Kenya: An aspiring regional powerhouse

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Key Drivers of Opportunity and Risk

- Kenya is the largest economy in East Africa and is well diversified. The steady growth of recent years is expected to continue, with real GDP forecast at around 6% in 2014.
- The government has devoted nearly 17% of the budget to infrastructure investment. This commitment, coupled with governance reforms and greater ease of doing business, should help Kenya remain the gateway to East Africa.
- Kenya's fast-growing middle-class has boosted domestic demand for banking, housing and construction, ICT, and consumer goods. This group's political power should pressure the government to improve public services and accountability.
- President Uhuru Kenyatta is fast tracking regional integration to establish a five-country East African common market, monetary union, and eventually political federation. As the dominant regional power, Kenya will benefit from the free movement of people, goods, and services.

2012-2013 Comparisons	Nigeria	Kenya	S. Africa	China
Population	174 million	44 million	53 million	♦1.36 billion
0-14 years of age	44%	42%	29%	18%
Male youth unemployment	14.1%	16.8%	♦47.5%	11.3%
% of women in the workforce	48%	62%	44%	64%
Real GDP growth, 2014 (IMF projection)	7.1%	6.3%	1.7%	7.5%
FDI inflows (2013 Current $)	$5.6 billion	$514 million	$8.1 billion	$124 billion
Gross national income per capita (PPP)	$5,600	$2,250	$12,240	$11,850
Population below national poverty line	♦70% (2010)	♦43.4%	♦31.3% (2009)	6.1%
Household consumption's contribution to GDP	70%	♦97%	83%	♦35%
Corruption perceptions (Percentile, among 177 countries)	♦81	♦77	41	45
Ease of doing business (Percentile, among 189 countries)	78	65	22	51
Innovation environment (Percentile, among 143 countries)	77	59	37	♦20

Notes: In percentiles, 1=Best; ♦=Notable drag on growth; ♦=Notable driver of growth.
Sources: World Bank, IMF, CIA, UNCTAD, Transparency International, Cornell University.

Issues to watch and questions to ask in conversation with President Kenyatta

- **Business environment** Kenyatta has supported a host of measures to improve Kenya's business environment, and the country's ease-of-doing business ranking has improved. What kind of businesses does the government seek to attract? What are the next steps for further improving the business climate?
- **Youth employment and entrepreneurship** Supporting entrepreneurship, especially among youth, is a policy focus. What are the lessons learned to date? What more needs to be done?
- **Regional integration** Kenya has championed regional integration aimed at making the country a business and trade hub for the region. What is the outlook for this process? Manufacturing is on the rise: What are the prospects for goods with the "Made in Kenya" label across East Africa and the world? What is the government doing to support such business development?
- **Innovation** Kenya is gaining a reputation as an ICT hub. What promising local innovations are emerging? How are they transforming business and creating opportunity, especially in underserved markets? What Kenyan innovations may spread to other parts of Africa and global markets?
- **Infrastructure** The government has undertaken an ambitious infrastructure development agenda. This has stressed public finances. Is the government pursuing alternative infrastructure delivery approaches such as public-private partnerships? Helter Skelter growth and immigration are challenging many African cities. As Nairobi evolves into a regional hub, what needs to be done to accommodate rapid growth?

Background

Kenya is the largest economy in East Africa and is well diversified. The steady growth of recent years is expected to continue, with 2014 real GDP forecast by the government at 5.7%. (Earlier in the year, the IMF forecast 6.3%.) Investments in transport and energy infrastructure, coupled with the adoption of governance and justice reforms, should help Kenya remain the gateway to East Africa.

Agriculture is the backbone of the economy and the largest contributor to GDP (26%). Other major sectors include the wholesale and retail trade, including hotels and restaurants (13.4%); finance, real estate and business services (12.1%); manufacturing (10.4%); and transport, storage and communication (10.4%). This diversification should help Kenya weather occasional shocks and provide opportunities to a growing workforce.

Drivers of Opportunity and Risk

Economic policy

Since taking office in 2013, Kenyatta has prioritized attracting FDI. This includes encouraging Chinese infrastructure investment, securing bilateral trade deals with Nigeria to remove issues of double taxation, attracting Qatari participation the country's new oil and gas development opportunities, and pursuing the economic integration of East Africa. These steps have increased FDI inflows by 98% from 2012 to 2013, to $514 million, although that falls behind Tanzania and Ethiopia ($1.9 billion and $1.1 billion, respectively).

Kenya has promoted a business-friendly policy and regulatory environment, boosting its Global Competitiveness Index rankings to 10th among African countries in 2014. This has encouraged international banks and technology companies to move their regional headquarters to Kenya. The government has also established the Nairobi International Financial Centre as a hub for foreign capital, for both the East African Community (EAC) and Africa.

Kenyatta signed a 5% capital gains tax into law in September 2014, calling it a crucial measure to finance infrastructure modernization and promote more broad-based growth that could lower unemployment and foster development.

Kenyatta's international priorities include fast-tracking East African Community integration as a part of the "Coalition of the Willing" with Rwanda and Uganda. The three have agreed to remove non-tariff barriers, develop and operate a standard gauge railroad to run through the region, remove work-permit fees between countries, and eliminate cell-phone roaming charges throughout the region as part of a "single mobile area."

In recent years, Kenya has seen official development assistance volumes decline as international lenders such as the World Bank shift their focus towards development finance. This has opened the door for China to step in and play a significant role, financing large infrastructure projects such as the regional railroad. But Kenya's relationship with the West remains strong, as US initiatives such as Power Africa and the African Growth and Opportunity Act provide a framework for finance and trade, respectively.

Kenya's recent Eurobond issue outperformed expectations by raising $2 billion. In light of the high volume of infrastructure development projects, the country's debt load has increased significantly, making debt servicing the government's biggest expense. The IMF and World Bank have sounded the alarm and suggested that Kenya explore innovative funding models, such as public-private partnerships, to lower the high public debt-to-GDP ratio.

Government effectiveness and corruption

Corruption and government effectiveness are still a concern. In 2013, Kenya ranked 136 out of 177 countries (in the 77th percentile) in Transparency International's Global Corruption Perceptions Index. With corruption rampant in the public sector, Kenya's ranking has remained dismally low over the years. One bright spot is that reform of the judicial system has led to marked improvement, increasing overall trust in the system. But critics say the courts are being exploited by unsuccessful tender bidders who use litigation to press charges of irregularities.

Natural resources

Recent discoveries in coal, lime, uranium, natural gas, and oil are likely to drive growth and opportunity for both the country and region. Although relatively new, Kenya's oil and gas sector is expected to attract significant investment and business in the medium term, and the IMF expects Kenya will produce oil in commercial quantities in 6-7 years. The development of pipeline and refineries will impact Kenya's ability to fully exploit these finds.

Kenya actively protects wildlife resources that form the backbone of the tourist industry. With funds from the US, Netherlands, France and Canada, the government deployed drones in April 2014 to all 52 national parks to monitor and protect elephant and rhino populations – helping lead to a 96% decline in poaching. Kenyatta, in his role as EAC summit chair, has urged regional cooperation on the protection of wildlife resources.

Demographics

More than three-quarters of Kenyans live in rural areas, and roughly 60% work in agriculture. Perennial risks surrounding rainfall and climate change pose the greatest challenge to agriculture and affect the sustainability of economic growth. Poverty alleviation remains a challenge for government, although the share of the population in poverty has declined from 47% in 2005 to between 34% and 42% today.

Thanks to increasing middle class demand, the new Kenyan consumer has gotten the attention of western companies such as Google and Yum! Brands, who are using Kenya as a launch pad into the East African market. This group of upwardly mobile, Westward-looking consumers will continue to be a boon to “aspirational” brands. As Kenya establishes itself as a key regional hub for companies looking to access this group, more companies are sure to follow.

Kenya has one of the world’s fastest growing populations and a young population, with 42% under the age of 15. With a literacy rate of 87%, the population is relatively well educated. To maximize Kenya’s human-capital advantage, Kenyatta has sought to improve educational outcomes, encourage youth to start businesses by providing start-up capital, and empower them to take advantage of innovation. Among other signs, this has led to increased enrollment in university IT departments.

Kenya is a diverse country with approximately 42 tribes, many of which have contentious relationships. Politicians have often used resource allocation to reward or punish groups. Tribal tensions peaked after the December 2007 presidential election, when large-scale violence erupted in response to electoral manipulation by incumbent president Mwai Kibaki. A new constitution, adopted in 2010, has devolved power to prevent future escalations, but tribal tensions persist and remain a source of politicization.

Infrastructure

As part of the Kenya Vision 2030 plan, investment in transport and energy projects are driving Kenya's development strategy. The government’s commitment to infrastructure, at 17% of the budget, is playing a large role in the country’s growth.

Several proposed projects are either underway or completed. These include the Standard Gauge Railway from Mombasa to Nairobi (and connecting to regional destinations); the expansion of Jomo Kenyatta International Airport and upgrading of regional airports through the country; and modernization of the Port of Mombasa.

Kenya’s energy grid cannot meet current demand, and prices are high for the 25% of the population with access to the grid. However, prices should drop and access should improve as new power plants begin to come on line. The current federal budget has allocated roughly $500 million to expand and maintain energy infrastructure, which includes hydro, fossil, and geothermal sources. The expansion of hydropower and geothermal capacity (using new domestic coal reserves) and the increased use of wind should increase supply by 2.5 times by 2016. In addition, the Obama administration’s Power Africa initiative will help direct foreign investment into Kenya’s energy sector.

Innovation and technology

Considered the ICT leader in the region, Kenya’s government has prioritized its role in development and encouraged its youth to find innovative solutions to everyday challenges.

Innovations such as the M-Pesa mobile money have not only increased financial access but driven growth of the telecom industry. The government has also spurred greater investment in private sector R&D, leading to an increase in the university IT departments. Plans to develop a technology hub, called the Konza Techno-city, outside of Nairobi, aim to transform the area into a global technology hub that many have already dubbed the "Silicon Savannah."

Geopolitical context

Kenya is one of only two EAC countries with access to the ocean, Tanzania being the other. The large port at Mombasa has made Kenya a crucial link to the East African economy and provides leverage in regional negotiations. As a result, the Kenyan government plans to not only develop the capital, Nairobi, into a regional financial hub but to expand country's role as a key offloading point for goods going in and out of the region. Most significant is the development of a new port in Lamu and a transit corridor that will service South Sudan and Ethiopia. This includes building a regional railroad, 90% of which is financed by a $3.8 billion loan from China, as well as oil pipelines, an oil refinery, three airports, and three resort cities. These projects will reinforce Kenya's position as the preeminent East African hub.

Among the biggest threats to Kenya's regional vision is security. The Al Qaeda-linked group al-Shabaab is based in Somalia but has had a direct impact on Kenya's economy and state of mind. In response to Kenya's 2011 military incursion into Somalia—designed to create a buffer between Somali fighters and the Kenyan border—al-Shabaab carried out several small grenade attacks on the Kenyan homeland. Then, the raid on Nairobi's Westgate Mall in 2013 and subsequent attacks on tourists and aid workers led to travel advisories and warnings of security threats. With talk of al-Shabaab recruiting from Kenyan nationals, the terrorist threat will continue to hurt the economy. Foreign tourist inflows have decreased from approximately 1.7 million in 2012 to a projected 1.2 million in 2014. In addition, the conflicts in Somalia and South Sudan have increased the number of refugees coming into Kenya, which now total 530,000 in camps and another 50,000 in cities. These conflicts may also impact regional infrastructure projects.

The International Criminal Court's efforts to bring Kenyatta to trial for allegedly orchestrating ethic violence in 2007-2008 also remain in the headlines. The ICC prosecution played a key role in the 2013 election narrative, as Kenyatta successfully painted it as a neo-colonial Western effort to persecute African leaders.