from assessing

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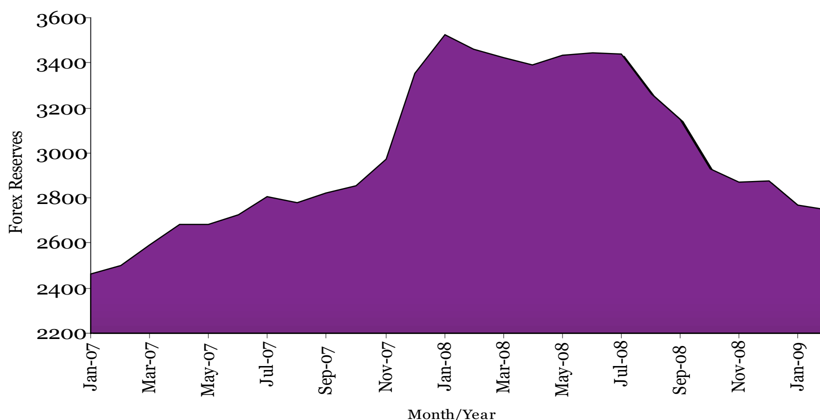
Figure 4.6: Official forex reserves (US$ million)



country-specific declines. As a result, this analysis will be done on an aggregate level.

While previously remittances were counter cyclical (increasing when receiving countries faced adverse conditions), they have of late been expected to decline due to the adverse conditions in the sending country (Figure 4.7).

When the bubble burst between August and September 2008, remittances were increasing but were below the 2007 levels during the same period. They peaked in October before dipping below 2007 remittances in December 2008 and January 2009, but again picked in February and were above what was experienced at the same time in the previous years.

4.1.6 Inflation

Inflation has been on the rise in Kenya, and this has been attributed to food shortages occasioned by the drought currently being felt in the country. The post-election crisis of early 2007 affected production, and this too has led to the high rate of inflation. However, the global financial crisis brought with it high crude oil prices that spilled into high fuel prices in the country, and consequently high costs of production. The effect again was an increase in food prices felt all over the country. Globally, from mid 2008, crude oil prices began to fall and so were the prices of raw materials, causing inflation to drop. In a time of economic crisis, a drop in prices could lead the public to expect a deflation in the medium term (Netherlands Bureau for Economic Policy Analysis-

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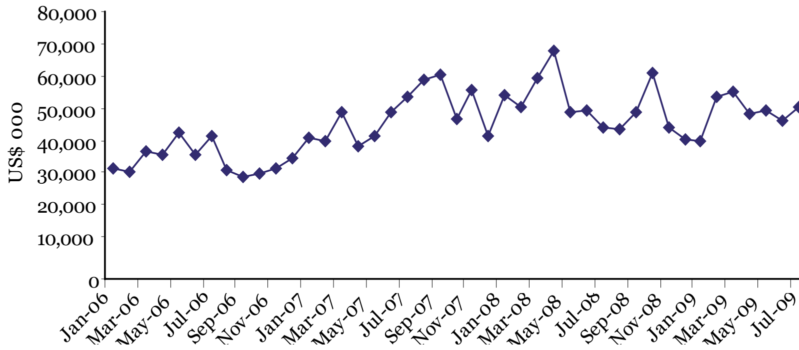
Figure 4.7: Remittances from Kenyans in diaspora



Source: Central Bank of Kenya (2009)

NBEPA, 2009). Growth in almost all economies has slowed owing to the global financial crisis, and this too has resulted to easing inflation.

In Kenya, underlying inflation rose steadily at about the time the bubble burst (August-October, 2008), but began to ease in November 2008. Overall, inflation rose to 25.1 in February 2009, from 21.9 in January 2009 due to the 18.5 per cent increase in price (Central Bank of Kenya, 2009). However, the underlying inflation eased from 11.1 to 7.9 per cent during the same period.

Figure 4.8 shows an increase in the underlying inflation (which excludes food items) in 2008. At the time of the financial bubble burst (between August and September 2008), inflation peaked but began easing in October 2008 and has been easing until March 2009.

4.1.7 Foreign Direct Investment

The ability of firms (both domestic and foreign) to invest largely depends on access to financial resources, including credit, profits gained from operations, and the economic prospects in the investing country.

From the onset of the crisis, the world is now experiencing gloomy economic conditions and markets, and as economies continue to recede, so has the prospects for firms to initiate further investments especially in the developed economies. The pre-crisis period was characterized by growth in international investment that saw FDI flows reach a historic record of US$ 1.8 billion in 2007 (United Nations Conference on Trade and Development, 2009).

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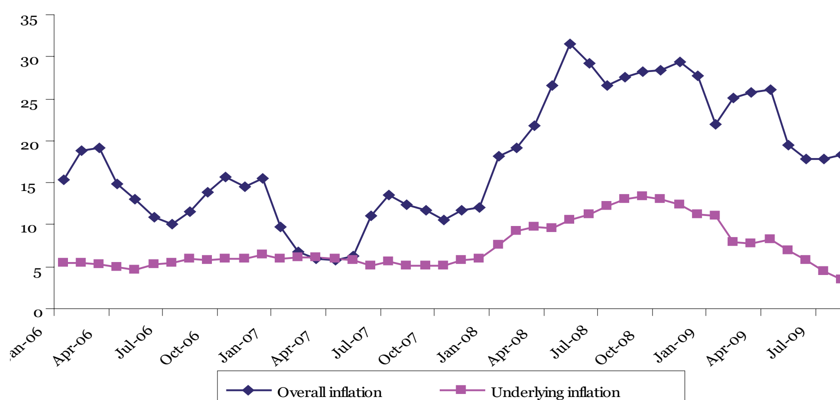
Figure 4.8: Inflation



Source: Central Bureau of Statistics

The pattern of net FDI flows to Kenya in the past has been erratic and the amounts have been minimal (Figure 4.9). However, FDI inflows rose sharply in December 2007 (US$ 488 million), but fell significantly in January 2008 (US$ 138 million). The net FDI flows in 2007 (excluding December) amounted to US$ 51 million while in 2008 (excluding January) they totaled US$ 14 million (Central Bank of Kenya, 2009). As a result, the effect from the financial crisis is not expected to be huge. FDI is mainly from the OECD, and most recently from China.

There are still prospects for investments even in the wake of the crisis. The fall in asset prices, seen globally, may tempt TNCs to acquire more assets especially now that assets are considered to be undervalued. The effect of the crisis on the economies has not been the same and this opens an opportunity for market seeking foreign investors to invest in economies that are not largely affected. Therefore, it is difficult to conclude that the overall effect on FDI from the crisis has been negative.

4.1.8 Portfolio investments

This represents securities such as foreign stocks, bonds, or other financial assets, none of which entails active management or control of the securities' issuer by the investor (Figure 4.10).

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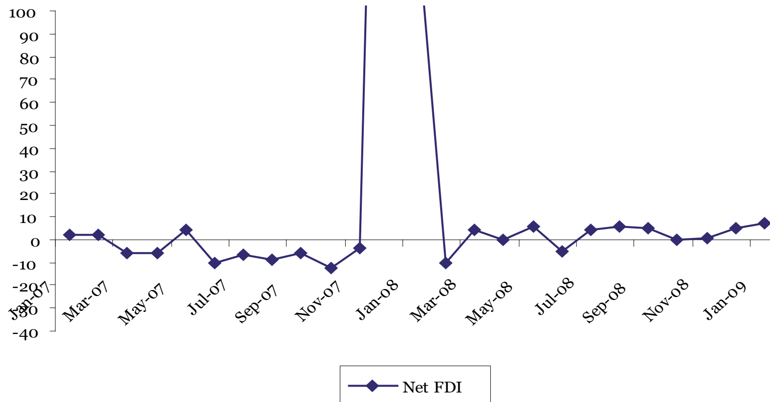
Figure 4.9: Net direct investment (FDI) US$ millions



Source: Central Bank of Kenya (2009)

4.2 Implications on Exports Demand, Prices and Earnings

With respect to the implications of the Global Financial Crisis (GFC) on the developing countries, it is argued that while recession in trade volumes will be the main channel of transmission of the crisis to exporters of manufactured goods and services, price developments will dominate the export performance of exporters. In many African countries, the implications of the global financial crisis will be manifested through reduced demand for their exports (caused by recession in developed countries) that are their main export markets, lower commodity prices that are also subject to significant volatility and which generate significant terms of trade changes, as well as scarce and more expensive trade finance, export credits and export insurance.

In particular, the GFC is expected to negatively affect Kenya's external trade due to its implications on exports demand, prices and earnings. It is anticipated that there will be reduced demand for exports. This will be reflected through slow international demand for commodities and a decrease in tourism arrivals and earnings. The recession in North America and Europe triggered by the credit crunch may reduce demand for Kenyan exports. However, the size of negative shock will be dependent on particular exports destination and the price, and income responsiveness of the goods being exported.

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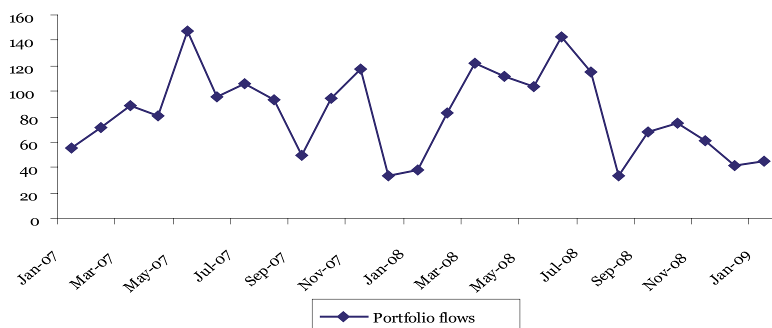
Figure 4.10: Short term portfolio flows (US$ millions)



Source: Central Bank of Kenya (2009)

However, considering that a large proportion of Kenya's exports are sold in the region (EAC and COMESA), these exports are unlikely to be affected by the global crisis. According to Government of Kenya (2008), in 2007 Kenya's exports to the two regional blocs accounted for about 55 per cent of total exports. Therefore, exports to the region will remain steady, with minimal negative implications in the short run. Exports to the Middle East and Asia will suffer minimal effects. A depreciating currency has helped cushion export earnings.

The crisis will also result into decreasing investment in the exports sectors due to a decline in FDI and ODA. This will be necessitated by reduced access to finance, since financial factors have negatively affected the capacity of multinational corporations to invest, both internally and externally. Furthermore, tighter credit conditions or non-availability of credit and lower corporate profits curtail the corporations' financial resources for overseas as well as domestic investment projects. In addition, due to risk aversion, companies' investment plans may be scaled back due to a high level of perceived risks and uncertainties brought about by the crisis. The GFC is also expected to bring about some indirect negative implications, such as slow growth of other sectors linked to the exports sectors, e.g. inputs and services, increased unemployment and subsequently, increased poverty levels in the country.

In order to assess the likely implications of the GFC on Kenya's external trade, this paper analyses the performance of the exports and imports of key commodities and services in terms of quantity, prices and earnings for the last three years. Figure 4.11 shows the performance of total exports, imports and trade balance since 2006.

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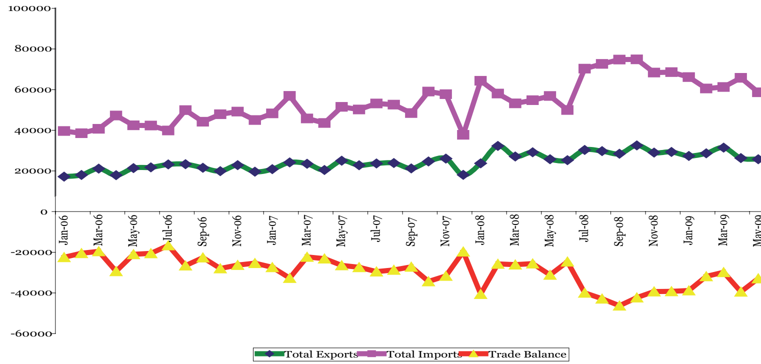
Figure 4.11: Kenya exports, imports and trade balance (Ksh mn)



Total exports have generally been increasing, but showed a declining trend from October 2008. On the other hand, total imports have been increasing with a higher rate than exports, hence Kenya has continued to experience an increasing balance of trade deficit that got into a peak of Ksh 46 billion in September 2008. Particularly in July–October 2008, total imports drastically increased, leading to a widening balance of trade deficit, which started easing in November 2008. The GFC could have contributed to the poor trade balance performance in July-October, 2008.

Commodity Exports

Kenya's main commodity exports are tea, horticulture, cut flowers and coffee. The performance of the commodities over the last three years has been mixed. Figure 4.12 highlights the exports earnings of tea, cut flowers and coffee. Additionally, Figures 4.13 and 4.14 show the unit export price of the three commodities, and auction price of tea and coffee.

Tea

Pakistan, Egypt and UK combined import more than 60 per cent of Kenyan tea. Over the last three years, earnings from tea exports has been increasing, with few instances of low earnings. However, from September 2008 the rate has been increasing slowly. On the other hand, the unit price (value) of tea exports has been slowly increasing

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Figure 4.12: Kenya exports value (Ksh million)

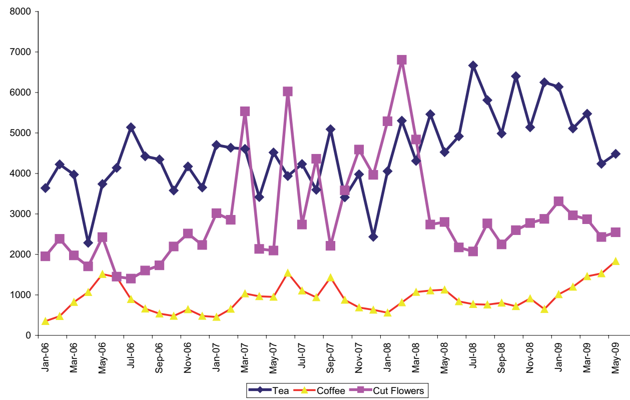


Figure 4.13: Kenya's exports unit prices (Ksh/Kg)

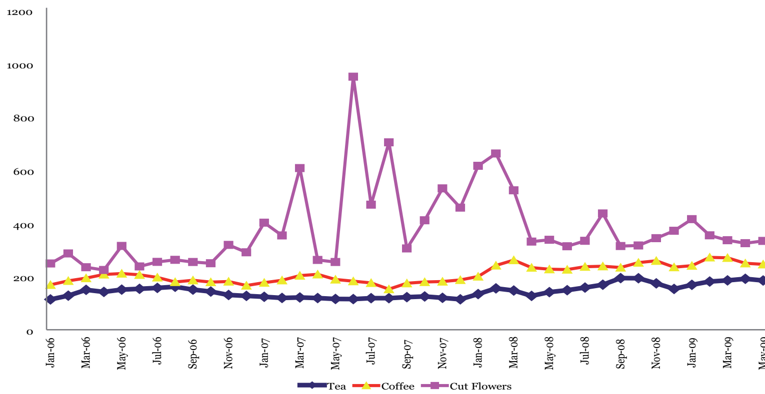
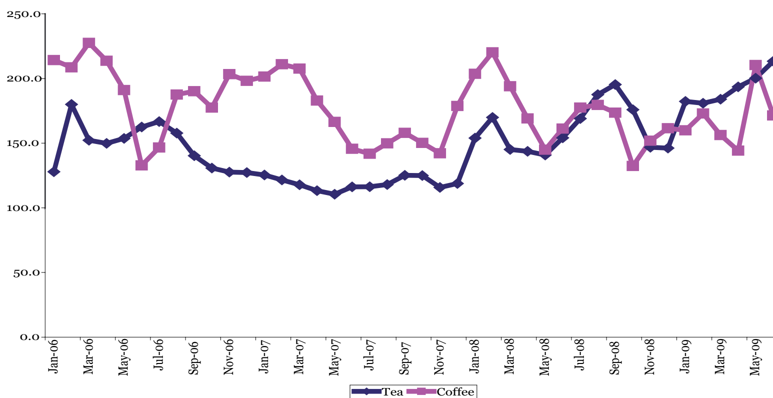


Figure 4.14: Kenya's commodity auction prices (Ksh/Kg)



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almost in constant trend. This implies that the quantity of exports has been quite erratic.

However, auction tea prices have substantially declined since September 2008, with major players staying away from the market. This has been caused by increased supply of tea in the global market. The decline has also been caused by political problems in Pakistan, which is a major buyer of Kenyan tea. Pakistan also entered into a free trade arrangement with Sri Lanka, hence buying more tea from that country. Other major buyers are Egypt and the UK, which may be severely affected by the global financial crisis, hence low demand for tea.

The decline in tea exports performance may be explained by several potential causes. The sector, being a net importer, loses more when the shilling depreciates. The cost of production is directly proportional to the price of crude oil, including transport of raw materials and final produce. The declining demand for tea may also be brought about by change in traders and consumer behaviour. Consumers have been forced to re-evaluate and cut back on spending habits, and indeed shoppers are willing to pay for what they need. The net effect of low demand is reflected in declining price trends. It is also expected that due to the financial crisis, returns to shareholders are likely to decrease, resulting to low income and investment.

Horticulture (cut flowers)

Although export earnings from cut flowers have been on an upward trend, the performance has been very erratic since February 2007. Furthermore, there was a sharp decline in the exports value in April 2008 and, since then, the earnings have been low. Likewise, the unit price has been erratic following almost the same trend as the earnings. It is expected that cut flower exports would decline because the flowers are considered luxury goods. However, others expect cut flower exports to be fairly stable because of their emotive feel-good factor.

The declining performance is attributed to the strengthening USD, which has increased freight costs, hence decreased profits. This implies that new expansions are put on hold, supply is cut down and some flower farms converted for vegetable growing with loss of revenue. There has been market contraction associated with EU market dependency. Other

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markets such as the Middle East, USA and Japan have been declining and, subsequently, there has been loss of jobs.

It is further expected that smallscale horticulture, which accounts for 70 per cent volume of vegetables and fruits and about 10 per cent flowers, will be hit hardest (most exposed to shocks). This will translate to increased poverty, loss of forex and losses to other interlinked sectors such as manufacturing (plastics and agrochemicals) that are dependent on horticulture. However, cut flower exports are likely to be boosted further by the planned introduction of direct flights between Kenya and the USA.

Coffee

Generally, coffee exports earnings have been on a slow and declining trend, although the unit price has been increasing. On the other hand, coffee auction prices have been irregular and on a declining trend. Considering that the coffee sub-sector has under-performed over the last two decades, it is more likely that the GFC will dampen its demand.

Tourism

About 75 per cent of Kenya's tourists come from North America and Europe. However, the US accounts for 5.9 per cent of the number of tourists. There has been a substantial decline in tourist earnings, caused by various factors including the post-election violence, increased oil prices and the global financial crisis. In the first 10 months of 2008, tourist arrivals declined by 35 per cent.

In 2007, the tourism industry experienced a good business performance with a record Ksh 65.4 billion. There were 729,000 arrivals in 2008 compared with 1.8 million in 2007. The top 10 source markets were the UK, USA, Germany, Italy, India, South Africa, France, Canada, UAE and The Netherlands. Between them, they accounted for over 55 per cent of all arrivals. By the third quarter of 2008, the industry started to show some indications of shrugging off the effects of the post-election violence, and there was some resumed interest in booking Kenya. Figure 4.15 shows the number of tourist arrivals for the last three years.

The effects of the global financial crisis in the tourism sector started to be felt towards the last quarter of 2008 when forward bookings

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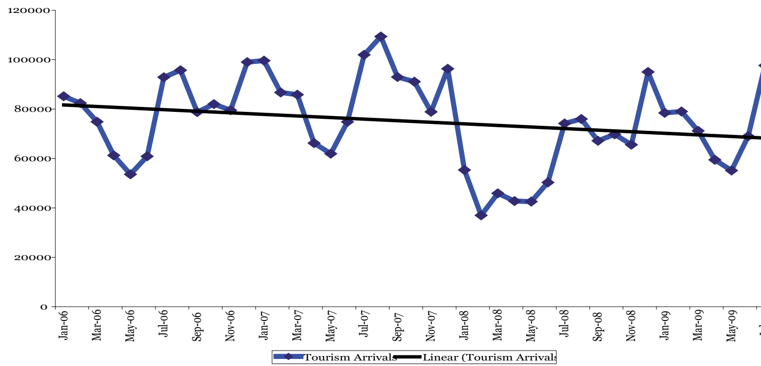
Figure 4.15: Total tourism arrivals



started to diminish. The uncertainty surrounding the financial future makes it almost impossible to indulge in spending for holidays, as this is a luxury. The global recession is therefore having adverse implications on forward bookings. The drop in number of travellers from the major international source markets will definitely have severe implications, not just on Kenya, but also on competing destinations.

The main challenge is to hold on to Kenya's market share with other countries in a declining international tourism market. One key constraint faced is that Kenya's major source markets cannot easily be replaced by growth from alternative emerging markets. The four biggest markets (UK, USA, Germany and Italy) accounted for 38 per cent of the total arrivals in 2008. This equalled the total arrivals combined from the next 23 source countries.

4.3 Implications on Kenya's Real Sector

4.3.1 Agriculture, forestry and fisheries

Agriculture is among the key sectors of the economy. It contributes about 24 per cent to the gross domestic product, provides over 75 per cent of raw material requirements in the industries and accounts for 60 per cent of the country's export earnings. Twenty six per cent of the earnings are indirectly linked to the agro-based industrial production, transport, wholesale and retail. The sector employs about 75 per cent of the labour force. The sector is also a major employer of rural population, accounting for 3.8 million people directly employed in the farm, livestock production, and fisheries while another 4.5 million

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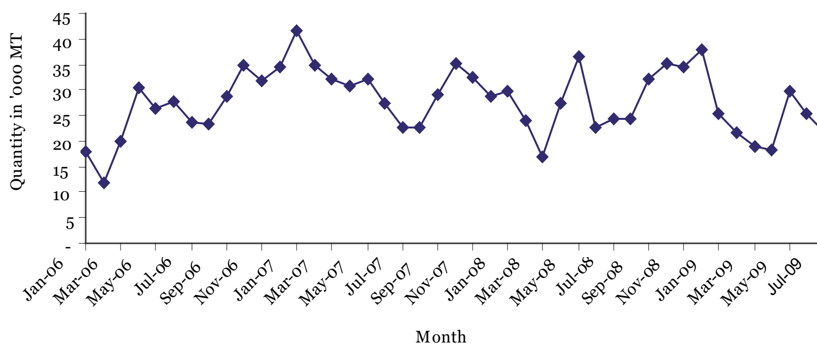
people are employed in off-farm informal sector activities (Government of Kenya, 2008b). The sector also accounts for about 50 per cent of the export revenue.

When looking at the performance of specific agricultural commodities, it is noted that tea output increased steadily from 11,675 metric tonnes in February 2006 to a high of 41,606 metric tonnes in January 2007 (Figure 4.16). Thereafter, there was a decline to 22,742 metric tonnes in July 2007 before rising to 37,922 metric tonnes in December 2008. It further declined to 18,343 metric tonnes in April 2009. The decline during the periods of May to August 2007, June to August 2008, and January to July 2009, is attributed to the dry weather in the tea growing regions.

Horticulture production increased by 12.4 per cent between January and July 2008, that is from 101,611 metric tonnes in the first seven months of 2007 to 119,864.3 metric tonnes. This growth was attributed to increased output in fruits, vegetables and cut flowers. Fruits comprised 4 per cent, vegetables 27 per cent and cut flowers 69 per cent of the horticulture export value between January and July 2008 (Central Bank of Kenya, 2008).

Domestic sugar production averaged 40,000 metric tonnes per month between January 2006 and December 2008. March 2006 recorded the highest domestic sugar production of 51,327 metric tonnes and thereafter a decline to 30,985 metric tonnes in July 2006 (Figure 4.17). The sector recovered and recorded an increased production of 50,865 metric tonnes in May 2008 before a reduction to 21,130 metric

Figure 4.16: Tea production, Jan 2006-July 2009



Source: KNBS leading economic indicators

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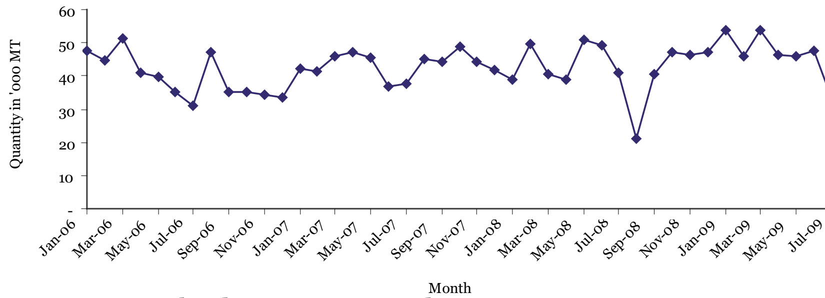
Figure 4.17: Domestic sugar production, Jan 2006-July 2009



Source: KNBS leading economic indicators

tonnes in August 2008. In December 2008, there was an upward trend when domestic production reached 47,686 metric tonnes with no signs of a decline. The steady trend in domestic sugar production is attributed to the good weather condition in the sugar growing regions.

There was unprecedented food shortage during 2008, and the government stepped in to facilitate importation of 10 million bags of maize. The shortage was caused by prolonged drought and the effect of the post-election violence in early 2008, leading to a reduction in farming within the affected areas. However, the global financial crisis could adversely affect the sector in a number of ways: Agricultural exports are likely to decline and thereby impact negatively on production, as market for the produce is curtailed; and due to rising inflation, the cost of imported farm inputs are likely to go up. This is likely to affect imports of agriculture machinery and fertilizers.

4.3.2 Wholesale and retail trade

This sector accounts for 10 per cent of GDP and 10 per cent of formal employment. Most of the employment in trade is found in the informal businesses that are not registered by the registrar of companies. These are small scale enterprises that are labour intensive and use adaptive technology (Government of Kenya, 2008b). The global financial crisis is likely to adversely affect the performance of this sector in form of reduced aggregate demand for goods and services, thereby causing redundancies leading to increased unemployment.

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4.3.3 Building and construction

This sector contributes between 12 and 14 per cent of GDP. The growth in this sector is proxied by the amount of cement produced and consumed.

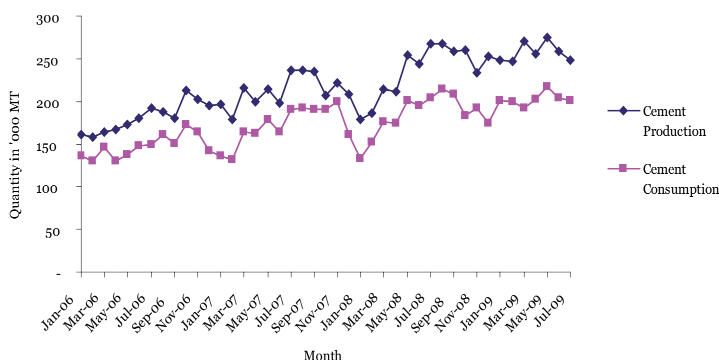
Cement production and consumption have both had an upward trend, with production being higher than consumption (Figure 4.18). Production shot up to 267,072 metric tonnes in July 2008 and dropped to 248,340 metric tonnes in July 2009. Cement consumption rose from 136,601 metric tonnes in January 2006 to reach 199,745 metric tonnes in November 2007. It declined to 133,429 metric tonnes in January 2008 before increasing to 200,840 metric tonnes in July 2009. It is noted that the domestic market for cement increased from 1.2 per cent in 2002 to 1.7 per cent in 2005, and recorded a 2.3 per cent growth in 2008 (Central Bank of Kenya, 2008).

Remittances from the Diaspora play a big role in the growth of the sector. As a result of the global financial crisis, remittances are likely to decline due to their procyclical nature, and thus adversely affect the sector even though they had increased from Ksh 30 billion in 2007 to Ksh 42.3 billion in 2008.

4.3.4 Manufacturing

The sector is important in wealth and employment creation and in

Figure 4.18: Cement production and consumption, Jan 2006-July 2009



Source: KNBS leading economic indicators

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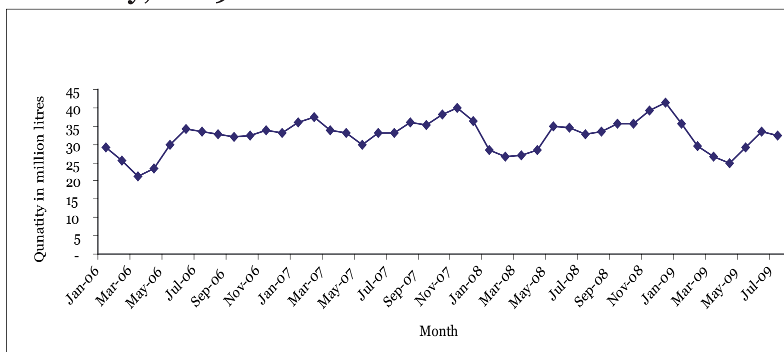
attracting foreign direct investment. It contributes about 10 per cent GDP and has been growing at an average annual rate of 5.5 per cent from 2003 to 2007. It employed 1.88 million people in both formal and informal activities in 2007. Employment in the formal manufacturing sector grew by 2.6 per cent annually over the period 2003 to 2007, accounting for 15.7 per cent of total employment within the manufacturing sector (Government of Kenya, 2008b). The manufacturing sector's products are sold on both local and international markets, making the sector to be susceptible to external shocks.

The milk intake in the formal milk sector averaged 30 million litres per month between January 2006 and July 2009. It rose from 21.1 million litres in March 2006 to 37.5 million litres in February 2007 (Figure 4.19). It further rose to 39.8 million litres in November 2007 before it declined to 26.5 million litres in February 2008 and rose again to 41.2 million litres in December 2008. It declined to 24.9 million litres in April 2009 and rose to 32.5 million litres in July 2009.

Since most of the products are exported to regional markets, the effects of the global financial crisis are likely to hit the sector through reduced demand for the products and increased prices of inputs, especially machinery and capital flows necessary for the growth of the manufacturing sector.

The sector is also likely to be hit by a credit crunch, as the credit becomes expensive and banks become more cautious on lending. Other sectors that are linked to the manufacturing sector are also likely to suffer from the impact of the global financial crisis on the manufacturing sector. For example, horticulture and tourism sectors are likely to

Figure 4.19: Milk intake in the formal milk sector, Jan 2006-July, 2009



Source: KNBS leading economic indicators

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record reduced performance due to the decline in the manufacturing sector. The manufacturing sector could further suffer due to decline in capital inflows, especially the decline of the much needed foreign direct investment for new enterprises or expansions. There is also a likely decline in the official development assistance to the government from bilateral supporters who have embarked on their own domestic bail-out programmes. This will translate to reduced funding for government supported projects, hence an increase in domestic borrowing by the government, which could drive up the interest rates as well as crowd out private sector investment. Kenya's manufactured exports are likely to face a declined market as other affected nations resort to protectionist policies to protect their domestic industries. On the other hand, there is a possibility of dumping manufactured exports in the country as a result of depressed commodity prices and loss of market.

4.3.5 Tourism

Tourism contributes about 10 per cent of the GDP, making it the third largest sector after agriculture and manufacturing. It is the leading foreign exchange earner which generated about Ksh 65.4 billion in 2007 compared to Ksh 21.7 billion in 2002 (Government of Kenya, 2008b). About 75 per cent of tourists to Kenya come from North America and Europe, with USA accounting for 5.9 per cent. In the first 10 months of 2008, tourist arrivals declined by 35 per cent mainly due to the post-election violence, high oil prices and the global financial crisis. Overall, international tourist arrivals declined by 30.5 per cent from 1,048,732 tourist arrivals in 2007 to 729,000 arrivals in 2008. Figure 4.20 shows that monthly arrivals of visitors through Jomo Kenyatta International Airport (JKIA) and Moi International Airport (MIA) declined from 109,403 in August 2007 to 36,970 in February 2008. The decline between January 2008 and June 2008 is attributed to the post-election violence that rocked the country. The arrival, however, improved thereafter to reach a high of 95,055 visitors in December 2008. Visitor arrivals further improved to 100,314 in July 2009. It is expected that earnings from tourism would remain low due to the continued financial crisis as the sector depends heavily on foreign tourists whose visits could decline as they consolidate their financial positions.

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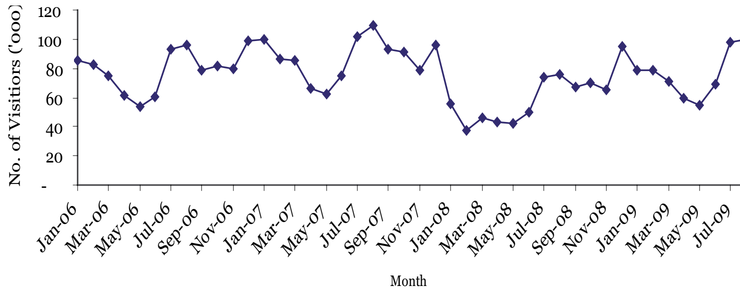
Figure 4.20: Visitor arrivals through JKIA and MIA, Jan. 2006-Aug. 2009



Source: KNBS leading economic indicators

4.3.6 Employment and wages

Employment is the most important source of income for majority of Kenyans. It is a means for poverty reduction, wealth creation and generation of government revenue. According to the Kenya Integrated Household Budget Survey 2005/6, out of a population of 35.6 million people, 18.8 million are in the primary working age category. However, there are 13.5 million people participating in the labour force with 12.1 million employed and 1.4 million categorized as openly unemployed. This gives an open unemployment rate of 10.5 per cent (Pollin, Githinji and Heintz, 2007). It is noted that the agricultural sector provides the bulk of employment, accounting for over 75 per cent of the labour force. Manufacturing, tourism, wholesale and retail trade, as well as building and construction sectors, play an import role in provision of employment opportunities. It is therefore noted that if these sectors' performance decline as a result of the global financial crisis, then they would impact negatively on the country's employment goals, thereby increasing unemployment.

The global financial crisis is also likely to occasion a reduction in demand for labour with implications for lay-offs and reduced wages as supply of labour outstrips demand.

4.4 Effects on the Financial Sector

The financial sector plays a vital role in economic activities. It plays a critical role in the development process through financial intermediation and/or renders service at a fee in the form of financial advisory,

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Table 4.1: Composition of GDP at current prices (%)

Share in real GDP	2003	2004	2005	2006	2007	2008
Agriculture, forestry & fishing	26.6	26.1	26.3	25.5	24.3	23.0
Mining & quarrying	0.5	0.5	0.5	0.4	0.5	0.5
Manufacturing	10.0	9.9	9.8	9.8	9.8	9.9
Electricity & water supply	2.6	2.5	2.4	2.2	2.2	2.3
Wholesale & retail trade, repairs	8.8	9.0	9.0	9.5	9.9	10.2
Hotels & restaurants	0.9	1.2	1.3	1.4	1.6	1.0
Building & construction	3.0	3.0	3.0	3.0	3.0	3.2
Transport & communications	9.9	10.1	10.4	10.9	11.7	11.8
Financial intermediation	4.0	3.8	3.8	3.8	3.8	3.8
Real estate, renting & business services	5.9	5.7	5.6	5.5	5.3	5.4
Public administration & defense	4.5	4.2	3.9	3.7	3.3	3.3
Education	6.7	6.5	6.2	5.9	5.7	5.9
Health and social work	2.4	2.4	2.3	2.3	2.2	2.2
Other community, social and personal services	4.1	4.0	3.9	3.8	3.7	3.7
Private households with employed persons	0.4	0.4	0.3	0.3	0.3	0.3
Less financial services indirectly measured	-1.0	-1.0	-1.0	-0.9	-0.9	-0.8
Total GDP at basic 2001 prices	89.2	88.3	87.7	87.1	86.3	85.7
Taxes less subsidies on products	10.8	11.7	12.3	12.9	13.7	14.3
Real GDP at 2001 market prices	100.0	100.0	100.0	100.0	100.0	100.0

Source: CBK's Monthly Economic Review, June 2009

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brokering, investment management, transfers and settlements. The financial services industry finances the working capital and investment needs for growth of firms. The diversity of the financial sector enhances availability of appropriate financial services. A well-diversified financial sector provides for short and long-term capital for investment by private firms. Long-term capital is crucial for private-led development strategy in terms of enhancing investment growth. Therefore, the financial sector is a critical component in the development process, particularly through the financial intermediation process.

The global financial crisis poses several challenges to the financial sector worldwide. Financing conditions are expected to deteriorate rapidly, and sound financial sectors could find themselves unable to borrow or unwilling to lend both internationally and domestically, therefore depriving the domestic productive sectors the much needed working and long-term capital. Such a scenario is expected to be characterized by a long and profound recession in high-income countries and substantial disruption and turmoil, including bank failures in a wide range of developing countries.

As part of the global community, Kenya's financial sector is not immune to these anticipated effects. However, since the sector is not highly integrated with the international financial system in terms of borrowing and lending, the effects might not be severe. However, an extended global recession that leads to a slow down in domestic economic performance may affect the financial system in terms of demand and supply of financial services. This may make the financial sector not to be vibrant and globally competitive as envisioned in Vision 2030.

4.4.1 Banking sector

Financial institutions in Kenya are adequately capitalized depicting a stable banking sector. Indeed, the performance of the banking sector has been improving over time. Table 4.2 shows selected performance indicators of the sector. Profitability increased from Ksh 27 billion in 2006 to Ksh 41.8 billion in 2008, an increase of 54.8 per cent. Loans and advances increased by 73.2 per cent, while non-performing loans decreased by 38.7 per cent in the same period. Similarly, foreign currency deposits increased by 83.9 per cent from Ksh 105.4 in 2006 to Ksh 193.8 billion in 2008. This is attributed to external donor inflows,

Table 4.2: Selected performance indicators of the banking sector

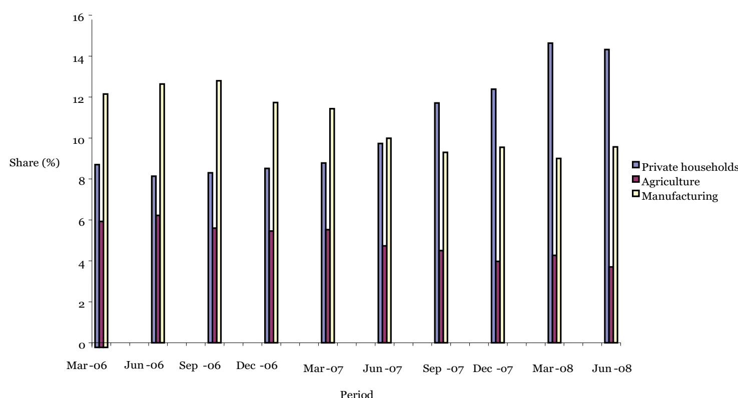
Year	Profitability: pre-tax profit (Ksh billions)	Loans & advances (Ksh billions)	NPLs (Ksh billions)	Foreign currency deposits (Ksh billions)
2006	27	396	100.3	105.4
2007	35.5	540.5	57.3	127.9
2008	41.8	685.9	61.5	193.8

Source: Central Bank of Kenya

remittances by Kenyans in the Diaspora, and receipts from exports. Generally, the improved performance in the banking sector was achieved despite the tough business environment brought about by the post-election violence witnessed in early 2008 and the first round of the global financial crisis.

Although the share of credit by banks to the real sector (agriculture and manufacturing) has been overtaken by credit to private households (Figure 4.20), bank loans are typically the second most significant source of capital for businesses in Kenya. Therefore, as the global recession extends, thus slowing domestic economic performance, the banking sector may be affected. A number of projects financed by the banks will likely face cash flow constraints, forcing them to default or reschedule their loan repayments. This in turn may lead to increased

Figure 4.20: Commercial banks' credit distribution



Source: Nairobi Stock Exchange (NSE)

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levels of Non-Performing Loans (NPLs). The situation might aggravate further when banks try to mitigate losses by restricting credit.

Similarly, as the financial crisis intensifies, Kenyan financial institutions having credit lines with foreign banking institutions, albeit small, are likely to face reduced short term credit. This then diminishes the ability of the banks from meeting the credit needs of the private sector. This will affect the profitability of banks, since the intermediation function is a major source of income for Kenyan banks.

The global financial crisis is expected to have repercussions on foreign exchange mainly due to reduced export demand, low export commodity prices and low remittances from Kenyans in Diaspora. This will negatively affect banks' profitability since foreign exchange transactions are a significant source of income for Kenyan banks. By January 2009, foreign currency deposits had reduced by 9.3 per cent to Ksh175.8 billion.

In general, the crisis is likely to hit more on small banks than their counterparts, mainly because of low capitalization, hence losses as they may be unable to cushion themselves. Also, due to their small market share, small banks' business volumes will be greatly affected, leading to reduced profitability.

4.4.2 Capital markets

Capital markets provide alternative saving tools and non-bank sources of financing for enterprises. Specifically, they are instrumental in enabling the private sector to raise capital for expansion projects and for financing of new businesses. Although capital markets comprising of equity and bond markets are functional in Kenya, the equity market is far much developed and bigger (volume) than the bond market.

While the stock market in Kenya has witnessed increasing activities over the years, this scenario has reversed. Table 4.3 shows the stock market performance indicators between 2006 and 2009. All the indicators depict a declining trend; for example, between September 2006 and March 2009, the 20 share index had lost 2,074.83 points, a decline of 42.5 per cent. Although in March 2009 the number of shares traded increased to 207.39 million from 170.90 million in December 2008, this is a decline of 90.4 per cent from June 2008. Similarly, turnover and market capitalization declined by 89.1 per cent, and 44 per cent, respectively, between June 2008 and March 2009. Figure 4.21

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shows market capitalization by sectors. Although all sectors are on a declining trend especially after June 2008, the commercial and services sector is hard hit. Several factors attributable to performance include withdrawal of foreign investors (especially during the first round of the global financial crisis), loss of investors' confidence, increase in inflation rate and unmet expectations from the Safaricom IPO.

As the global recession stretches out, improvement in the performance of the stock market may not be achieved. Foreign investors' withdrawal is likely to continue. Continued reduction in remittances from the Diaspora will also plunge the market. Further, as the domestic economic performance dips coupled by decline in export demand, profitability of most companies listed at the NSE will be gravely affected. This is expected to reduce activities at the stock market.

4.4.3 Other institutions

Other financial institutions are also likely to be affected as the global financial crisis extends. The insurance industry will, for example, face reduced business. The down turn of the economy may lead to reduced demand for life insurance, resulting to lower monthly premium payments. In most credit transactions, insurance becomes compulsory because the lender will not want to leave him or her unprotected, even if the borrower does not want to insure the asset that is the subject

Table 4.3: Nairobi stock market performance indicators

Period	NSE 20 Share Index 1966=100)	Number of Shares Traded (Millions)	Equities Turnover (Ksh Millions)	Market Capitalization (Ksh Billions)
September 06	4,879.86	177.42	12,377.72	726.78
December 06	5,645.65	77.42	5,770.67	791.58
March 07	5,133.67	114.27	6,955.35	696.92
Jun 07	5,146.73	151.11	6,079.43	743.91
September 07	5,146.46	275.7	9,902	791.7
December 07	5,444.83	140.80	6,017.99	851.13
March 08	4,843.17	180.64	7,320.55	781.66
June 08	5,185.56	2,154.90	22,130.01	1,230.67
September 08	4,180.40	485.30	6,787.80	972.30
December 08	3,521.18	170.90	4,617.14	853.68
March 09	2,805.03	207.39	2,414.,12	688.67

Source: Nairobi Stock Exchange (NSE)

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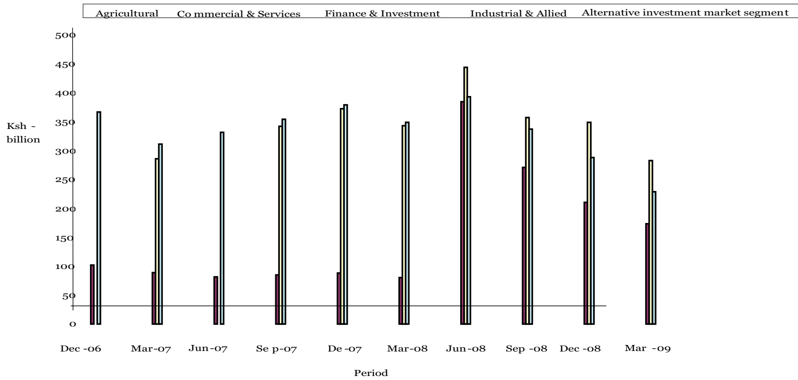
Figure 4.21: Market capitalization by sectors



Source: Nairobi Stock Exchange (NSE)

matter of the credit transaction. Therefore, with restricted credit, such businesses may not be forthcoming. As the stock market experiences a bearish run, institutional investors, including insurance companies, unit trusts schemes and pension funds will be adversely affected, since they have made huge investments in the market. Though it is difficult to quantify, the slowing down of the economy will also have negative effects on other institutions such as Micro finance institutions and SACCOs.

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5. Medium Term Growth and Prospects

Towards the end of 2008, world trade was hit hard by the worsening global recession. According to the IMF estimates, world trade for 2008 grew by 3.0 per cent, which is low compared to 7.3 per cent recorded in 2007. This is expected to shrink further in 2009, as it is projected to grow by a negative 11.9 per cent. Thus, effects of the global recession will be felt strongly in 2009. Towards the end of 2009, economies will start registering positive growth as the recovery sets in worldwide. Nonetheless, the recovery is expected to be slow, as financial systems remain impaired. The global economic recovery pulled up the strong performance of the Asian economies and stabilization or modest recovery in other parts of the world. The world output registered a growth of 3.0 per cent in 2008 and a projected negative growth of 1.1 per cent in 2009, before a rebound to 3.1 per cent in 2010 (WEO, 2009).

The global crisis did not spare sub-Saharan Africa, which has been going through a period of strong growth. With the expectation of a more pronounced global downturn, weaker commodity prices and pressure on capital flows, the IMF expects growth in sub-Saharan Africa to reduce from about 5.5 per cent in 2008 to about 1.3 per cent in 2009. With significant uncertainty at the global level, risks to growth remain tilted to the downside.

The key assumptions underlying the medium term projection (2009-2011) are:

1. Economic growth: Economic growth slowed down in 2008, a slight recovery is expected by end of 2009 to bring back the country in a growth trajectory by 2011. The performance in 2008 was affected by both the external and internal environment. Agriculture and tourism sectors recorded very slow performance given the post-election crisis and delayed long rains. However, the two sectors are likely to take time in recovery in 2009 due to failed rains, but a stronger recovery is expected in the outer years. All the same, the preliminary projections for 2009 to 2011 are based on key assumptions that the economic stimulus package and the Vision 2030 strategies are fully implemented. Under this scenario, real economic growth is projected to average 3.1 per cent in 2009, 4.2 per cent in 2010, and 5.0 per cent in 2011.

2. Consumption: This is also expected to shrink with the decrease in disposable income. Also, the high rate of inflation for 2008, which was on average 26.2 per cent, and the continued high levels in the first

nine months of 2009 at 21.1 per cent affected the total consumption by households. With the projected improvement in the economy in the medium term, the consumption is expected to increase.

3. Private investment: Though private investment was affected by the post-election crisis, the ongoing government efforts on recovery strategy (economic stimulus) are expected to work towards boosting private investments. Efforts geared to creating a favourable investment climate in the country through the continued stabilization of macroeconomic variables and the public infrastructure reconstruction efforts are expected to continue boosting the sector. Stability in interest rates and prudent fiscal policy as stated in the Government's fiscal policy are expected to underpin the recovery in business investment.

4. International trade: The current promotion activities in the tourism sector aiming at selling Kenya as a preferred tourist destination would be expected to revive tourism in the medium term. This is expected to boost exports in the medium term projections and play a role in the economic growth outcome. Imports are expected to expand with the economic growth. The projected positive growth for Africa given at 1.7 per cent for 2009 and 4.0 per cent for 2010, is expected to provide an impetus to private investments for the recovery process.

5. Inflation: The average inflation recorded for 2008 was 26.2 per cent. As much as it is expected to ease gradually, the position for 2009 is still gloomy at 19 per cent. This is due to failed long rains, thus food shortages leading to high food prices domestically. However, it is assumed that in the medium term, inflation rate will ease so as to converge to the policy scenario.

From the projections in Table 4.4, economic recovery is expected in 2009 so as to have a growth rate of 3.1 per cent. This is supported by the released quarterly GDP reports from KNBS, where the first quarter of 2009 registered 4.0 per cent growth and the second quarter had 2.1 per cent. If the remaining two quarters of 2009 perform equally well, the projection of 3.1 per cent can be achieved. As the projects in Vision 2030 continue to be implemented, recovery is expected in the medium term, where growth is projected to register 4.2 per cent in 2010 and 5.0 per cent in 2011.

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Table 4.4: Selected economic indicators

Kenya's medium term GDP preliminary projections - Demand side						
	2006	2007	2008	2009	2010	2011
% changes						
international						
Income of trading partners	4.7	4.8	4.1	1.6	2.8	3.2
World trade price (in Ksh)	1	0	16	-0.7	1	1
Long-term interest rate USA	5	4.6	3.6	3.3	4	4
Short-term interest rate USA	5	5.3	3.0	0.8	1	1
Prices (%)						
CPI inflation (overall)	14	9.8	26	19	15	11
GDP mp deflator	7	5	13	18	15	13
Volumes (%)						
Volume consumption households	10	7	0.5	2.4	4	6
Investments Businesses	19	11	3	7	13	12
Volume consumption government	2	8.5	4	7	9	8
Investments government	41	40	30	20	18	11
Export volume	2	6	4	6	8	8
Import volume	18	11	5	9	13	13
Gross value added Businesses	6	8	1	4	5	6
GDP (market prices; 2001; % vol. change)	6.4	7.1	1.7	3.1	4.2	5.0
Wage employment <B> (% change)	5	4	9	10	4	5

Source: KTMM October 2009 projections

NOTE: The KIPPRA-Treasury Macroeconomic Model (KTMM) is an aggregate supply/aggregate demand type of macro model of a market economy, and it describes the behaviour of the market actors. It consists of equations basically for the demand side of the economy and some selected for supply side. The model is in use at KIPPRA to analyze the effects of economic developments on the budget of the Government as well as the effects of the budget on the economy. It is a simultaneous model. The model is demand driven in the short run, with multiplier effects through consumption and investment. An important assumption of the model is that any demand is actually met, that is, it is assumed that the price system ensures there is always some excess capacity in the economy. High demand leads to high capacity utilization rates of capital and low unemployment rates, which lead to wage and price increases. In this way, the model has a tendency to return to equilibrium with 'normal' capacity utilization and unemployment rates in the medium and long run.

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As much as inflation is expected to converge to the policy scenario, the pace is expected to be slow. In 2009, on average, inflation is expected to be 19 per cent, 15 per cent and 11 per cent in 2010 and 2011, respectively. The policy level for inflation is single digit and more preferably at 5 per cent per year on average.

Investments both in Government and private sector are also expected to improve so as to boost the economic recovery process. The private investments volume growth is expected to be at 7 per cent in 2009, 13 per cent in 2010 and 12 per cent in 2011. The Public Private Partnerships (PPPs) arrangements are expected to drive this sector more strongly.

The consumption growth is expected to be in tandem with the economic growth and to register positive growth with the recovery process. Trade deficit is expected to widen in the medium term, but as the economy recovers from the global recession, it will narrow.

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6. Strategies to Mitigate the Effects of the Crisis

The financial crisis helped identify the structural weaknesses and shortcomings in the regulation of financial services. Lack of control mechanisms for regulators towards hazardous behaviour by institutions and lack of transparency, has proved that stricter rules and a coordinated framework for regulators are needed. Some of the interventions that Kenya could adopt to mitigate the effects of the crisis include:

Sustain macroeconomic stability: The peak of the current inflationary trends appears to have broken following declining oil prices and the onset of the rain season. It is important that the government continues pursuing prudent monetary policy. An analysis of the direct contributions to inflation by different components of the household consumer basket reveals that food plays an important role, partly because it constitutes a large share of aggregate household expenditure. In this regard, measures that enhance food supply and security will support macroeconomic stability.

Public expenditure management: The financial crisis has the potential of derailing the effective implementation of the national budget due to resource shortfalls related to the delayed issuance of the sovereign bond and lower revenue collections due to lower than projected growth. While essential public expenditures on social services and infrastructure need to be safeguarded, it will be important to prioritize and eliminate wastage. Historical experience shows that whenever Kenya faces serious fiscal challenges, the development budget suffers more. This should not happen. Therefore, rather than cut the development budget, available options, including approaching multi-lateral and bilateral development partners to access long-term finance, should be explored. However, extra-borrowing should be undertaken without undermining macroeconomic stability.

Productivity: During a global economic slowdown, it is only the efficient and highly productive producers that will be able to stem the tide. The Vision 2030 envisages a growth in total factor productivity of about 2.5 per cent per annum. It may be important to launch a productivity and competitiveness movement, whose objective will include promotion of productivity and competitiveness in the Medium Small and Micro enterprises sector. Additionally, efforts towards enhancing business environment need to be given high priority.

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Financial sector regulation and supervision: It is now widely recognized that financial innovation has moved at a faster pace than the requisite regulatory framework and risk management methods, especially with regard to the development of derivative markets. Some of the key issues under review in many countries include better management of liquidity risk, as well as greater transparency in the financial sector, and clearing and settlement arrangements for the derivative markets. Trading in these markets has remained fragmented and opaque. Although many banks may not be active in the derivative markets, the events in the global financial markets warrant that we re-look these markets and their future. Globally, the derivative market is very large and growing, estimated at approximately US$ 600 trillion at the end of 2007 (Bank of International Settlements). Recent experiences also reveal that we can improve the existing regulatory framework and develop new ones, especially for our capital markets and non-bank financial institutions.

There is need to strengthen regulation in the banking sector through more strict bank surveillance on capital adequacy, liquidity risk management, foreign exchange exposure and market risks. The CBK should enhance and sustain the policy of increasing liquidity within the financial system. This has been done by reducing the cash ratio requirements for the banking sector from 6 per cent to 5 per cent and the Central Bank Rate (CBR) from 9 per cent to 8.5 per cent. Capital requirements for banks to support their off balance sheet exposure should be enhanced. In addition, there will be need to continuously monitor commercial banks liquidity position, re-appraise the roles and activities of the capital markets, and reform the capital market to restore confidence among investors. Other measures include: transformation of the capital markets authority from a members association to a for profit association, formalization of SACCOs, and strengthening coordination of regulatory authorities in Kenya.

Crisis management preparedness: Experience from the current crisis reveals that even in the industrialized countries, there is lack of proper framework for management of distressed banks as reflected in adhoc and improvised schemes. It is an opportunity to re-look at financial crisis management preparedness. A sound framework could also have provisions on special measures to be taken under exceptional cases.

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Inspiring confidence: To inspire confidence on the government's commitment to move the economy to a higher growth of 10 per cent per annum, it would be advisable to fast track approval of major investment projects under consideration, including those in the medium-term plan.

Structural transformation and export diversification: In the medium term, the government should continue to undertake structural reforms that enhance economic transformation and export diversification. Public sector reforms, including privatization, civil service reforms, reforms in tax administration, the fight against corruption, and development of more efficient energy sources need to be strengthened.

Adopt a multilateral approach: Since the financial crisis is global, a multi-lateral approach especially on issues of common interest is likely to be more effective. Thus, there should be effective representation on key international issues under review, including reform of the Breton Woods institutions and pushing for fulfilment of pledges to provide increased resources so as to mitigate the impact of the global financial crisis.

Banks need to intensify portfolio oversight and prepare for rapid and flexible responses to clients needs. This must be coupled by exercising a new degree of selectivity for new operations, focusing on projects that demonstrate strong development relevance.

There is also need to continue improving the investment climate so as to attract both domestic and foreign investors.

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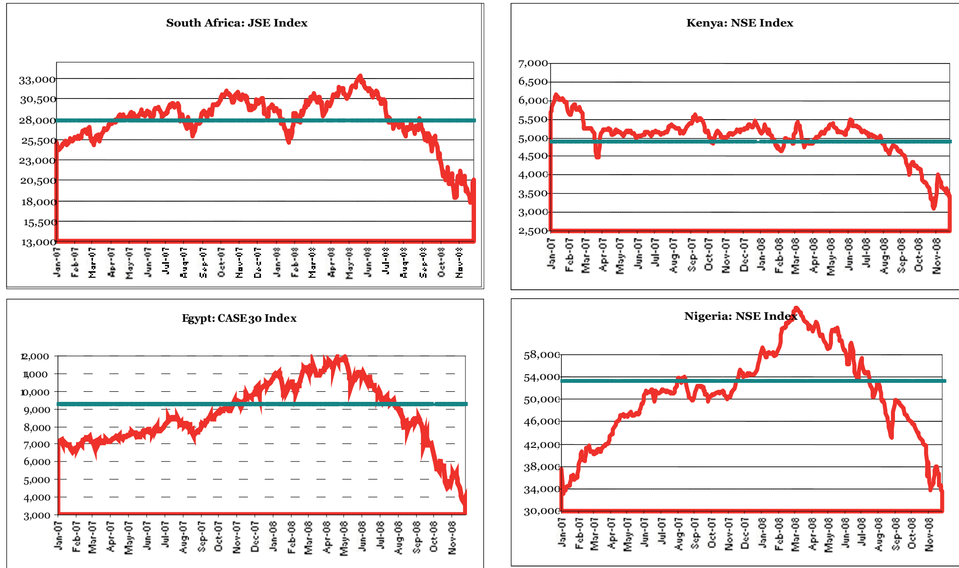
Appendix

Appendix 1: Index trends in various African markets



Source: Kasekende – African Development Bank

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Appendix 2: Summary of the possible implications of the crisis for FDI in the short to medium term

Variable affected by the crisis	Present evolution	Impact on FDI flows in 2009	Uncertainties in the medium term
Availability of financial resources	Intensive credit squeeze (less availability and higher costs) Decreased company profits Necessity to repatriate capital to compensate for losses	Growing financial constraints on investments, though some companies and institutions still have large amounts of cash	Speed of the recovery in the financial sector and end of the credit squeeze Capacity of new types of investors (companies from emerging countries, SWFs), to act as a major engine of FDI growth
Asset prices	Large decrease in the value of stocks	Reduced M&A activity, including leveraged buy-outs. At the same time, some M&A operations are encouraged by companies well-endowed with cash, but at a lower value by definition	Recovery patterns of the stock exchange market (with an impact on the value of international M&As)
Market growth	Slowed world economic growth at least until 2009	Reduced incentives for market-oriented FDI, especially in developed countries	Time schedule and geographic patterns of the economic recovery
Perception of uncertainty	Very negative evolution of all available business confidence indices	Companies to restrain further investment plans and cut extensively in existing costs and assets, especially in hard-hit advanced countries	A progressive return of confidence is a prerequisite for a new pickup in investment

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Public policies	Monetary and fiscal stimulus policies carried out in various countries in the world; the reform to the financial system has not yet begun; no specific impact of the crisis on FDI policies, but existence of some protectionist tensions	Impact of macroeconomic policies on business environment will affect demand and business environment, and FDI flow as a result	Capacity of public policies to ensure stability of the financial system, to renew commitment to an open attitude to FDI, to encourage investment and innovation, and to foster confidence of economic actors
Sector-specific crisis and restructuring	The financial sector, automotive, construction and intermediate goods have been especially hit, but the crisis rapidly extends to other industries and services	Divestments, sale of assets and M&As for restructuring in hardest-hit industries	Speed and scope of the restructurings and shifts in market power triggered by the crisis (increased role of companies from emerging and developing countries?)
Location patterns of FDI	Market-seeking FDI projects in developed countries are the most affected due to the looming recession there	Export-oriented FDI projects in developing and emerging economies (both efficiency-and resource-seeking) could be increasingly affected due to the low dynamism of advanced country markets	Rising attractiveness of the South for both market-oriented and efficiency-seeking FDI?
New sources of FDI	Growing role of SWFs and companies from emerging countries (but financial resources somewhat squeezed in the short term)	Growing share of emerging and developing countries in FDI outflows	Will FDI from the newer sources compensate for the decline in FDI from advanced countries?

Source: UNCTAD

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