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Speech delivered to the National Assembly on 16th June, 1994, by the Hon. W. Musalia Mudavadi, Minister for Finance, Republic of Kenya, presenting the Budget for the Fiscal Year 1994/95 (1st July to 30th June).

Mr. Speaker, Sir,

I beg to move that Mr. Speaker do now leave the Chair.

1. **INTRODUCTION**

Mr. Speaker, the financial year 1993/94 which is just coming to a close was marked by extraordinary turbulence in the sphere of short-term economic management. A turbulence, I hasten to add, which has now passed. The economy has emerged from it not only unscathed, but refreshed and vigorous, proving yet again the resilience acquired through the structural adjustment process of the last several years.

Mr. Speaker, our national leaders and economic managers would not be able to steer the economy through the storm, unless they had firm commitment to the structural adjustment policies that were being implemented. When I presented the Budget to Parliament in June last year, the discount rate on Treasury bills exceeded 70 percent, the annualised three-month rate of inflation was above 100 percent, the external value of the Kenya Shilling had fallen sharply, and the country's foreign exchange reserves had been depleted to a critically low level. Yet through the year, we persisted with high volumes of Treasury bill sales in the weekly auctions, continued to decontrol prices, extended the foreign exchange retention scheme to all exporters and liberalised the exchange control regime further. There were Doubting Thomases among us who were afraid that these policies would push the economy over the brink into economic chaos. But today, all those doubters and critics will agree, I hope, that their fears have been proved unfounded. The rate of discount on Treasury bills has come down from dizzy heights to below

30 percent, the three-month annualised rate of inflation fell to 16 percent in December, the external value of the Kenya Shilling has stabilised, and the country's foreign exchange reserves have grown to a very healthy level in relation to our import requirements.

Mr. Speaker, our firm commitment to reform policies and the economic turn-around have been duly appreciated by all commentators, both at home and abroad. The embargo imposed on quick-disbursing external aid in November 1991 was lifted in the second half of 1993. A successful Consultative Group Meeting was held in Paris in November last year, in which the donors made substantial new aid commitments. We have also been able to reach understanding with our creditors on a schedule of repayment of our accumulated external debt service arrears.

Mr. Speaker, a crucial factor in all these has been the personal involvement and wise counsel of H.E. the President. I am sure that Honourable Members will join me in expressing our sincere thanks and appreciation for his continuing guidance and leadership of the Nation.

Mr. Speaker, as is customary, I shall first make some brief remarks on recent developments in the international economic scene, including the countries of Sub-Saharan Africa, before drawing your attention to developments in the domestic economy and our policy framework for the short and medium-term future.

2. WORLD ECONOMIC SCENE

Industrial Countries

Mr. Speaker, the world economy posted a mixed performance in 1993 with policy successes and failures spread unevenly among the rich industrialized nations. Among the OECD countries, USA, Canada and U.K. recorded GNP growth rates of between 2 and 3 percent. However, performance was poor in other major OECD member countries, including, in particular, Germany and Japan which experienced contraction of GNP of between 1 and 1.5 percent. The German economy suffered from relatively high interest rates and non-competitiveness of industry arising from high production costs in a situation of declining labour productivity. Economic growth in Japan, on the other hand, was affected by the appreciation of the Yen, and contraction in private expenditure resulting from balance sheet adjustments due to a steep fall in asset values. The overall growth rate for the OECD region was about 1.1 percent in 1993, while that for the G7 countries was slightly higher at 1.5 percent.

Mr. Speaker, the industrial countries' performance on the inflation front was very satisfactory in 1993. The average OECD inflation rate was 3.7 percent, with inflation in the G7 countries even lower at 2.6 percent. This trend of very low inflation has been continuing for sometime, leading many people to wonder whether the world economy may now realistically target a zero inflation rate. One reason for continuing low inflation rates was, of course, the sluggishness of economic recovery itself. Another contributory factor was the low price of crude oil.

Mr. Speaker, while the picture was mixed for economic growth and good for inflation, it was generally depressing for employment. For OECD countries as a whole, unemployment rose from 7.8 percent of the labour force in 1992 to 8.2 percent in 1993. Changes in technology, labour market rigidities and high unemployment benefits are regarded as the major reasons for the persistence of high unemployment. Public authorities in these countries are under pressure to devise effective policies for generating more employment. Reducing the number of hours of work per week, lowering real wages, cutting down on unemployment benefits, and raising labour productivity are among the measures being discussed. However, the only sure solution to the problem of unemployment in the long run, Mr. Speaker, is a sustained high rate of economic growth.

Mr. Speaker, one major event on the international economic scene in 1993 was the signing of the GATT agreement in December, after protracted negotiations spread over 7 years since the beginning of the Uruguay Round of trade talks. Strong protectionist tendencies in some large industrial countries, including the USA, Japan and the European Union had to be overcome before the final deadline of December 15, 1993. The process has been advanced further with the signing of the Marrakesh Declaration in March this year, paving the way for the setting up of the World Trade Organisation. While the agreement will still need to be ratified by the legislatures in the respective countries, there is widespread optimism that any remaining hurdles will be removed. Mr. Speaker, this was very good news for international trade and development. Various estimates have been made of how much additional growth for the global economy can be expected to result from the signing of the GATT deal. One recent estimate by OECD puts the additional world output at \$ 275 billion per year by the year 2002. It is important to note, Mr. Speaker, that the alternative to an agreement would not be continuation of the *status quo*, but a *deterioration*, resulting from the intensification of protectionist wrangles and the replacement of multilateralism in trade by regional groupings.

Mr. Speaker, the short-term outlook for the industrialised world is a somewhat higher GNP growth of 2.1 percent in 1994, rising to 2.7 percent in 1995. The inflation rate is expected to remain low with the OECD average expected to be around 3.2 percent, and the average for the G7 countries around 2.4 percent. The 1994 growth performance is expected to improve for all countries, with the good performers of 1993 such as the USA, Canada and UK likely to achieve somewhat higher growth rates and the other important G7 countries such as Germany, Japan and France forecast to record positive growth during 1994, as compared to declines registered in 1993. The employment situation, however, is expected to take some more time to turn around. Specifically, it is anticipated that the unemployment rate will worsen from 8.2 percent of the labour force in 1993 to 8.5 percent in 1994.

Developing Countries

Mr. Speaker, following the general pattern of the last decade, the GNP growth rate for developing countries during 1993 continued to exceed that of the industrialised countries. The gap in growth performance was very substantial in 1993, with developing countries' growth rate averaging about 5.7 percent, which compares with 1.1 percent for industrial economies. As

usual, the developing countries' performance varied across regions. China put up a spectacular growth performance of 13 percent. Other Asian economies recorded satisfactory growth of around 5.3 percent. Latin American countries achieved a more modest growth rate of about 3.5 percent, while the African economies managed to attain an average growth rate of only 1.4 percent. The worst performers were the economies in transition in Eastern Europe and the former Soviet Union where there was a sharp *decline* in GNP of about 10 percent.


Mr. Speaker, one reason for the faster growth in poor nations is the substantial policy reforms which most of them have introduced during the last few years. An important consequence of these reforms was a sharp increase in foreign private capital flows into the developing economies, some of which was a return flow of domestic savings that had deserted the countries under the earlier command economy regimes. Another factor is the rapid growth in trade among the various regions and sub-regions of the developing world.

Mr. Speaker, medium-term forecasts for developing countries as a whole indicate that the strong growth of over 5 percent will continue in both 1994 and 1995, rising to 6 percent in 1996. Growth rates are also expected to improve somewhat in Africa and in the transition economies of Eastern Europe and the former Soviet Union.

The African Scene

Mr. Speaker, the estimated low growth rate of 1.4 percent recorded in African economies in 1993 still compares favourably with 0.7 percent recorded in 1992. For the countries of Sub-Saharan Africa, the growth rate was somewhat higher at around 2 percent. The slow pace of recovery in African economies can be attributed to various factors, such as: (i) drought in North Africa, as well as in Eastern and Southern Africa; (ii) continuing civil and political conflicts, especially in Liberia, Somalia, South Sudan, Rwanda and Angola; and (iii) a further fall in the terms of trade for African countries. Mr. Speaker, the growth rate of population in Africa is estimated at around 3 percent per year. 1993 was, therefore, yet another year when per capita income and living standards of Africans deteriorated, marking a continuation of the trend that had set in from the early 80's.

The prospects for 1994 do not look very bright either. There are signs that the drought is going to end in most of in Africa, but normal rainfall patterns are not firmly established yet. Also, it will take continuing good rains for two to three seasons before the productive potential of land can be fully restored. Armed conflict is still continuing in some African countries; uncertainty and insecurity continue to inhibit the resumption of normal levels of production, trade, saving and investment. A major good news on the African continent is the long overdue political settlement and recent elections in South Africa. This will now pave the way for the economic re-integration of South Africa into the regional economy, boosting trade and investment in the entire region. Another positive factor is the expected recovery and growth in industrial countries. However, the completion of the Uruguay Round may have some adverse effects on *African economies in the short run*, through: (i) rise in food import costs due to reduced subsidies on European food; (ii) limitations on the further expansion of textile exports



due to the delay in bringing the Multi-Fibre Agreement under GATT discipline and (iii) increased competition in the European markets because of the relative erosion of the privileges enjoyed by African countries under the LOME Convention.

Mr. Speaker, the current forecast of growth in African economies during 1994 is about 2.5 percent. For the medium term, opinions vary. Optimists expect the growth rate in Africa to rise gradually to 5 percent and above, while pessimists forecast the growth rate to stagnate around 2 percent for the rest of this decade. The former pin their faith on the expected benefits of economic and political reform measures implemented in course of the last few years, while the latter point to the possible continuation of economic mismanagement, corruption, and civil and political strife. Mr. Speaker, the absence of consensus on this issue is understandable, because sustained high growth of African economies will not be easy to achieve. It will call for inspired and selfless political leadership, continued social harmony, competent economic management and focussed international co-operation.

3. DOMESTIC ECONOMY

Mr. Speaker, I now turn to the domestic economy. The overall performance in 1993 was even worse than that of 1992, with a real GDP growth of only 0.1 percent. Indeed, 1993 was the fourth year in a row of decreasing growth in Kenya. Although in this respect the Kenyan economy appears to have replicated the performance of industrial economies, there were some specific factors working in the Kenyan situation which should be noted. These were: first, the continuing poor rainfall making three seasons in a row; second, the lingering effect on coffee output of the serious neglect of the crop by farmers following the price crash of 1989; third, the disruption to economic activities due to ethnic clashes that continued through 1993, although on a reduced scale; fourth, the continuing weakness of the confidence factor among investors and the business community in general; and finally, the progressive cuts applied to Government development expenditure in real terms for containing the Budget deficit.

Sectoral GDP

Mr. Speaker, the agricultural sector performed poorly in 1993 with an estimated 24 percent decline in the production of maize and a 12 percent decline in the output of coffee. The sharp fall in maize production was mainly a consequence of the failure of rains in major growing areas at critical times in the crop cycle. As regards coffee, although auction procedures and payment systems were improved, and international prices recovered significantly, especially for Kenyan coffee, farmers had to pay the price for neglecting the crop for about three years in the past. Coffee production should begin picking up again this year, and I see no reason, Mr. Speaker, why there should not be a period of sustained recovery and growth in this sector.

The outturn for tea was good, with a growth rate of output of over 12 percent achieved in 1993, despite the adverse rainfall conditions mentioned before. In the area of horticulture, while the production of fresh fruits declined marginally, that of fresh vegetables and flowers

registered satisfactory growth. Among other crops, production of wheat fell sharply, while that of rice, beans, sisal and pyrethrum increased. Overall, GDP from the agricultural sector declined by 4.1 percent, due mainly to the large shortfalls in the production of maize, coffee and wheat.

Mr. Speaker, agriculture is the prime mover of the Kenyan economy, generating income and effective demand, supplying raw materials to agro-based industries and merchandise for our major exports. When agriculture is depressed, the other sectors of the economy also perform poorly. Thus, the manufacturing sector recorded only a low growth rate of 1.8 percent. Although this was an improvement over the performance in the previous year when the growth rate was 1.2 percent, it was much lower than the 6 percent growth recorded as recently as in 1989, and the long-term average growth potential of this sector. Apart from the contraction of the agricultural sector, other factors which affected manufacturing activities adversely were a fall in real investment in the sector during 1991 and 1992, and the high cost of both foreign exchange and domestic bank credit. A positive factor was strong growth in exports of non-traditional manufactured goods. Canned food, textiles, plastic products and furniture and fixtures are some of the industry groups which registered strong growth during 1993. Industries which recorded declines, on the other hand, were domestic consumer durables and non-durables like grain mill products, clothing, leather and footwear, and transport equipment.

Mr. Speaker, among the other major sectors, building and construction suffered the sharpest decline of 6.7 percent, as a result of reduced investment in both the public and the private sectors. Major service sectors like trade and transport recorded marginal growth rates of less than 1 percent. The finance sector, however, registered strong growth of 7.5 percent, due mainly to the steep rise in interest rates and expanded scale of activities in the financial system, including the capital market. Growth in GDP in the Government Services sector was only 2 percent, compared to 2.4 percent in 1992, due to deliberate compression of both recurrent and development expenditures in real terms.

Investment and Saving

Mr. Speaker, the most disappointing news on the performance of the economy in 1993 was the continuing fall in investment or gross fixed capital formation. In real terms, it *fell* by 16.4 percent in 1993, following declines of 5.8 percent in 1992 and 2.9 percent in 1991. It is the most disappointing news because fixed investment increases the capital stock, which is the basic determinant of the growth potential of an economy. Low investment today is bad news for growth in output and employment tomorrow.

Mr. Speaker, the falling trend of investment is a matter of serious policy concern and I shall return to this subject later in my comments on the policy framework. At this point, I wish only to note a few statistics in the area of investment and saving. As I have already mentioned, total gross investment fell in 1993 by 16.4 percent. In absolute terms, this represented a decline of K£ 117.8 million in constant 1982 prices. The *good news within this bad news* is that nearly 80 percent of this contraction occurred in investment by Government and the parastatals sectors.