Country Focus Report 2023

KENYA

Mobilizing Private Sector Financing for Climate and Green Growth





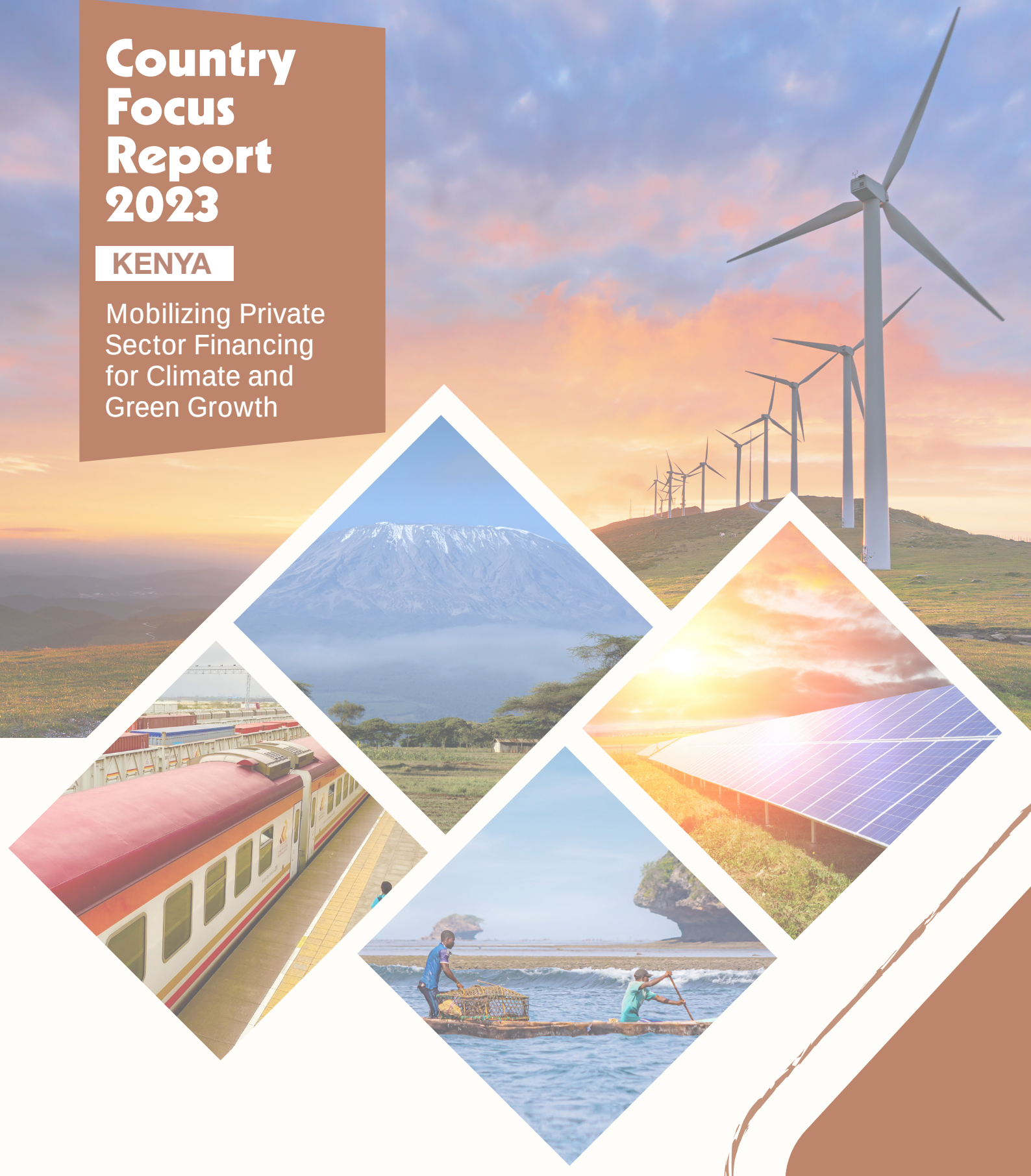


AFRICAN DEVELOPMENT BANK GROUP
GROUPE DE LA BANQUE AFRICAINE DE DÉVELOPPEMENT

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TABLE OF CONTENTS

ACKNOWLEDGEMENTS iii
TABLE OF CONTENTS iv
LIST OF FIGURES v
LIST OF BOXES V
LIST OF TABLES v
LIST OF ABBREVIATIONS vi
KEY MESSAGES vii
I INTRODUCTION 1
II KENYA'S ECONOMIC PERFORMANCE AND OUTLOOK 3
2.1 Recent Macroeconomic Developments 3
2.2 Outlook and risks 7
III PRIVATE SECTOR FINANCING FOR CLIMATE AND GREEN GROWTH IN KENYA 9
3.1 Introduction 9
3.2 Private sector finance flows, gaps and needs for green growth and climate action in Kenya 12
3.2.1 Current flows of finance 12
3.2.2 Private sector finance needs for the future 12
3.3 Opportunities and barriers for mobilising private sector finance for green growth and climate action 13
3.3.1 Opportunities for private sector investments 13
3.3.2 Barriers to private sector investments 16
3.3.3 Pathways to mobilising private sector finance for green growth and climate action in Kenya 18
IV NATURAL CAPITAL FOR CLIMATE FINANCE AND GREEN GROWTH 23
4.1 Introduction 23
4.2 The Evolution of Natural Capital 23
4.3 Opportunities for Enhancing the Contribution of Natural Capital in Kenya 25
4.3.1 Non-Renewable Resources 26
4.3.2 Renewable Resources 27
V CONCLUSION AND POLICY RECOMMENDATIONS 29
5.1 Conclusion 29
5.2 Policy Recommendations Relating to Macroeconomic Performance and Outlook 30
5.3 Policy Recommendations to Mobilize Private Sector Finance for Climate and Green Growth 31
5.3.1 National Government 31
5.3.2 MDBs and DFIs 31
5.3.3 Domestic and international private sector 31
5.3.4 Developed country governments. 31
5.4 Recommendations to Increase the Contribution of Natural Capital for Climate and Green Growth 32
REFERENCES 33
ANNEX 1 35

LIST OF FIGURES

Figure 2.1: Green Growth Index for Kenya and Peers, 2010 – 2021
Figure 2.2: Upfront private investment opportunities to adapt to droughts and floods. 2021-2040 (% of GDP)
Figure 2.3: Estimated annual private climate finance gap for African countries, lower and upper bounds
Figure 2.4: Public climate finance per capita in Africa
Figure A1.1: Changes in the value of natural capital for African countries, 1995-2018
Figure A1.2: Mining and quarrying value added, 2022 (e)
Figure A1.3: Forest land and non-renewable assets

LIST OF BOXES

Box 1.1: Impact of Russia's Invasion of Ukraine on Kenya
Box 2.1: The Kenya Green Bank Initiative

LIST OF TABLES

Table 1: Macroeconomic Indicators
Table 2.1: Innovative instruments used to mobilise private sector finance in Kenya.
Table 3.1: Evolution of Natural Capital in Kenya (1995-2018)

LIST OF ABBREVIATIONS

AfCFTA	Africa Continental Free Trade Area
AfDB	African Development Bank
AEO	African Economic Outlook
BOP	Balance of Payments
CAR	Capital Adequacy Ratio
CBK	Central Bank of Ghana
CCCF	County Climate Change Fund
CFR	Country Focus Report
CPI	Climate Policy Initiative
EAC	Eastern Africa Community
DFIs	Development Financing Institutions
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
GESIP	The Kenya Green Economy Strategy and Implementation Policy
GGGI	Global Green Growth Initiative
GGI	Green Growth Index
GoK	Government of Kenya
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IUU	Illegal, Unreported and Unregulated
KCB	Kenya Commercial Bank
KEPSA	Kenya Private Sector Alliance
LAPSSET	Lamu-Port South Sudan-Ethiopia Transport
LLOP	Lokichar-Lamu Oil Pipeline
NDC	Nationally Determined Contribution
OMO	Open Market Operation
NPLs	Non-Performing Loans
MDAs	Ministries, Departments and Agencies
MDBs	Multilateral Development Banks
MSMEs	Micro, Small, and Medium-Sized Enterprises
MTP	Medium Term Plan
NCCAP	National Climate Change Action Plan
NEER	Nominal Effective Exchange Rate
REO	Regional Economic Outlook
PPPs	Public-Private Partnerships
REER	Real Effective Exchange Rate
RMCs	Regional Member Countries
TNC	The Nature Conservancy
$	United States Dollars
UTNWF	Upper Tana Nairobi Water Fund
WHO	World Health Organization
WWF	Worldwide Fund for Nature

Kenya

KEY MESSAGES

Macroeconomic Performance and Outlook

Kenyan GDP growth slowed to 5.5% in 2022 from 7.5% in 2021. This slowdown was caused by shocks, namely drought, Russia's invasion of Ukraine, and constrained international financial market conditions. To mitigate the socioeconomic impact of the shocks and to support growth, policy makers responded with prudent monetary, fiscal and exchange rate policies.

The outlook is positive. The GDP is projected to increase by 5.9% in 2023 and by 6% in 2024, premised on the assumption that commodity prices and global inflation would recede in the medium term. Inflation is projected to fall within the target band of 7.5% and 5.5% in 2023 and 2024, respectively; fiscal deficit to narrow to 6.1% and 5.5% of GDP in 2023 and 2024, respectively. The current account deficit is projected to narrow to 5.3% and to 5.1% in 2023 and 2024, respectively. Downside risks to the outlook include a slowdown in global growth and persistent global financial market tightening. Risk mitigation measures could include creating policy spaces by deepening the fiscal consolidation program, restructuring public debt, and seeking external financial assistance.

There is already a strong political commitment towards green growth and climate action in Kenya. Kenya has made good progress in developing its national green growth frameworks and roadmaps, all of which highlight the important role of the private sector in generating the finance needed to meet established goals. This has also been accompanied by comparatively good performance on green growth.

However, this political commitment needs to be translated into action through strengthening cross-sectoral coordination that will contribute to mobilising additional private sector finance. The country needs to move a step further and implement these frameworks while also ensuring strong horizontal and vertical integration. Implementation also requires the development of green skills and addressing the existing capacity gaps that limit the development of commercially viable green growth and climate change projects for private sector investments.

Private sector financing for climate change and green growth

The climate financing needs to meet Kenya's NDC target by 2030 is estimated at S6.2 billion per annum. The private sector has the potential to meet 25% to 75% of the climate finance need. This is against current private sector contribution to climate finance of S979 million per annum. Key barriers preventing the mobilisation of private sector finance at scale to meet the country's green growth and climate action goals relate to the high levels of external debt emerging from the high cost of capital, the low levels of skills and capacities within institutions to develop and implement commercially viable green growth and climate action projects for private sector investments, particularly for non-energy related sectors and the limited integration amongst different sectors at the national level needed to ensure equitable distribution of mobilised private sector finance.

Blending and green finance instruments are an opportunity for Kenya to further mobilise domestic and international private sector finance for green growth and climate action. Blending of finance also offers Kenya an opportunity to de-risk investments in key sectors for green growth and climate action. This, combined with the activation of green and sustainable financing frameworks that have already been developed or proposed will accelerate the mobilisation of affordable capital from the private sector.

The private sector financing opportunities for green growth and climate change in Kenya are immense. Unlocking these opportunities will need concerted action by multiple stakeholders.

- The Kenyan government should ensure vertical coordination by national level institutions responsible for facilitating the implementation of green growth and climate action frameworks. They should also rapidly implement the sustainable financing frameworks that were developed during the implementation of the third Medium Term Plan (MTP III) and the draft fiscal incentives policy developed in 2023.

- Ministries, departments and businesses (MDBs) and Development Finance Institutions (DFIs) should become less risk averse by further engaging with the Kenyan government to identify ways to provide affordable capital for green growth and climate change investments. They should also use innovative financing instruments that de-risk private sector investments, particularly in non-energy sectors such as water and health infrastructure development.

- The domestic and international private sector should collaborate with national government, MDBs and DFIs and other private sector actors to identify key risks to investments and propose ways of addressing these investment risks.

- Developed country governments should work with MDBs and DFIs to ensure that these institutions have sufficient capital to enable them to implement risk-agnostic measures for financing green growth and climate action in Kenya and other African countries.

Natural capital for climate finance and green growth

There is huge potential for Kenya to benefit from natural capital to support climate change and green growth. For renewable natural resources, the expansion of cropland and pastureland can help reduce food insecurity as well as mitigate the climate change challenges being experienced. For the non-renewable natural resources, further exploration of crude oil and natural gas is required to enhance revenue to support GDP growth and sustain climate change initiatives.

The enormous natural resources have the potential to enhance revenue to support growth and finance climate change initiatives. There is potential for Kenya to benefit from the fisheries and blue economy sector as Kenya has several freshwater lakes and rivers and a coastline of about 510 kms. Investments to increase the harvesting of fish, which has the potential to generate $4.4 billion will help to enhance growth and finance green growth. Kenya's blue economy can provide revenue, and this can be done through the issuance of blue bonds that assist the conservation of the ecosystem. Ecotourism in Kenya is a source of revenue; however, it is sensitive to shocks. Enhanced marketing of the sector is needed to diversify the tourist market to build resilience.

Strong partnership and collaboration with development partners can support Kenya's ability to gain from the benefits of natural capital. As such, Kenya should exploit international agreements in several areas such as a single market for the trade of emissions credits (under Article 6 of the Paris International Agreement) to help scale up the price of carbon credits from forests. Kenya should also consider enhanced-visibility voluntary markets as opportunities come up based on the post-2020 Global Biodiversity Framework. For Kenya to achieve and benefit from the agreement, it has to establish MRV procedures and to participate in the market by establishing NDCs with clear mitigation targets.

Integrity of certification of voluntary carbon markets is crucial for Kenya to achieve its objectives of climate change mitigation and adaptation through natural capital. Therefore, Kenya will have to scale up efforts for carbon sequestration in areas such as forestry and land use, agriculture and soil sequestration, and blue carbon.

Increasing investment and efficiency of rents on cropland and pastureland by taking account of climate change impacts has the potential to support Kenya's climate change objectives. Therefore, the use of short-term policies such as reforestation will enhance resources from the carbon credit market.

I INTRODUCTION

1.1 To meet the Nationally Determined Contribution (NDC), Kenya needs $6.2 billion annually over the period 2020-2030. This Country Focused Report (CFR), in line with the theme of AEO 2023 i.e., "Mobilizing Private Sector Financing for Climate and Green Growth in Africa", analyses the role that the private sector can play in mobilizing climate finance in Kenya to meet NDC targets.

1.2 The report is structured as follows. Section 2 presents Kenya's recent macroeconomic performance and outlook. Section 3 discusses the state and opportunities for leveraging private sector financing for climate action and green growth in Kenya. Section 4 explores possible options to harness natural capital in the mobilization of climate finance and promotion of green growth in Kenya. Section 5 concludes and draws policy recommendations targeting Kenyan authorities, donors, domestic and international private investors, and governments of developed country partnering with Kenya, with a view to scaling up private sector resources and harnessing natural capital for financing climate action and green growth in Kenya.

II KENYA'S ECONOMIC PERFORMANCE AND OUTLOOK

Kenya's economy has shown resilience to successive shocks that it has faced since 2020 – COVID-19 in 2020, Russia's invasion of Ukraine in February 2022[1]; and shifts in monetary policy stances in advanced economies since 2022. In this section, a brief analysis is attempted of recent macroeconomic developments, the impact of the shock, policy responses, prospects, and risks.

2.1 Recent Macroeconomic Developments

GDP growth: Kenya's economy grew on average by 4.5% between 2013 and 2022, lower than East Africa's average regional growth rate of 5% but higher than the continental average growth rate of 3.2%. Growth slowed to 5.5% in 2022 from 7.5% in 2021. This is attributable, among other things, to drought, Russia's invasion of Ukraine (Box 1.1) and constrained government finances. The latter was caused by, inter alia, tight global financial conditions. In general, growth has been driven by an accumulation of factors, with human and physical capital accounting for over 48% and 28% of the growth between 2013 and 2022, respectively. The services sector has benefited the most from factor accumulation-led growth. It absorbed, on average, 77% of the 4% average growth in employment and 34% of the 5% average growth in investment during the period. The services sector contributed 75% of the GDP growth followed by industry (10%) and agriculture (15%). On the demand side, expenditure growth was domestic absorption-driven (i.e., consumption and investment). External demand remained a drag on growth. Domestic absorption accounted for 97% of the average growth, of which about 67% came from households. In general, structural transformation has been slow - not appreciably inclusive in job creation although it has been progressive in other dimensions such as health and education. There is an ongoing process of structural transformation from agriculture to services with marginal improvements in the industrial sector. At the current pace of structural transformation, a growth far higher than current rates is required to absorb new entrants into the labour market. Structural transformation is constrained by weak private sector participation in the industrial sector, a low agricultural productivity, a shortage of skilled labour, weak governance, limited access to finance, and infrastructure constraints.

Monetary policy and inflation: The Central Bank of Kenya (CBK) was able to contain headline inflation within the target band of 2.5% to 7.5% until recently, averaging 5.3% between 2018 and 2021. The year 2022 was relatively difficult for the monetary authorities. Monthly headline inflation fluctuated between 5.3% in January 2022 and 9.6% in October 2022, settling at 7.6% in December 2022, slightly higher than the upper target band of 7.5%, but lower than the regional and continental averages of 14.2% and 28.9%, respectively. The sharp rise in inflation was attributable to the impact of Russia's invasion of Ukraine and the weakening Kenyan shilling against major currencies caused by exodus of portfolio investments due to shifts in monetary policies in advanced economies. The exchange rate depreciated by 9% from 113 per US dollar in December 2021

Kenya's economy remains resilient despite successive shocks. Growth is projected to increase by 5.6% in 2023 against 5.5% in 2022 and consolidate at 6% in 2024.

[1] Agreed wording at the Africa Development Bank Annual Meetings 2022 in Ghana – Algeria, China, Egypt and South Africa entered a reservation and proposed "Russia-Ukraine Conflict".

to 123 per US dollar in December 2022. Food inflation accounted for 64% of the change in headline inflation; fuel inflation contributed 22% and core inflation contributed 14%.

Kenya was among the frontier economies impacted by tight global financial market conditions. This was reflected in an increase in foreign investors' outflow, a decline in foreign exchange reserves, and the depreciation of the exchange rate. To counter those trends, the CBK hiked the policy rate three times from 7% in December 2021 to 8.25% in December 2022. It aimed at suppressing demand to contain domestic inflation and narrow the interest rate differentials to reverse portfolio investment outflows. Its effectiveness in narrowing the interest rate differential will depend on the impact on the high-risk premiums that global risk aversion sentiments caused - a difficult call for a small economy such as Kenya. Kenya could consider increasing its external position by more government borrowing for budget support to narrow the interest rate differential.

Table 1: Macroeconomic Indicators

	2018	2019	2020	2021	2022(e)	2023(p)	2024(p)
Real GDP growth	5.6	5.2	-0.3	7.5	5.5	5.6	6.0
Real GDP growth per capita	3.6	3.2	-2.3	5.5	3.5	3.7	4.0
Inflation	4.7	5.2	5.4	6.1	7.6	8.6	5.9
Overall fiscal balance, including grants (% GDP)	-7.7	-7.3	-7.7	-8.2	-6.3	-6.1	-5.4
Current account (% GDP)	-5.4	-5.2	-4.8	-5.5	-6.0	-5.2	-5.0

Source: AfDB Statistics Department; data from domestic authorities; estimates (e) and predictions (p) based on author's calculations; April 2023

The CBK also implemented other policy instruments to fight inflationary pressures e.g., Open Market Operation (OMO) to mop up excess liquidity in the system, fiscal-monetary policy complementarity (e.g., subsidies on fuel, food, and fertilizer) to allow partial passthrough of global inflation to domestic inflation, and selling foreign exchange to minimize exchange rate fluctuations. The latter contributed to the decline in the reserve buffer to 4.2 months of import cover (at end December 2022) against the Eastern Africa Community (EAC) minimum monetary union convergence criteria of 4.5. The policy options that could be taken to rein in inflationary pressures include: a prudent policy rate hike in cases where inflation is demand driven; seeking external financial support to narrow the interest rate differentials and stabilize the exchange rate while letting the exchange rate depreciate to allow adjustment to shocks; addressing fiscal imbalances (though enhanced fiscal consolidation) identified as one of the major drivers of exchange rate pressures; deepening reforms to improve monetary policy effectiveness (e.g., monetary policy transmission) and enhancing monetary policy credibility to anchor inflation expectations.

Fiscal balance: The fiscal deficit narrowed to 6.3% of GDP in 2022 from 8.2% in 2021. This is higher than the regional and continental averages of 4.3% and 4% of the

GDP, respectively. Government revenues, expenditures and fiscal deficit averaged 17%, 25% and 8% between 2018 and 2022, respectively. Trends in the fiscal metrics have improved since 2021. This could be attributed to adherence to quantitative targets of the fiscal consolidation path, anchored on a positive primary balance. The country sustained fiscal pressure from COVID-19 in 2020 thanks to the fiscal space created by international cooperation. Similarly, in 2021 and 2022, Kenya allowed partial passthrough of global inflation instigated by pent-up demand in the global market and the Ukraine crisis. In 2021 and 2022, the additional costs of the shocks to the fiscus were financed by increases in revenue collection, the removal of tax cuts introduced in 2020, and revenue enhancement measures.

Recently, fiscal operations have been impacted by exposure to the international financial market. This shock was not factored into the fiscal consolidation program in place since 2021, and it exposed Kenya to external financing pressures. The GoK has introduced additional fiscal measures since then to meet fiscal targets. The shocks have increased government's gross financing needs. This calls for minimizing fiscal/debt vulnerability by, among others, growth-enhancing structural reforms (e.g., rationalizing/improving the efficiency of government expenditure and the rate of tax compliance, currently estimated at 70%). If the external shocks persist and their adjustment costs significantly increase, a last resort solution to ensure fiscal and debt sustainability could include combining the ongoing growth-friendly fiscal consolidation program with a domestic and external debt restructuring.

Public debt: Public debt as a percent of GDP showed sign of stabilization in 2022 (67.5%) after significant surges from 56% of GDP in 2018 to 69% in 2021. This could be attributed to the fiscal consolidation program which is anchored on a positive primary balance. Both external and domestic debt increased during the period; however, the rate of increase was greater in the latter due to the country's constrained access to the international financial market. Debt accumulation to date is driven both by fiscal risk (primary fiscal deficit) and debt risks (increase in interest rate and exchange rate depreciation). Kenya has introduced debt and fiscal rules to stabilize debt which have yielded some positive results e.g., cost escalation risks and primary fiscal deficit have decreased. Nevertheless, these efforts are constrained by tighter liquidity in the international financial market causing an increase in the adjustment cost to rein in the primary balance. This entails creating the required fiscal spaces to finance the adjustment costs by deepening the fiscal consolidation program (on the fiscal policy front) and debt restructuring (on the debt policy front). Since 2018, credit rating agencies have downgraded Kenya's sovereign debts on solvency and liquidity grounds. The IMF has estimated a moderate to high risk of debt distress while Moody's and Fitch downgraded the country's risk from stable to negative.

External sector: As in previous years, external demand continued to be a drag on GDP growth. The current account deficit widened to 6% of GDP from 5.5% in 2021. All components of the balance of payments (BoP) registered deficits in 2022 except the secondary income and capital accounts. The current account deficit was driven by the trade deficit. Exports grew due to increases in receipts from tea and manufactured goods but were offset by a growth in imports due to an increase in fuel and intermediate goods. The deficit in the trade balance could be explained by structural factors e.g., declining terms of trade as exports were dominated by less valued primary commodities while imports were dominated by high value-added manufactured goods. Kenya's real effective exchange rate (REER) slightly depreciated compared with the period prior to 2019, mainly driven by the depreciation of the nominal effective exchange rate (NEER) against major trade partner currencies. Improving the trade balance requires diversifying the export base away from primary commodities to higher value-added goods as well as diversifying export destinations.

The Africa Continental Free Trade Area (AfCTA) is expected to provide Kenya with an opportunity to diversify its export base and export destinations. Kenya was among the frontier markets affected by capital reversal caused by global financial tightening. As a result, the role that the financial account played in financing the current account deficit diminished in 2021 and 2022. Part of the current account deficit was financed by the capital account and the remainder by drawing down foreign exchange reserves. The foreign exchange reserves decreased to $7.42 billion (4.2 months of import cover) at the end of December 2022 from $9.5 billion (5.8 months of import cover) the previous year. The Kenyan shilling depreciated by 9% from 113 per US dollar in December 2021 to 123 per $in December 2022.

Financial sector: The financial sector is composed of the banking and insurance sectors, capital markets, pension funds and savings and cooperative societies. The sector is dominated by the banking industry. Credit provided to the private sector increased by 12.5% (4.9% after inflation) in 2022 against 8.6% (2.5% real growth) in 2021. In 2022, the banking industry met all statutory requirements except for the non-performing loans (NPLs) ratio which reached 14%, implying a high level of credit risk. Credit risk concentration was high in manufacturing, energy, water, and agriculture. The banking sector is well capitalized with a capital-adequacy ratio (CAR) of 18.9% against the required 14.5%; and has a strong liquidity ratio of 55% against the required 20%. Access to financial services increased to 89% of the population, mainly due to digital technology. The banking sector's provisions for loans increased by 47.5% as required by the International Finance Reporting Standards (IFRS). This was to mitigate the effects of poor asset quality. The capital market was adversely impacted by global financial tightening. The NSE 20 share index declined to 1,676 points (by 11.9%) in December 2022 from 1,903 points in December 2021 while stock market capitalization fell to Ksh 1,986 billion (a decline of 24.4%) against Ksh 2,593 billion the previous year. The country's financial sector is highly interconnected and diversified with a growing number of cross-border operations. Kenya has a vibrant microfinance sector made up of deposit-taking microfinance institutions, in addition to standard MFIs, non-governmental organizations, church-based organizations, rotating savings and credit associations, accumulative savings and credit associations and investment groups. The MFIs cater for the financial needs of micro-enterprises. The Micro, Small, and Medium Enterprises' (SMSMEs) financing remains constrained by the high cost of borrowing and limited diversification of financial products, collateral requirements, and lack of long-term finance. Efforts are under way to address these challenges on the demand side, including by de-risking MSMEs through government-sponsored guarantee schemes and enhancing banking liquidity as well as on the supply side, by diversifying financial products. The CBK has also issued guidance for banks to incorporate climate-change considerations in their lending, in order to promote sustainable financing.

Poverty and social indicators: Kenya's performance in poverty, unemployment, and income inequality has improved, albeit slowly. According to the World Poverty Clock, the number of people living in extreme poverty declined marginally to 18% in 2022 from 19% in 2019; income inequality measured in terms of the gini-coefficient decreased to 40.8% from 45%; and the rate of unemployment increased to 6.6% from 6.2% in 2019. The unemployment rate is highest among those aged 20-24 at 16%. The modest improvement in poverty and unemployment can be attributed to the increase in per capita income, government social safety net programs, and recently, the normalization of economic activities. The Human Development Index (HDI) dropped slightly to 0.58 in 2021 from 0.60 in 2019, probably due to the unprecedented effects of COVID-19 pandemic. According to the 2021 Africa Sustainable Development Goal (SDG) Index, Kenya is ranked 118 out of 163 globally and 7th in sub-Saharan Africa with a score of

61 out of 100. Efforts are under way to link the supply and demand sides of the labor market to address unemployment and skills shortages and gaps by improving education curricula; improving access, quality, and relevance of technical, vocational, education and training (TVET) institutions; developing frameworks to strengthen partnership between academia, industry and entrepreneurship development. In general, increased structural transformation, macroeconomic stability and pro-poor distributive policies continue to be critical to build an economy that is resilient to shocks and to address perennial challenges of poverty, unemployment, and income inequality.

Box 1.1: Impact of Russia's Invasion of Ukraine on Kenya

Kenya is a net importer of grain, fuel, and fertilizer. It was among the countries most impacted by Russia's invasion of Ukraine. In a normal year, fuel import alone accounts for not less than 18% of the import bills. The Russian invasion of Ukraine has had multifaceted impact on the Kenyan economy. On the supply side, increases in energy, transport, and fertilizer prices contributed to the surge in the producer price index (PPI). These shocks caused increases in food and energy inflation, which together accounted for the lion's share of the weight in the Consumer Price Index (CPI). The cost-push factors slowed down activities across all sectors of the economy while the demand-pull factors, through decreasing per capita income, contributed to a decline in household consumption. Output growth decelerated to 5.5% from 7.5% in 2021. On the fiscal policy front, fuel, energy, food, and fertilizer subsidies were introduced to minimize the socioeconomic impact of the shocks. However, they had to be scrapped in the same year on the grounds that they would derail the fiscal targets of the ongoing fiscal consolidation program. On the monetary policy front, the CBK shifted its monetary policy stance by raising the policy rate by 125 basis points to 8.25%. The CBK also applied open market operations to mop up excess liquidity in the system and sold foreign exchange to minimize exchange rate fluctuations which also limited the passthrough effect of exchange rate depreciation to domestic inflation.

2.2 Outlook and risks

GDP growth: The GDP growth outlook is positive. The GDP is projected to increase by 5.6% in 2023 and 6% in 2024. It is premised on the assumption that commodity prices and global inflation would recede in the medium term. Growth is projected to be driven, on the demand side, by domestic absorption (i.e., household consumption and investment) and improved external demand, and on the supply side, by services. In the short run, should global financial tightening persist, growth recovery will require additional financing. This could mean higher adjustment costs to the fiscus as the country is committed to meeting certain fiscal targets. Therefore, international financial assistance would be required to support growth in the immediate to short term. Otherwise, use of own resources to finance the adjustment cost could imply aggressive expenditure cuts and introduction of growth-unfriendly revenue enhancement measures. Building resilience to shocks in the medium to long-term will require countercyclical policies (to build financial buffers) and structural change.

Inflation: Headline inflation is projected to increase to 8.6% in 2023 and fall to 5.9% in 2024. On the supply side, it is assumed that pressures on the exchange rate will recede. This would follow the slowdown in monetary policy tightening in advanced economies. Kenya is expected to capitalize on this through a prudent policy rate hike. The slowdown in global monetary policy tightening is expected to suppress global risk averse sentiments, narrow the interest rate differentials, increase

foreign exchange inflow, and reduce the impact of imported inflation on domestic inflation. On the demand side, demand for foreign exchange is projected to be suppressed by pick up in global demand (in 2024), decline in oil prices, and improved public saving owing to the ongoing fiscal consolidation program. The fiscal consolidation program is projected to minimize the impact of fiscal risk on the balance of payment risks (i.e., exchange rate pressure).

Fiscal account balance: The fiscal deficit is projected to remain on the fiscal consolidation path and to narrow to 6.1% and 5.4% of GDP in 2023 and 2024, respectively. This is expected to happen on the back of a projected decline in the primary deficit (due to the ongoing fiscal consolidation), lower interest payments, and exchange rate stabilization (due to an expected slowdown in monetary policy tightening). Public debt is projected to stabilize in the medium term owing to the continued implementation of the fiscal consolidation program anchored on a positive primary balance. According to the recent Debt Sustainability Analysis (DSA) done for Kenya by the IMF, public debt in present value terms is expected to decline to 60% and 57.8% of GDP in 2023 and 2024, respectively, and is projected to fall below the sustainable threshold of 55% by 2026. Risks to the outlook could emanate from persistent global financial tightening. This could challenge fiscal sustainability due to the increase in the adjustment cost required to stabilize debt. This danger could be mitigated by further deepening the fiscal consolidation program and as a last resort combining it with a debt restructuring.

Current account balance: The current account deficit, in percent of GDP, is expected to narrow to 5.2% and 5.0% in 2023 and 2024, respectively. This is attributable to a projected decline in commodity prices. The fuel import bill accounts for over 18% of the total import bill in Kenya. Furthermore, the projected decline in the interest rate differential is expected to improve financial and capital account balances and foreign external positions. Risks to the outlook could arise from a slowdown in global demand caused, among others, by prolonged monetary tightening in advanced economies. Mitigation measures to be taken, in the immediate to the short term, could include diversifying export destinations, and in the medium to the longer-term, diversifying the export base.

III PRIVATE SECTOR FINANCING FOR CLIMATE AND GREEN GROWTH IN KENYA

3.1 Introduction

Green growth and climate action are important if Kenya is to achieve its national development vision of becoming a middle-income country by 2030.

Kenya is one of the countries that is highly vulnerable to climate change globally and in Africa. Having contributed to less than 0.1% to the total global historical emissions, Kenya is disproportionately affected by extreme risks such as floods and droughts which not only threaten development gains but also risk pulling people into poverty. Kenya is also grappling with social inequalities. For example, as of 2022, 52% of Kenyans still lacked access to safe water and 77% to improved sanitation,[2] respectively, while in 2018, only 19% of Kenyans had access to any form of health insurance, making healthcare costs unaffordable.

Economic growth is a priority outcome for Kenya, which is a low middle-income country. Kenya recognises that economic growth cannot compromise other aspects of development. For example, the fourth Medium Term Plan (MTP IV) for 2024-2028, which is currently under development, also plans to build on these pillars to increase annual GDP from 5.0% and 4.7% in 2019 and 2020, respectively, to 7% in 2024[3]. MTP IV builds on the achievements of MTP III and proposals of the government manifesto under the Bottom-up Economic Transformation Agenda (BETA). The BETA Plan of the GoK has identified five pillars that include (i) agriculture, (ii) micro, small and medium enterprises (MSMEs) economy, (iii) housing and settlement, (iv) healthcare, and (v) digital superhighway and the creative economy. However, this growth is planned to be pursued alongside other priorities, such as the reduction of social inequalities and action to address climate change. Addressing the drivers and effects of climate change, ensuring sustainable use of environmental resources and addressing inequalities is therefore considered a conditional requirement for sustainable development and economic growth. This is the basis for green growth in Kenya. For instance, although Kenya has committed to reducing its greenhouse gas emissions by 32% by 2030 relative to the business-as-usual scenario, a comprehensive approach to addressing climate change also involves investments in climate change adaptation, addressing losses and damages from climate change, investments in natural resource management and in reducing social inequalities.

Kenya is one of the countries globally that have low emissions with a small volume of stranded assets in high-emitting infrastructure, meaning that its transition to low emissions can be quick

[2] https://water.org/our-impact/where-we-work/kenya/#:~:text=Kenya%27s%20water%20and%20sanitation%20crisis,lack%20access%20to%20improved%20sanitation.
[3] https://www.planning.go.ke/wp-content/uploads/2022/02/Final-MTP-2023-2027-Concept-Note-1-Final.pdf

and less costly. Kenya is also endowed with significant natural capital for renewable energy generation through hydropower, wind, solar, and geothermal, as well as forests and land that can support transitions to green growth.

Kenya has demonstrated strong political commitment to green growth and made considerable progress in outlining its green growth and climate action priorities.

Kenya has made considerable progress in outlining its green growth and climate action visions and strategies, which have collectively provided guidance on priority sectors and investments for green growth. This is through policies such as the National Constitution 2010, the Vision 2030, the third MTP 2018-2022, the Green Economy Strategy and Implementation Plan, the National Climate Change Action Plan and the NDC.[4]Kenya's Vision 2030 has pillars that recognise the importance of climate action, sustainable use of environmental resources and processes that reduce social and economic inequalities to economic growth and sustainable development.[5] The Third Medium Term Plan (MTP III), aimed at providing guidance for the achievement of Kenya's Vision 2030, also highlights implementation priorities that contribute towards Kenya's Vision 2030, including in infrastructure, science, technology and innovation, labour and employment etc.[6] The Kenya Green Economy Strategy and Implementation Plan 2016-2030 (GESIP), developed in 2016, aims to steer the country towards achieving the goal outlined in the Vision 2030 through inclusive green growth pathways.[7] A summary of key policies for green growth in Kenya is summarised in table 2.1.

Kenya's green growth index has been stable over the past 11 years and is the one of the highest performing countries on green growth.

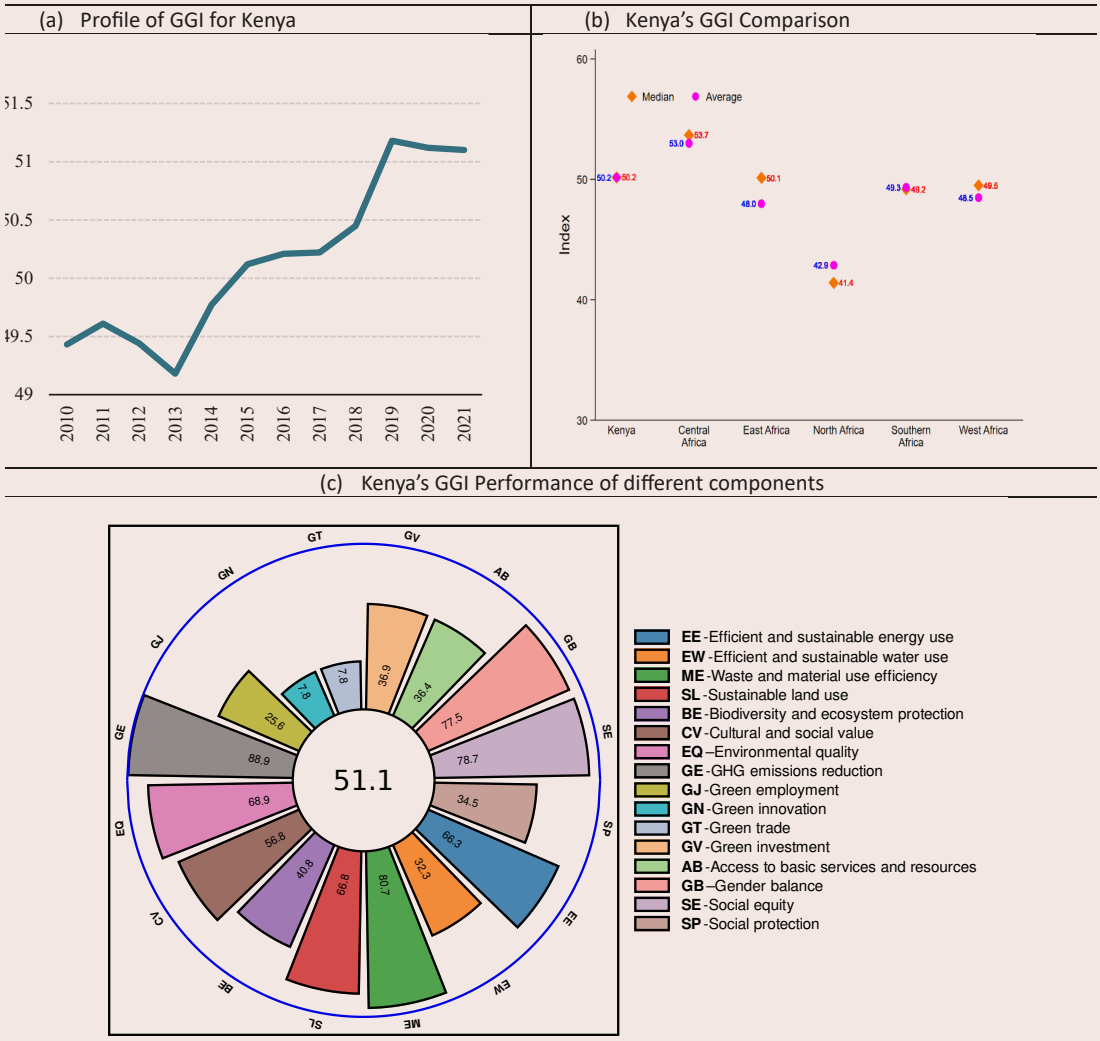
Kenya has had a stable mean GGI, increasing from 47.6 in 2010 to 48.6 in 2021 (figure 2.1a). Kenya's GGI is mainly driven by high performance on greenhouse gas emission reduction (88.9), waste and material use efficiency (80.7), social equity (78.7), gender balance (77.5) and environmental quality (68.9) (see figure 2.1c). Kenya with a GGI average index of 50.2 performs above East Africa (48.0), North Africa (42.8), Southern Africa (48.3) and West Africa (48.5) regions. Central Africa, with an average of 53.7 performs above Kenya (see figure 2.1b). To support green growth in Kenya, the MTP III outlines key initiatives to be achieved through the promotion of climate resilience and green growth with a focus on the exploitation of renewable energy, carbon credits and clean production systems.

For Kenya to achieve its green growth and climate action ambitions, private sector investments will need to be mobilised at scale. However, meeting green growth and climate action needs will require significant investments. For example, assessments show that simply adapting to the effects of floods and droughts in Kenya will require more than 18% of Kenya's GDP (figure 2.2).

Kenya has committed to addressing climate change challenges. Therefore, significant environmental and social issues such as inequalities remain, that can be addressed by promoting green growth.

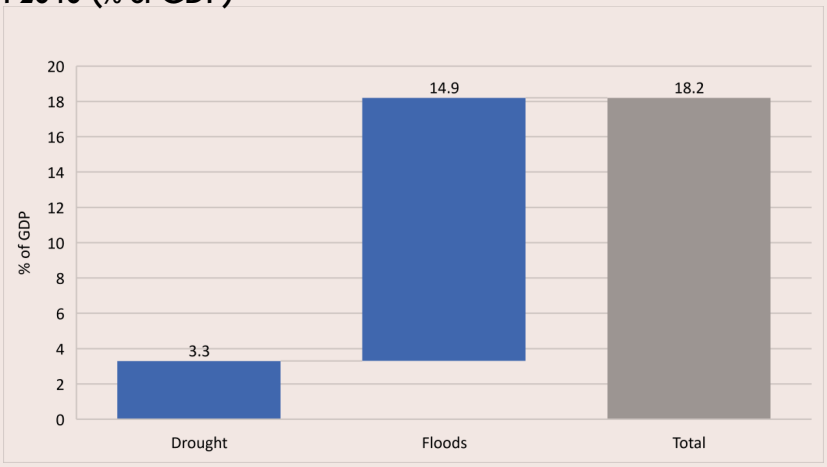
[4] See Readiness report by GGGI and AfDB
[5] Government of Kenya. Vision 2030
[6] https://vision2030.go.ke/wp-content/uploads/2019/01/THIRD-MEDIUM-TERM-PLAN-2018-2022.pdf
[7] https://wedocs.unep.org/handle/20.500.11822/33042;jsessionid=FDAB7C8A789EF729399A5F9BFD2D5BB0

Figure 2.1: Green Growth Index for Kenya and Peers, 2010 – 2021



Source: Staff computations based on Global Green Growth Institute database

Figure 2.2: Upfront private investment opportunities to adapt to droughts and floods. 2021-2040 (% of GDP)



Note: Figures are expressed as a percent of GDP in 2021. Source: Bari and Dessus (2022)

National frameworks recognise that the private sector can play a role in catalysing other sources of private sector finance, as well as in directing finance towards sectors and areas that are currently underfunded. All Kenya's policies and strategies on green growth and climate action recognise the importance of the private sector in mobilising the resources that are needed to meet the collective goals. For instance, MTP III notes that implementing the different projects will require affordable capital from both the public and private sector, while the updated NDC notes that mobilisation of finance will need to be from the international public and private sector to meet the annual financing needs.

3.2 Private sector finance flows, gaps and needs for green growth and climate action in Kenya

3.2.1 Current flows of finance

The largest proportion of climate finance flows in Kenya are from public finance, with private finance accounting for only 41% of total climate finance flows.

In 2017/2018, KES 243.3 billion ($($($2.4 billion) of public and private capital was invested in climate-related activities. This is approximately half of the financing that Kenya needs annually to meet the targets set in its NDC. Overall, public investment (from domestic and international providers) totaled KES 144.3 billion (59.4%) while investment from the private sector totalled KES 98.9 billion (40.7%). Fifth five (55%) of the public finance came from international sources and 45% from domestic public finance sources.

Although international private sector finance flows are higher than domestic private finance flows in Kenya, this volume is still miniscule compared to public sector finance flows.

For the period 2017/2018, the private sector invested $979 million, with about 34.4% of this sourced from the domestic private sector and 65.6% sourced from the international private sector. Investment from the private sector totalled KES 98.9 billion ($979 million), 34.4% originating domestically from Kenyan companies through their own resources and 65.6% from overseas private companies investing into projects located in the country.
Most private sector finance flows in Kenya are directed towards the energy sector, with limited investments towards other sectors that are important for effective climate action and green growth.

Slightly more than 79% of climate finance in Kenya in the period 2017/2018 was directed to the implementation of climate mitigation measures such as those involving investments in renewable energy and energy efficiency.[8] These investments were driven by foreign private sector actors invested who directed 99.7% or Ksh. 64.9 billion ($643 million) of their investments for the 2017/2018 period towards renewable energy projects. [9] Further, according to CPI, only 11.7% of climate finance in Kenya was directed to adaptation. Most of this financing is driven by philanthropic foundations who are considered private sector actors. [10] However, the low proportion of finance allocated to adaptation means that very little finance goes towards other sectors that are important for green growth and climate action, such as the health sector, education, and risk management. The largest gap in the financing of climate action is in sectors that contribute towards adaptation. CPI assessments also find that the largest financing gap in meeting Kenya's NDC is in the water and blue economy sector.

3.2.2 Private sector finance needs for the future

Kenya will need more than $6.2 billion annually up to 2030 to meet its climate change and $700 million annually by 2030 to meet its green growth objectives.

[8] CPI, landscape of finance in kenya report.
[9] CPI, landscape of finance in kenya report.
[10] CPI, landscape of finance in kenya report.

According to Kenya's updated NDC, meeting adaptation and mitigation costs outlined in this policy will require $62 billion between 2020 and 2030, which translates to 6.2 billion annually between this period. 71% of this would be allocated towards adaptation and resilience goals, with the government committing to financing 21% of this through domestic sources. $40 billion would need to come from international public and private sources. The Kenya GESIP also estimates that approximately $700 million annually (based on 2016 exchange rates) will be needed to meet Kenya's green growth ambitions by 2030.[12]

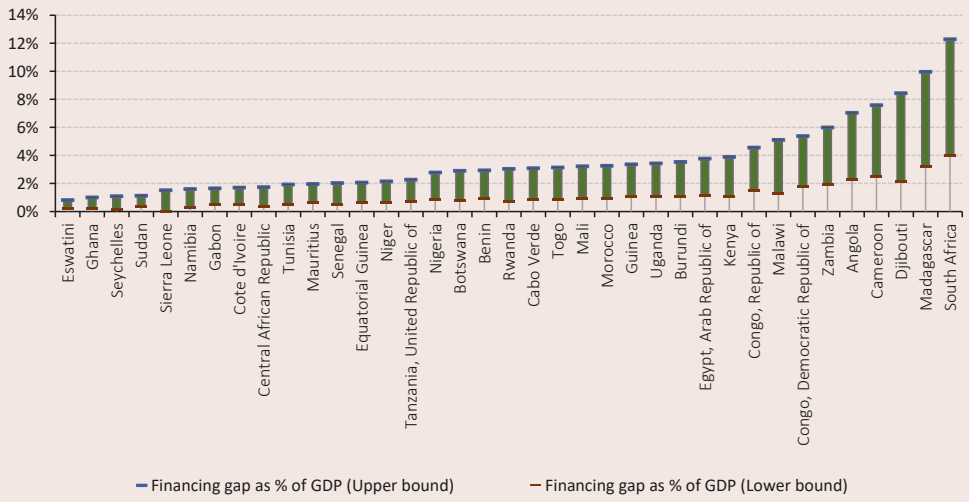
Given recent trends in global private climate finance flows to Kenya, the private sector is likely to contribute 25%-75% of the climate financing needs of the country. For a 25% contribution to climate financing needs, which represents a conservative scenario, the private sector would need to increase its finance contribution by $14 billion annually. For a 50% contribution to climate finance by the private sector, which is a moderate scenario, private sector financing would need to grow by $22 billion annually, a 75% contribution to the climate financing gap, which is an ambitious scenario, would see private sector finance grow by $26 billion annually (see Figure 2.3).

3.2.3 Emerging innovative private sector financing mechanisms for green growth and climate action

New and innovative instruments for mobilising private sector finance towards green growth and climate action in Kenya are emerging, but their use remains constrained.[11]

The private sector has the potential to meet 25% to 75% of the climate financing needs. Private sector contribution to climate finance is estimated at only $979 million per annum.

Figure 2.3: Estimated annual private climate finance gap for African countries, lower and upper bounds



Note: Figures are expressed as a percent of GDP in 2021. Source: Bari and Dessus (2022)

Despite the shortfall in the mobilisation of private sector finance for green growth and climate action, Kenya has observed an emergence of innovative mechanisms that have contributed to the available private sector finance. Some of the innovative financing mechanisms used to generate finance for green growth and climate action in Kenya are summarised in table 2.1 (see AEO 2023[12] for definitions of these instruments). Table 2.1 provides a summary of the emerging innovative private sector financing instruments for green growth and climate action in Kenya. Other sectoral instruments that could be scaled up further include index-based insurance for agriculture, disaster risk insurance for infrastructure, and net metering for energy.

3.3 Opportunities and barriers for mobilising private sector finance for green growth and climate action

3.3.1 Opportunities for private sector investments

Kenya mobilises more private sector finance than its peers.

[11] https://wedocs.unep.org/handle/20.500.11822/33042;jsessionid=FDAB7C8A789EF729399A5F9BFD2D5BB0
[12] Africa Economic Outlook (2023): https://www.afdb.org/en/documents/african-economic-outlook-2023

Table 2.1: Innovative instruments used to mobilise private sector finance in Kenya.

Type of instruments	Green and sustainable finance e.g., sustainable bonds, sustainability-linked loans/bonds, social bonds	Blended financing instruments e.g. guarantees, first loss	Private equity and venture capital	Carbon markets
Current performance	Still very limited use, but there are plans under way to expand the use of different sustainable finance mechanisms for mobilising private sector finance.	As of 2022, Kenya was one of the leading destinations of blended financing from international actors, with 77 deals amounting to $13 billion invested.[14]	Kenya was one of the five highest countries receiving funding in 2022.[15] More than 75% of investments for 2022 went to Kenya. Most of this finance is invested in start-ups in the financial services sector.	Kenya is the eighth largest issuer of nature-based carbon credits in Africa in 2022 globally.[16] Value of the carbon market in Kenya likely to reach $258-800 million in 2030.[17]
Contextual challenges to scaling up in Kenya	Market conditions, policy Insufficient operationalisation of regulation and governance Smaller ticket size project opportunities Limited technical capacity	Absence of conducive supporting frameworks for the use of blended finance instruments across some sectors such as AFOLU The limited technical capacity for blending of finance, particularly at the sub-national level in Kenya	Shallow domestic financial markets that limit sources of investments to only international investors.	Integrity of credits from a few Kenyan projects has particularly come under scrutiny, which is likely to slow down the development of new projects. Most demand for carbon credits is from international sources, with very limited consumption locally that could further expand the market.
Key factors enabling successful use of instrument	High volume of national wealth held by domestic private sector which could be used to mobilise sustainable finance in domestic currency -Presence of legislation and policy reforms that support further expansion of sustainable finance.	A government commitment to financing climate action using public sector domestic finance Presence of strong public finance management systems e.g., that track public finance allocation and spending	Presence of regulatory frameworks that encourage innovation Presence of a deep consumer market for products	Increased carbon pricing globally, which provides a positive market signal for current investments in carbon reduction The high potential for emission reductions and emission removals in Kenya Strong experience in Africa in the development of carbon projects, mainly developed from the execution of Kyoto Protocol CDM projects. The establishment of the African Carbon Markets Initiatives means that Kenya can build on its existing experiences to further scale up the use of these schemes to mobilise additional climate finance. First round of projects implemented in Kenya

Source: AfDB staff computations.

[14] https://www.convergence.finance/news-and-events/news/7EWXr00u5WgDBXTXM51yO0/view
[15] https://www.weforum.org/agenda/2022/08/africa-start-up-nigeria-egypt-kenya-south-africa/
[16] https://climatefocus.com/wp-content/uploads/2023/01/VCM-Dashboard-2022-Overview-1.pdf
[17] https://sustainableinclusivebusiness.org/wp-content/uploads/2023/03/Change-the-story-Developing-a-local-carbon-market-in-Kenya.pdf

Analyses carried out for the AEO 2023 found that public sector climate finance investments (proxied by public finance investment per capita) were a significant determinant of private sector investment.[21] A closer look at the data reveals that Kenya mobilises significantly more private sector finance than other countries that have the same level of public sector finance allocation (figure 2.4). This means that Kenya can use public finance much more effectively than other African countries with the same level of public finance investments.

Figure 2.4: Public climate finance per capita in Africa



Source: Staff computation using submitted NDCs and CPI's Africa landscape of climate finance data

Opportunities for private sector investments in green growth and climate action in Kenya cut across the economy.

Kenya holds various sectoral opportunities for investments in green growth in different sectors, including infrastructure, agriculture, health, education, transport, water, and other resource management etc. These private sector investment opportunities are driven by several factors. First is the increasing population size. Analyses suggest that Kenya's population is expected to rise to 85 million people by 2080 from approximately 50 million in 2019.[17] Most of this population is projected to be composed of young and middle-aged, and urban residents.[18] This opens investment opportunities for the private sector to invest in the provision of affordable and green urban housing and transport, food, and waste management services. These goods and services will also need to be provided in the rural areas to cover the existing gap. Already, digital technology has contributed to the strengthening of the Kenyan transport sector, and further investments in this sector will be essential to meet the projected increased demand.[19]

Kenya's intended transition to a middle-income economy by 2030 also means that there will be increased demand for products such as those that provide energy for cooking and other productive uses.

For example, research suggests that Kenya's per capital LPG consumption will increase from 4.5kg in 2021 to 8-9kg in 2050.[21] This is an opportunity for private sector investments to provide alternative clean fuels such as those derived from renewable energy to enable Kenya to capitalise on this increasing demand while also making progress on its green growth objectives.

[17] https://doi.org/10.1016/S0140-6736(20)30677-2
[18] https://doi.org/10.1016/S0140-6736(20)30677-2
[19] https://www.worldbank.org/en/news/feature/2021/05/12/how-digital-integration-has-transformed-kenya-s-transport-sector
[20] AEO (2023).
[21] https://www.spglobal.com/commodityinsights/en/ci/research-analysis/kenya-lpg-market-outlook.html

3.3.2 Barriers to private sector investments

a. High costs of capital are leading to accumulation of unsustainable debt

Kenya is suffering under the weight of unaffordable capital offered by international lenders including MDBs and DFIs as well as other private sector lenders.

Although it is considered a strong economy due to its middle-income status, the COVID-19 pandemic and effects of the Russian invasion of Ukraine have led Kenya to be one of the African countries considered to be at high risk of debt distress. For instance, in 2021, external debt accounted for nearly 35.4% of GDP,[22] resulting in Kenya being classed as a country at high risk of debt distress in 2022.[23]

External debt unsustainability is driven by a high cost of lending, characterised by high interest rates and exchange rate volatility. The high costs of borrowing are driven by lenders' actual and perceived risks to their investments, which determine interest rates. These rates are not applied uniformly and are instead calculated on a case-by-case basis. For example, although Kenya took two international Eurobond loans in 2014, one repayable after 10 years and another after 30 years, the second loan had a higher interest rate than the first one because lenders associated this financing with higher risk.[24] This perceived higher risk that comes with lending to African countries is termed the 'African Premium', where African countries pay, on average, an estimated 2.9% higher interest on debt than the rest of the world, a factor that is likely to result in debt unsustainability.[25] Fluctuations in foreign currency that have been observed over the past five years have also led to ballooning interest rates for external debt.

Research shows that unaffordable rates of repayments on capital increases, thus reducing the volume of public finance available for countries to use for blending finance for green growth and climate action or allocating towards green growth and climate action priorities in alignment with NDC commitments.[26] For Kenya, which is amongst the continent's top borrowers, the high cost of lending therefore limits the country's capacity to develop blending instruments for financing green growth and climate action, and limits the volume of investments that can be directed towards developing the basic infrastructure and conducive investment frameworks for private sector financing of green growth.

b. Low levels of skills within the country to meet green growth and climate action needs

Kenya lacks adequate green skills across sectors, with existing skills are mostly concentrated in the renewable energy sector.

Transitions to green growth and the implementation of climate change adaptation and mitigation requires green skills and capacities within key sectors. A readiness assessment by Global Green Growth Initiative (GGGI) and AfDB found that Kenya lacked sufficient skills and capacities to realise its green growth and climate action plans. Existing skills and capacities are limited to a specific set of sectors, mostly those related to renewable energy as this is where most of the private sector financing is directed. The absence of adequate skills and capacities increases the risks that private sector investors and lenders attach to lending, as this means that projects may not be sufficiently implemented on time and to completion. Skills gaps also leave

[22] https://www.ndi.org/sites/default/files/Role%20of%20Parliament%20in%20Public%20Debt%20Oversight%20in%20Kenya.pdf
[23] https://www.imf.org/external/pubs/ft/dsa/dsalist.pdf
[24] https://www.wits.ac.za/news/latest-news/in-their-own-words/2018/2018-08/kenyas-public-debt-is-rising-to-dangerous-levels.html
https://www.ft.com/content/4397a32a-f572-11e3-be21-00144feabdc0
[25] https://www.brookings.edu/wp-content/uploads/2021/10/21.10.07_Perception-premiums.pdf
[26] https://www.brookings.edu/wp-content/uploads/2021/10/21.10.07_Perception-premiums.pdf

countries dependent on external providers, which fail to contribute to a sustained flow of financing once these external sources of skills exit. This means that Kenya needs to focus on further deepening and expanding its skills and capacities across sectors, while at the same time promoting innovation in other sectors to attract private sector investors.

c. Lack of deep integration amongst sectors and government ministries to enable meaningful coordination on green growth and climate action

Although Kenya has a strong national green growth and climate change policy framework, there are still gaps in coordination, particularly across different levels of governance, which fail to ensure an integrated approach to the mobilisation and use of private sector finance.

A readiness assessment conducted by GGGI and AfDB found that although the country has strong cross-sectoral national level institutional frameworks for climate action and green growth, for example through the National Climate Change Council which oversees the implementation of the National Climate Change Action Plan (NCCAP) and the establishment of a climate change unit in each key ministry, these mechanisms are only able to focus on horizontal coordination across key ministries with very limited vertical coordination.[27] The limited vertical engagement means that they engage very little with devolved governments to ensure that green growth and climate action priorities are identified and funded through existing private sector finance mechanisms.

Additionally, although there are institutions that have been set up for mobilising private sector finance for green growth and climate action at the national level, these have not yet been fully operationalised. A good example is the Kenya National Climate Change Fund and the County Climate Change Fund (CCCF), which mobilises and channels climate finance towards local projects.[28] However, this Fund has not been fully operational in all counties across the country, meaning that many counties are missing the opportunity to streamline the allocation of climate and green growth finance to priority sectors.

Lack of sectoral and scalar integration on green growth and climate action has led to a significantly higher allocation of private sector finance towards the energy sector while the other sectors that are important for progress on green growth and climate action being left behind.

Efforts to mobilise private sector finance for green growth have mostly focused on making resources available to projects in the energy sector. For example, although Kenya has made considerable progress in ensuring that the domestic private sector is involved in the mobilisation of private sector finance for climate change, very little has been raised to support mitigation and adaptation initiatives. For example, according to the NCCAP progress report for the period 2018-2022, over 200 staff from three domestic commercial banks received training from the Kenya Association of Manufacturers on opening and maintaining credit lines towards green financing.[29] However, this training was offered for credit lines for financing renewable energy and energy efficiency projects, without focus on other sectors that are critical for green growth.
In 2018, the KBA, working with Worldwide Fund for Nature (WWF) as a key partner, disseminated the results of a landmark research, which sought to quantify the green investment opportunity in Kenya, besides identifying the barriers to entry in the medium to long term. The report was part of a three-part series based on research titled “Assessment of Green Investment Opportunities in Kenya” and focused on three sectors of the economy, such as agriculture, transport and manufacturing[30].

[27] Readiness report by AfDB and GGGI
[28] https://adelphi.de/en/publications/the-county-climate-change-funds-in-kenya
[29] https://napglobalnetwork.org/wp-content/uploads/2022/01/napgn-en-2022-kenya-NCCAP-2018-2022-Implemantation-Status-Report.pdf
[30] https://www.greenbondskenya.co.ke/publications

3.3.3 Pathways to mobilising private sector finance for green growth and climate action in Kenya

There are several pathways that Kenya can use to unlock private sector finance for green growth and climate action. These are discussed below.

a. Deepening domestic financial markets to mobilise domestic finance for green growth.

Kenya's domestic financial markets are expanding and could be used to mobilise private sector finance for targeted green growth and climate action projects.

The mobilisation of private sector finance through domestic financial markets reduces currency risk. Kenyan domestic financial markets therefore potentially have the highest potential to contribute towards the mobilisation of private sector finance in Africa. For instance, assessments show that Kenya's capital markets are already deepening, with local pension assets valued at 13% of GDP in 2019.[31] With this, Kenya ranks second highest in Africa (after Namibia).[32] The potential of these assets can be leveraged to direct these funds towards investments in green growth sectors.

Already, the government of Kenya has led the issuance of infrastructure bonds based on local currency, which has tapped into the domestic private sector space. However, there is still need for concerted efforts to target these instruments towards other non-hard infrastructure sectors and projects that directly contribute towards green growth and climate action, such as water resource use and management, health, education, and innovation and technology. Additionally, according to the NCCAP progress report for the period 2018-2022, the Kenya Commercial Bank (KCB) became the first domestic financial institution to be accredited by the Green Climate Fund for the mobilisation of green finance in East Africa. [33] This means that Kenya already has a starting point for further mobilisation of private sector finance through domestic financial markets.

b. Stronger engagement with sustainable and green finance through implementation of the policies

Already, Kenya has developed policies for sustainable finance and what remains is their implementation.

Kenya's experience with green bonds means that it is possible to further expand the use of green bonds. Progress has however been made over the past three years in relation to further scaling up the use of green bonds and other sustainable finance instruments for the mobilisation of private sector finance for green growth and climate action. For example, according to the NCCAP assessment report for the period 2018-2022, the National Treasury developed the National Sovereign Green Bond framework which was accompanied by the approval of the green bond listing rules by the Capital Markets Authority, the development of the Green Asset Register, the development of a sovereign green bond committee and the development of the draft fiscal incentive policy framework.[34] These need to be implemented to ensure progress on the mobilisation of green and sustainable finance. Part of this national level framework development includes the strengthening of domestic innovation and green finance institutions that will be useful for the mobilisation and disbursement of private sector finance from both domestic and international private sector (see Box 2.1).

c. Ramping up the use of blended finance instruments for financing green growth

[31]https://www.convergence.finance/news-and-events/news/7EWXr00u5WgDBXTXM51yO0/view
[32]https://www.theglobaleconomy.com/rankings/pension_funds_assets/Africa/#:~:text=Pension%20fund%20assets%20as%20percent,available%20from%201990%20to%202020.
[33]https://napglobalnetwork.org/wp-content/uploads/2022/01/napgn-en-2022-kenya-NCCAP-2018-2022-Implemantation-Status-Report.pdf
[34] https://napglobalnetwork.org/wp-content/uploads/2022/01/napgn-en-2022-kenya-NCCAP-2018-

Blending of finance across sectors will need frameworks that are informed by the nature of markets in those sectors.

Kenya is one of the leading countries on the continent on public finance management. For example, through the climate finance policy and the development of country climate change policies and strategies. Kenya has established a dedicated green growth fund to channel public and private sector investments into green growth. However, the fund is yet to be developed and further mobilising private sector finance through blended finance instruments in Kenya will require the development of relevant sectoral regulatory frameworks for blending of finance and the provision of technical assistance for the structuring of blended finance projects.

The implementation of a conducive operating framework for the blending of finance in different sectors is based on a contextual understanding of the financing needs as well as the nature of the market. The level of risk that is encountered by private sector investors will determine the extent to which public finance is used to de-risk investments. However, levels of risk will vary by sector and region e.g. different regions have different levels of physical risk, while different sectors will have varying levels of willingness to pay for goods and services provided by the private sector. Kenya should have sector-specific frameworks for guiding the development of blended finance instruments, while also maintaining the flexibility to allow cross-sectoral blending of finance. Kenya has already demonstrated that sectoral context-specificity can accelerate blending of finance and scale up private sector investments. For example, the 2002 Water Act established providers as autonomous entities, ring-fenced revenues within the sector by directing income from water sales to operation, maintenance, and capital expenses, and introduced independent regulators which enabled the financing of water development projects using blended financing instruments.[35] Through this framework, in 2015, the Nature Conservancy (TNC) launched the Upper Tana-Nairobi Water Fund (UTNWF) to help secure the source of water for Nairobi. Water funds are founded on the principle that it is cheaper to prevent water problems at the source than it is to address them further downstream. Public and private donors and major water consumers downstream contribute to the Fund to support upstream water and soil conservation measures, resulting in improved water quality and supply[36]. Additionally, Kenyan institutions looking to use blended finance will also need technical assistance to enable them to effectively assess the technical and financial feasibility of investments as well as ensuring that the project is implemented to completion.

d. Skills and capacity, particularly for the informal sector to increase innovation and engagement with key private sector.

The development of green skills and capacities needs to be integrated into existing institutions, including education institutions and innovation centres.

A readiness assessment by GGGI and AfDB found that Kenya lacked sufficient skills and capacities to realise its green growth and climate action plans.[37] Existing skills and capacities are limited to a specific set of sectors, mostly those related to renewable energy as this is where most of the private sector financing is directed. This means that Kenya needs to focus on further deepening and expanding its skills and capacities across sectors, while at the same time promoting innovation in other sectors to attract private sector investors.

Addressing the skills and capacity gap that has been identified in Kenya through recent assessments also needs further integration of innovation that contributes to green growth and climate action into institutions of learning to ensure that the workforce is equipped with the skills for mobilising private sector

[35] https://documents1.worldbank.org/curated/en/635751472041647214/pdf/107977-Kenya.pdf
[36] https://www.nature.org/en-us/about-us/where-we-work/africa/stories-in-africa/nairobi-water-fund/
[37] GGGI and AfDB (2022). Green growth readiness assessment.

finance. Institutions that will be essential for this are the Innovation Agency, the National Council on Science and Technology, and the Kenya Intellectual Property Office, which must be involved in conversations on how to mainstream innovation into the education system. Other institutions such as the Kenya Climate Innovation Centre are also important in the development of skills, incubating project concepts and ideas and linking investors with project developers.

e. Implementation of fiscal incentives to attract private sector investments particularly towards other sectors that generate soft infrastructure outcomes.

Policies on appropriate fiscal incentives have already been developed at national level in Kenya and these need to be working to take advantage of the global momentum on green growth and climate action.

Fiscal incentives have already been used in Kenya to direct investments to key sectors, particularly the energy sector. For example, the Kenyan government has removed subsidies on petroleum products, thus making investment in clean energy much more attractive. Kenya has also implemented power purchase agreements for renewable energy and developed feed-in tariffs for providers of clean energy to encourage private sector participation in energy provision.[38] However, the application of these fiscal incentives is limited to the energy sector. Meeting national green growth objectives will require incentives that apply to other sectors in the economy.

Kenya already recognises the need for a cross-sectoral approach to the development and implementation of fiscal incentives for private sector investments in green growth. Consequently, it has published a draft National Green Fiscal Incentives Policy Framework (2023) whose goal is to provide policy goals and guiding principles for the provision of fiscal incentives to investments in green growth. The framework also presents Kenya's plan to use tools such as carbon tax, rebates, subsidies, concessional loans and guarantees to attract investments towards specific sectors and projects.[39] However, the benefits of these incentives can only be achieved if these frameworks reflect the needs of all stakeholders, particularly the domestic and international private sector, and are implemented across sectors.

f. The role of MDBs and DFIs

Kenya needs more affordable capital from MDBs and DFIs

Kenya is already one of the highest recipients of MDB and DFI finance in the East Africa region. For example, for the period 2012-2021, Kenya was the largest recipient of flows from the African Development Bank Group amounting to 26.3% of the total among the 13 countries in the cluster. Therefore, building on this among other MDBs and DFIs to enhance private sector finance will be crucial to support climate change and green growth in Kenya.

MDBs and DFIs can play a more significant role in private sector finance mobilisation to Kenya through increasing their risk appetite for investments, providing more affordable capital that has low interest rates and longer repayment periods. Additionally, MDBs and DFIs and funding interventions that enable capacity development of national and local public and private sector institutions to enable mobilisation of private sector finance. Lastly, MDBs and DFIs can work with the Kenyan government and other key private sector actors (particularly financial institutions) to increase the country's credit rating, which will enable it to acquire more affordable capital from other lenders.

[38]https://www.energyforgrowth.org/wp-content/uploads/2021/10/Enhancing-Public-Participation-in-Kenyas-Power-Purchase-Agreement-Process.pdf
[39] https://globaltaxnews.ey.com/news/2023-5202-kenya-publishes-draft-national-green-fiscal-incentives-policy-framework

g. Enhancing stakeholder collaboration

Collaborations across different stakeholders, particularly between governments and the domestic and international private sector to identify and address primary risks to investments in green growth and climate action.

Multistakeholder partnerships are important for strengthening collaborations for the mobilisation and use of private sector finance in enabling green growth. The Kenyan government already recognises the importance of these partnerships and continues to work with private sector associations such as the Kenya Private Sector Alliance (KEPSA) and the Kenya Association of Manufacturers. These have been instrumental creating spaces for collaborative learning and developing strategies for the private sector involvement in financing of green growth. However, these networks and collaboration should be further strengthened such that domestic private sector can engage with international private sector, MDBs and DFIs to generate a deeper understanding of financing needs, capacities and existing mechanisms.

Box 2.1: The Kenya Green Bank Initiative

Green Banks are a proven mechanism through which African countries can mobilise domestic and international private sector finance for green growth by providing tailored products for different sets of investors and users. For Kenya, several green growth initiatives have been developed to support its green growth agenda.

Kenya has already kickstarted the process of developing a national green bank. In 2023, Kenya launched an initiative to establish its first green ban—the Kenya Green Investment Bank (KeGIB)—which is a commercial bank that would mobilise and direct lending towards initiatives that contribute towards green growth and climate action. The bank is part of the national Green Fiscal Incentives Framework, which aims to generally use fiscal incentives to accelerate Kenya's progress towards low carbon climate resilient development.

Kenya has also initiated efforts to align the Nairobi Stock Exchange (NSE) through capital markets authority policy with infrastructure projects that support green growth. Further efforts have resulted in the launch of the Acorn bond, the first green bond in Kenya.

IV NATURAL CAPITAL FOR CLIMATE FINANCE AND GREEN GROWTH

4.1 Introduction

This section explores the scope for harnessing natural capital to finance adaptation and mitigation to climate change and to promote green growth in Kenya, within the broader context of East Africa. The section begins with a review of the evolution of natural capital and the main reasons for the trends observed. It goes on to consider ways in which underperformance in natural capital can be improved. These cover both non-renewable resources (fossil fuels and minerals), as well as renewable ones, such as forests, cropland, pastureland, grasslands, and marine areas.

The channels for increasing the returns from natural capital without damaging the base that provides these returns include domestically driven actions as well as internationally driven ones. On the former, the importance of good governance in the management of the returns from natural capital and in bringing together physical and human capital to add value to exports offer good opportunities. On the latter, there is a special role for making greater use of international agreements on climate change and biological diversity to finance higher returns from the substantial endowments of natural assets in the region that can serve the global goals in these areas.

4.2 The Evolution of Natural Capital

Natural capital is tracked in three groups: (a) renewable capital, consisting of forest timber, forest non-timber, mangroves, fisheries, protected areas, cropland, and pastureland; (b) non-renewable assets, separated into oil, natural gas, coal, and minerals; and (c) non-measured forms of natural wealth, such as renewable energy potential from solar, wind and hydro-resources, landscapes, and marine assets. The data for Table 1 is from the World Bank, covering the period 1995-2018.[40] The natural capital endowment in East Africa is presented in Table A1.

The renewable assets have increased by 9.5% in total value over the period 1995-2018 which is higher than for East Africa and the whole of Africa at 3% and 6%, respectively (Table A1). Of the renewable assets, mangrove (65.5%) and pastureland and protected areas (45.9%) had the highest increase while cropland (17.7%) has the highest decrease. The per capita renewable energy reduced by 41% and the highest reduction was reported in cropland at 56% (see Table 3.1). Kenya is less endowed with non-renewable capital despite an increase of 14% between 1995 and 2018. The oil discovery led to revenue amounting to $17 million in 2018 as Kenya produced and shipped 250,000 barrels of oil in 2019. The largest reduction of the non-renewable natural resource was metals and mineral extractions reducing to 35%. The investigations to look for reasons for the decline in renewable natural capital have focused on forests, cropland and pastureland. There are three trends to consider: a change in the areas of land that are under each category, the unit income that these lands provide, and the sustainability of these rents (measured in terms of the lifetime of the return). This deconstruction is important because it directs the policymakers on where action is needed to increase the value of natural capital.

Kenya has the potential to leverage on its natural resources to minimize the impact of climate change and accelerate green energy transition e.g., geothermal energy, wind and solar energy

[40]World Bank 2021. The study covers 146 countries and it excludes those with no data, which are mainly small island states. In Africa, Djibouti is excluded from the list.

Table 3.1: Evolution of Natural Capital in Kenya (1995-2018)

	Total $ 2018 m.			Per Capita $ 2018		
Variable	1995	2018	% increase	1995	2018	% increase
Renewable natural resources	169761.2	185909.6	9.5%	6113.5	3617.4	-41%
Forests, timber	47856.3	41525.4	-13.2%	1723.4	808.0	-53%
Forests, non-timber	4742.7	4655.8	-1.8%	170.8	90.6	-47%
Mangroves	308.3	510.4	65.5%	11.1	9.9	-11%
Fisheries	0.0	291.1	n.a.	0.0	5.7	n.a.
Protected areas	15339.6	23864.1	55.6%	552.4	464.3	-16%
Cropland	52003.2	42824.4	-17.7%	1872.8	833.3	-56%
Pastureland	49511.1	72238.4	45.9%	1783.0	1405.6	-21%
Non-renewable natural resources	19.0	39.9	110.5%	0.7	0.8	14%
Oil	0.0	17.0	n.a.	0.0	0.3	n.a.
Natural gas	0.0	0.0	n.a.	0.0	0.0	n.a.
Coal	0.0	0.0	n.a.	0.0	0.0	n.a.
Metals and minerals	19.0	22.8	20.5%	0.7	0.4	-35%

Source: World Bank (2021)

In the case of Kenya, the area of agricultural land (cropland and pastureland) went up from 272,000 km2 in 1995 to 276,000 in 2018, which is only an increase of 1.4%[41]. This increase was occasioned by investments in irrigation services and allocation of forest land to accommodate the growing population. At the same time, the value of land per hectare based on the wealth accounts just presented rose from $3,732 to $4,169, an increase of 12%. Kenya's increase in land value in 2018 was above other East Africa regional countries such as Burundi $3,194/Ha, Tanzania $1,962/Ha, and Uganda $3,092/Ha, but below Rwanda which stood at $15,557/Ha. The increase in land value for agriculture was due to improvements in the agrifood supply chain in Kenya. Also, it is important to note that Kenya, like other East African countries, has not experienced a decline in net unit rents from agriculture compared to other regions that faced significant declines in net unit rents for agricultural land[42].

The other category of capital that is undervalued is forests. As noted in the AEO 2023 report, the efficiency of sequestering carbon in terrestrial ecosystems (particularly forest) can be increased. By choosing more selective land use and land management methods to increase GHG storage without compromising the use for forests for productive purposes, the amount stored can be increased

[41] Figures for agricultural land area are from the World Bank: Agricultural land (sq. km) - Kenya | Data (worldbank.org).
[42]World Bank (2021), Op Cit. Table 3.5.

globally to around 20%[43]. The forest cover in Kenya has declined from 6.9% of the total land area in 1995 to 6.3% in 2020. This reduction is driven by deforestation for human settlement, unregulated charcoal production and overgrazing of animals in forest lands. This has also affected forest sector contribution to GDP reducing from 7.3% in 1995 to 2.4% in 2018. Further, reduction in forest cover has also affected Kenya's water towers such as Mau Forest, Mt. Kenya, Mt. Elgon, Aberdare's and the Cherangani hills. This has also resulted in a reduction of carbon storage as forest cover is crucial to carbon sequestration value.

The AEO 2023 report noted that the categories of natural capital evaluated do not cover all sources of such capital on the continent. Africa benefits particularly from sunshine, wind and hydro resources that can generate clean energy. Kenya, in particular, has geothermal resources, which can contribute to increasing local energy and the low carbon pathway. The climate, together with the landscape, fauna and flora, forms a strong basis for tourism. The contribution of natural capital to the flows of goods and services from all these sources of natural wealth, however, is not estimated, which then underestimates their contribution to the economy. In Kenya, the role of tourism is particularly important. The World Tourism Council estimated the contribution of tourism in Kenya to GDP to be 8.2%[44] which was well above the sector contribution to GDP of 7% in Africa as a whole. Revenue from the tourism sector increased from $ 0.79 billion in 1995 to $ 1.78 billion in 2018. The increase in tourism receipts shows the importance of the sector in driving economic growth from natural capital. However, during the period of the COVID-19 pandemic, tourism revenue reduced by 80% as health containment measures were implemented. Furthermore, given the countries' exceptional landscapes, fauna and flora, an increase in the share of GDP from tourism can be an objective for further exploitation. The other contributions of natural wealth, such as solar or hydro in generating electricity, have not been made either and should be done as a matter of urgency.

An important component of the natural capital of Kenya in East Africa is marine wealth, which has not been covered in the wealth accounts prepared so far. As the AEO 2023 notes, fishery capture provides protein, minerals, and micronutrients for over 400 million people on the continent and employs around 13 million people. There is concern, however, about the over-exploitation of wild stocks, which are decreasing. Key factors contributing to overfishing in Africa are overcapacity; illegal, unreported, and unregulated (IUU) fishing activities; poor resource governance; and insufficient knowledge and misperception. A composite index that measured the state of IUU fishing practices found insusceptibility and vulnerability in global coastal African countries on scores ranging from 1 to 5, where one is the best and five is the worst[45]. It found an improvement in some countries between 2019 and 2021 but a decline in others. During this period, Kenya showed a significant decline in East Africa, followed by Tanzania.

Kenya is endowed with non-renewable energy of natural resource deposits such as mining and quarrying. In 2022, Kenya had $931.4 million, behind Tanzania with a value of $4,699 million, Sudan with $3,344 million, and South Sudan with $2,866 million. In terms of GDP, this translates to 0.8% of GDP. In South Sudan it translates to 60% of GDP (see Figure A1.2 a and b). For renewable energy, Kenya has 3,611 hectares of forest land (see Figure A1.3).

4.3 Opportunities for Enhancing the Contribution of Natural Capital in Kenya

The channels for increasing the returns from natural capital without damaging the base that

[43]World Bank (2022). A Balancing Act: Efficiency, Sustainability, Prosperity. World Bank, Washington DC.
[44] Fact-checking minister about tourism's value to Kenyan economy - Africa Check; accessed 28th April 2023.
[45]www.iuufishingindex.net

provides these returns in Kenya include both domestic and international-driven actions. On the former, the importance of good governance in the management of the returns from natural capital and in bringing together physical and human capital to add value to exports offers good opportunities. On the latter, Kenya can make use of international agreements on climate change and biological diversity to finance higher returns from the substantial endowments of natural assets in Kenya that can serve the global goals in these areas.

The review has shown that natural capital has declined sharply in per capita terms for Kenya over the last quarter of a century. Measures to reverse this trend are divided into those pertaining to non-renewable natural capital and those pertaining to renewable natural capital.

4.3.1 Non-Renewable Resources

For non-renewable natural capital the AEO 2023 report notes that revenues from the extractive sector contribute significantly to the private and public finances of many African countries. At the same time, these countries need to ensure that they receive a fair share of resource rents from these resources and can effectively manage the revenues; the negotiated royalty rates for example are often too low. However, obtaining a "fair share" of the revenue from non-renewable resources does not guarantee economic development if the revenues are not well spent; there are issues of corruption and weak institutions in mineral-rich countries resulting in countries in Africa and elsewhere in the developing world experiencing low growth and high poverty rates.[46]

The non-renewable resources in Kenya present significant opportunities to advance the development agenda. Kenya has substantial non-renewable resources that are unexploited due to several factors that include inadequate technical know-how and resources for access requirements. Kenya has had a long history of oil exploration that began in the 1950s and it was not until 2012 that commercially feasible oil deposits were discovered. Currently, there are around 86 oil wells being drilled and 23 international companies are involved in exploration with a large concentration in the Rift Valley region of Kenya, notably, Turkana County. The oil reserves are estimated at 4 billion barrels with a current discovery of 750 million barrels in one sub-basin at Lokichar of Turkana County[47]. At the time of discovery of commercial oil reserves in Kenya, oil reserves were valued at $ 215 billion, and this is expected to increase with continued exploration in other areas[48]. Kenya plans to construct the Lokichar-Lamu Oil Pipeline (LLOP) which is part of the Lamu-Port South Sudan-Ethiopia Transport (LAPSSET) project.

The recommendations from the AEO 2023 report for ensuring a fair share of rents for the state and for transparency, efficiency, and good governance in managing them are clearly valid for South Sudan. For the other states, with small but nevertheless important amounts of minerals, the same strictures apply to the management of those sectors.

Aside from improving transparency and accountability in the resource rents, Kenya should consider aligning its industrial policies with current trends and opportunities in the energy transition. Despite Kenya having limited green minerals, that which is available can be aligned to energy transition. A national approach working in partnership with East African regional member states for exploration towards minerals-based industrialization will help in maximizing their contribution to sustainable growth. This way, Kenya's local content and other industrial linkages can be improved for job creation, among other benefits.

[46] Barbier 2011.
[47] National Oil Corporation of Kenya (2021). Oil and Gas Exploration History in Kenya; last accessed in June 2023: https://nationaloil.co.ke/upstream/
[48] The East African Standard Newspaper: https://www.theeastafrican.co.ke/tea/business/80pc-of-kenya-crude-oil-cannot-be-tapped-3553356

4.3.2 Renewable Resources

Renewable resources are at the heart of sustainable development in East Africa. Several ways in which they can be exploited more effectively and sustainably have already been noted.

In regard to cropland and pastureland, Kenya has not experienced as large an expansion in the areas of such land over the last quarter of a century as other countries in Africa and the developing world.[49] There may be potential for a small increase, if this can be done without deforestation, to add to the stock of land that can generate longer-term income. The main effort, however, will be to raise unit value from the land, by moving up the value chain for the agrifood system.

The forest cover in Kenya has declined by 8% which is small compared to other East Africa regional countries such as Uganda (28%), followed by Tanzania (15%), Rwanda (9%), and Kenya (8%). In East Africa, Burundi experienced an increase of forest area of 19%[50]. For Kenya to increase the forest cover, there is a need to implement measures such as the replanting of tress, and enforce policies geared to stop grazing and cutting of forest tress. The AEO 2023 report proposes several measures in this regard that support improving and sustaining forest cover. Governments should promote and enforce policies and regulations protecting forests, including protecting reserved areas and preventing illegal logging through increased enforcement and greater penalties for illegal logging. Sustainable forestry practices such as selective logging practices and reforestation should also be promoted by governments using instruments such as performance bonds for forest lessees. Indeed, Kenya has embarked upon reforestation through a presidential directive to plant 15 billion trees by 2032. Currently many of the government agencies have started to enforce this directive in their annual programs.

In terms of unit values, per hectare, in Kenya it remained steady over the last 25 years. However, across the East Africa region there were mixed results on forest cover with Rwanda having a sharp rise by 38%, Tanzania increased by 28%, Burundi's forest cover remained the same, and in Uganda it declined by 31%. Therefore, to support improvements in forest cover, policies for green growth will be crucial to raise revenue from forests and to support the increase in the efficiency of carbon capture (as discussed earlier) as well as raising the price received for carbon sequestered through accessing international agreements on carbon. The AEO 2023 report noted that an important channel for doing this is the creation of a single market for the trade of emissions credits (under Article 6 of the Paris International Agreement). For Kenya to achieve and benefit from the agreement, it must establish MRV procedures and participate in the market by establishing NDCs with clear mitigation targets. Kenya stands to gain sales of carbon credits that can support the mitigation and adaptation of climate change.

At the same time as taking this route, Kenya can also benefit through increased participation in the voluntary market, where new opportunities are arising. Among these is an ambitious new Post-2020 Global Biodiversity Framework, to scale up ecosystem restoration, reduce the extinction risk of species, and protect 30% of land, freshwater and marine areas by 2030. The AEO 2023 report notes that for Africa to benefit from such arrangements, the establishment of an Africa Biodiversity Fund may be needed to attract private capital. To service this demand, many project developers who offer a range of greenhouse gas emission offsets have emerged. Many of these are nature-based solutions (NbS) related to forestry and land use, agriculture and soil sequestration, and blue carbon. These credits

[49] In Rwanda, there was a steep decline in land under agriculture between 1991 and 2002 but land in 2018 is similar to that in 1992. In Uganda and Tanzania land under agriculture increased 18% while in Burundi and Kenya it changed very little.
[50] Data are from the World Bank: Forest area (sq. km) - Uganda | Data (worldbank.org)

would expand the voluntary market greatly, so Kenya should prepare itself to be part of the growth by developing new offsets and ensuring the integrity of certification of voluntary carbon markets.

In regard to other forms of natural capital, the roles of fisheries and landscapes (for tourism) have been noted. For fisheries and the blue economy Kenya remains unexploited, with great potential for revenue generation. Kenya has a coastline that stretches about 510 kms on the Indian Ocean and other fresh-water lakes such as Lake Victoria, Baringo and Naivasha and rivers Tana and Yala. To achieve benefits from fisheries and the blue economy, Kenya needs to do more to challenge IUU fishing. Fishing activities are undertaken in small and large scale with amounts of catches standing at above 123,000 tonnes in 2021. The fisheries sector in Kenya has great potential to contribute to the financing of climate and green growth. Some of the initiatives that can be pursued are through the blue economy, estimated at an annual income of $4.4 billion which remains unexploited. In Kenya, exploitation of the blue economy has only focused on living resources with more room for expansion while the non-living resource of the blue economy remains unexploited. The earnings from the exploited blue economy and fisheries have the potential to finance climate and green growth. This can be achieved through issuance of green and blue bonds to generate finance for climate change and green growth. While benefiting from fisheries and blue economy revenue there is a need to support the communities along the fishing coastline.

To exploit landscapes more effectively for tourism, countries are looking to develop ecotourism further. As the AEO 2023 report notes, the potential for ecotourism in Africa is significant but not fully realized. If properly utilized, it could yield considerable economic and social benefits for local communities while safeguarding natural resources. While specific data on the revenue generated by ecotourism in Africa is not readily available there is evidence that ecotourism is growing in Africa. In Kenya, the tourism sector is a key generator of GDP growth with revenues reaching $2.13 billion in 2022 with 1.5 million visitors during the same year. The significant ecotourism sites in Kenya include, among others, the Maasai Mara National Reserve, Amboseli National Park, the Wildebeest migration, and the Nairobi National Park (the only park in National city).

Other means for making natural capital more productive in Kenya could focus on capturing more value for the goods and services generated by the natural capital. While attempts to do this by enforcing local content requirements in products have not been so successful, there are opportunities for increasing value-added through strategic partnerships with state-owned enterprises and foreign investors, for fostering innovation, and creating a conducive environment for Kenya-owned firms to emerge and thrive. Apart from local content, AEO 2023 also recommends that countries explore franchising agreements with foreign firms to complement existing local content policies and requirements, especially where capacity (both technical and financial) is lacking. Recent studies[51] show the potential for franchising to be huge. However, in Kenya, franchising has not been explored, thus, there remain huge potential to benefit from.

[51] Afreximbank (2020)

V. CONCLUSION AND POLICY RECOMMENDATIONS

5.1 Conclusion

Kenyan GDP growth slowed to 5.5% in 2022 from 7.5% in 2021 caused by shocks, namely drought, Russia's invasion of Ukraine, and constrained international financial market conditions. To mitigate the socioeconomics impact of the shocks and to support growth, policy makers responded with prudent monetary, fiscal and exchange rate policies. The outlook is positive. The GDP is projected to increase by 5.9% in 2023 and by 6% in 2024, premised on the assumption that commodity prices and global inflation would recede in the medium term. Inflation is projected to fall within the target band of 7.5% and 5.5% in 2023 and 2024, respectively; fiscal deficit to narrow to 6.1% and 5.5% of GDP in 2023 and 2024, respectively. The current account deficit is projected to narrow to 5.3% and to 5.1% in 2023 and 2024, respectively. Downside risks to the outlook include a slowdown in global growth and persistent global financial market tightening. Risk mitigation measures could include creating policy spaces by deepening the fiscal consolidation program, restructuring public debt, and seeking external financial assistance.

Mobilising finance for green growth and climate action in Kenya to meet the estimated need will require the private sector to play a major role. Actions should be taken to leverage the opportunities for private sector investments in adaptation and mitigation of climate change, while reducing the barriers to private sector investments. This will involve tapping into the emerging innovative private sector financing mechanisms for green growth and climate action.

Natural capital, both renewable and non-renewable, also plays a major role in climate finance. The analysis has been based on data collected by the World Bank for major categories of assets but the coverage of forms of natural capital is not complete. Work is needed on estimating the value of renewable energy sources such as sunshine, wind and hydro, as well as that of landscapes and biodiversity. Natural capital has not grown over the last quarter century to keep pace with population and so the per capita level of such wealth has declined. If this is to be reversed in the coming years, action will have to be taken to prevent loss of forest ecosystems and marine biodiversity as well as harnessing the returns from these systems in a sustainable manner. More can also be done to exploit clean energy resources.

The role of non-renewable assets is much smaller in Kenya compared to other East Africa regional countries. The current exploration efforts for crude oil and natural gas are expected to reduce reliance on imports and improve revenue. However, several challenges are experienced that include limited resources for exploration and human capacity. Efforts for construction of a pipeline under the LAPSSET project are welcome and it is important that revenue from oil be used to benefit the local communities.

For cropland and pastureland more goods and services can be generated in value terms by investing in new technologies, as well as extending the value chains. This may require bringing in foreign partnerships in selected cases. For forests, there are several incentives that can be introduced to reduce loss or damage to the forests and to increase the efficiency with

which carbon can be captured. These should be pursued vigorously. In addition, accessing international mechanisms to market carbon credits at higher prices will increase unit rents a great deal. Fisheries countries with ocean coasts need to do more to stop IUU fishing and to sign access agreements for distant water fleets that prevent the overexploitation of wild stocks while generating fair revenues for local communities. For tourism the aim should be to increase total income, with an emphasis on ecotourism. The areas where this is being developed on the continent are mainly in East Africa. Below we provide the policy recommendation for private sector financing and natural capital.

5.2 Policy recommendation for macroeconomic performance and outlook

Kenyan GDP growth slowed to 5.5% in 2022 from 7.5% in 2021. This slowdown was caused by shocks, namely drought, Russia's invasion of Ukraine, and constrained international financial market conditions. To mitigate the socioeconomics impact of the shocks and to support growth, policy makers responded with prudent monetary, fiscal and exchange rate policies. Kenya's GDP is projected to grow by 5.6% in 2023 and by 6% in 2024. However, growth could be adversely impacted should the Ukraine crisis and tight global financial conditions persist. They could cause additional financing. For example, a tight international financial market environment could mean higher adjustment costs to the fiscus as the country is already committed to meeting certain fiscal targets. Given the opposition to the planned reforms by the opposition, relying on own resources to bridge the financing gap could imply aggressive expenditure cuts and/or introduction of growth-unfriendly revenue enhancement measures. Therefore, international financial assistance in the form of improved access to concessional financing (e.g., budget support) might be required to support growth in the immediate to short term. Policy targets in the medium to the longer term could focus on building resilience for a rapid and sustainable growth which could require among other things structural change.

The year 2022 was relatively difficult for the monetary authorities. Monthly headline inflation fluctuated between 5.3% in January 2022 and 9.6% in October 2022, settling at 7.6% in December 2022, slightly higher than the upper target band of 7.5%. The increase was driven by the Russia's invasion of Ukraine, the weakening Kenyan shilling against major currencies, and the drought. In addition to policy rate hike, other policy instruments were implemented to fight inflationary pressures, among other things, Open Market Operation (OMO) to mop up excess liquidity in the system, sell of foreign exchange to minimize passthrough effect of exchange rate fluctuations to inflation, etc. Inflation is projected to fall within the target band (7.5% and 5.5% in 2023 and 2024, respectively). Going forward, the policy options to be taken to rein in inflationary pressures, where policy spaces allow, could entail: a prudent policy rate hike, seeking external financial support (key to narrow the interest rate differentials and stabilize the exchange rate), allowing the exchange rate depreciate, addressing fiscal imbalances (important driver of exchange rate pressures), deepening reforms to improve monetary policy effectiveness (e.g., monetary policy transmission) and enhancing monetary policy credibility to anchor inflation expectations.

Trends in the fiscal metrics have improved since 2021. The fiscal deficit narrowed to 6.3% of GDP in 2022 from 8.2% in 2021. This could be attributed to adherence to quantitative targets of the fiscal consolidation path. The Government is pursuing fiscal and debt sustainability anchored on a positive primary balance. The fiscal deficit is projected to narrow to 6.1% and 5.4% of GDP in 2023 and 2024, respectively. In general, fiscal operations could be impacted by possible delay in the implementation of planned fiscal policy reforms and exposure to the international financial market. Should they happen, the fiscal adjustment cost could increase resulting in an increase in government's gross financing

needs. Bridging the financing gap created as a result could entail additional fiscal measures that may turn out to be growth unfriendly due to the limited fiscal space. While looking for other feasible options for increased revenue collection, the country could combine the ongoing fiscal consolidation program with debt restructuring.

The external demand continued to be a drag on GDP growth in 2022. The current account deficit widened to 6% of GDP from 5.5% in 2021. It was driven by the trade deficit caused by declining terms of trade. Improving the trade balance requires diversifying the export base away from primary commodities to higher value-added goods as well as diversifying export destinations. Part of the current account deficit was financed by the capital account and the remainder by drawing down foreign exchange reserves. The foreign exchange reserves decreased to $7.42 billion (4.2 months of import cover) at the end of December 2022 from $9.5 billion (5.8 months of import cover) the previous year. The Kenyan shilling depreciated by 9% from 113 per US dollar in December 2021 to 123 per $in December 2022. The current account deficit is expected to narrow to 5.2% and 5.0% in 2023 and 2024, respectively on the back of projected decline in commodity prices. Furthermore, projected decline in the interest rate differential is expected to improve financial and capital account balances and foreign external positions. Risk to the outlook could emanate from slowdown in global demand and monetary policy tightening in the international financial market. Diversifying export destinations (in the short-run) and the export base in the medium to the longer-term remain critical.

5.3 Policy recommendations for mobilizing private sector finance for climate and green growth

Mobilising finance for green growth and climate action in Kenya to meet the estimated need will require interventions by different sets of stakeholders in the short, medium, and long term. Below is a set of recommendations, with indications of whether these should be implemented in the short **[S]**, medium **[M]**, or long term **[L]**.

5.3.1 National Government

[S] Ensure vertical coordination by national level institutions responsible for facilitating the implementation of green growth and climate action frameworks.

[S] Rapidly implement the sustainable financing frameworks that were developed during the implementation of the MTP III and the fiscal incentives policy developed in 2023.

[M, L] Mainstream green skills development into education institutions to ensure that there is a continuous supply of green skills to enable the transition to green growth.

[M] Develop multistakeholder platforms that link domestic private sector with other international actors such as MDBs, DFIs and the international private sector that are sources of private sector finance.

5.3.2 MDBs and DFIs

[S] Become less risk-averse by further engaging with the Kenyan government to identify ways to provide affordable capital for green growth and climate change investments.

[M, L] Use innovative financing instruments that de-risk private sector investments, particularly in non-energy sectors such as water and health infrastructure development.

5.3.3 Domestic and international private sector

[M, L] Collaborate with national government, MDBs, DFIs, and other private sector actors to identify key risks to investments and propose ways of addressing these investment risks.

5.3.4 Developed country governments.

[S] As shareholders of MDBs and DFIs, developed country governments can instruct these institutions to be less risk-averse when

financing green growth in Kenya and providing additional capital to these institutions.

5.4 Policy recommendations for increasing the contribution of natural capital to climate finance and green growth

[M, L] The Kenyan government to consider increasing investment and efficiency to rents on cropland and pastureland, taking account of climate change impacts. This is something that needs to be undertaken in the short term and continued in the coming decades.

[S] The Kenyan government to consider promoting and enforcing stricter policies and regulations protecting forests and preventing illegal logging. Sustainable forestry practices, such as selective logging practices and reforestation, should also be promoted through instruments such as performance bonds for forest lessees. These are short term measures.

[S] There is a need for collaboration between development partners and the Kenya government to exploit international agreements in a number of areas. These include the creation of a single market for the trade of emissions credits (under Article 6 of the Paris International Agreement), which will raise the price of carbon credits in the forests; and increased participation in the voluntary market, where new opportunities are arising through the Post-2020 Global Biodiversity Framework. This can start straight away but may take a few years to mature.

[M, L] The Kenyan government needs to prepare itself to be part of the growth in carbon sequestration related to nature-based solutions related to forestry and land use, agriculture and soil sequestration, and blue carbon. They can do this by developing new offsets and ensuring the integrity of certification of voluntary carbon markets. They will need some support from development partners to achieve these goals.

[S, M] The Kenyan government needs to exploit landscapes more effectively for tourism by developing ecotourism further as a short-to-medium term endeavour.

[M, L] In the area of renewable energy, the national government, working with development partners and capital markets, needs to exploit the potential for such energy at a much faster rate. This will take some time and can be seen as a medium-term goal, but one that can be started straight away.

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Figure A1.1: Changes in the value of natural capital for African countries, 1995-2018



Source: AfDB Computation using data from the World Bank (2021)

Note: Grey circles denote the values in 2018, arrows indicate the direction of change, red circles indicate a decline in value, and green circles indicate an increase in value.

East Africa	Total US$2018 Mn.			Per Capita US$2018		
	1995	2018	% Increase	1995	2018	% Increase
Renewable natural resources	452,150	464,505	3%	20,671	11,746	-43%
Forests, timber	96,886	93,880	-3%	3,745	2,120	-43%
Forests, non-timber	33,997	35,213	4%	1,333	746	-44%
Mangroves	397	770	94%	14	15	3%
Fisheries	631	608	-4%	21	11	-47%
Protected areas	52,603	62,994	20%	1,959	1,338	-32%
Cropland	176,906	159,659	-10%	9,980	5,090	-49%
Pastureland	90,730	111,381	23%	3,619	2,427	-33%
Sub-soil assets	523	7,558	1346%	25	168	564%
Oil	0	17	n.a	0	0	n.a
Natural gas	0	459	n.a.	0	8	n.a.
Coal	33	227	594%	1	4	266%
Metals and minerals	490	6,855	1299%	24	156	542%
Total	452,672	472,063		20,696	11,915	-42%

Figure A1.2: Mining and quarrying value added, 2022 (e)

Chart 2: Value Added: Mining and quarrying, 2022(e)
(Millions of $)

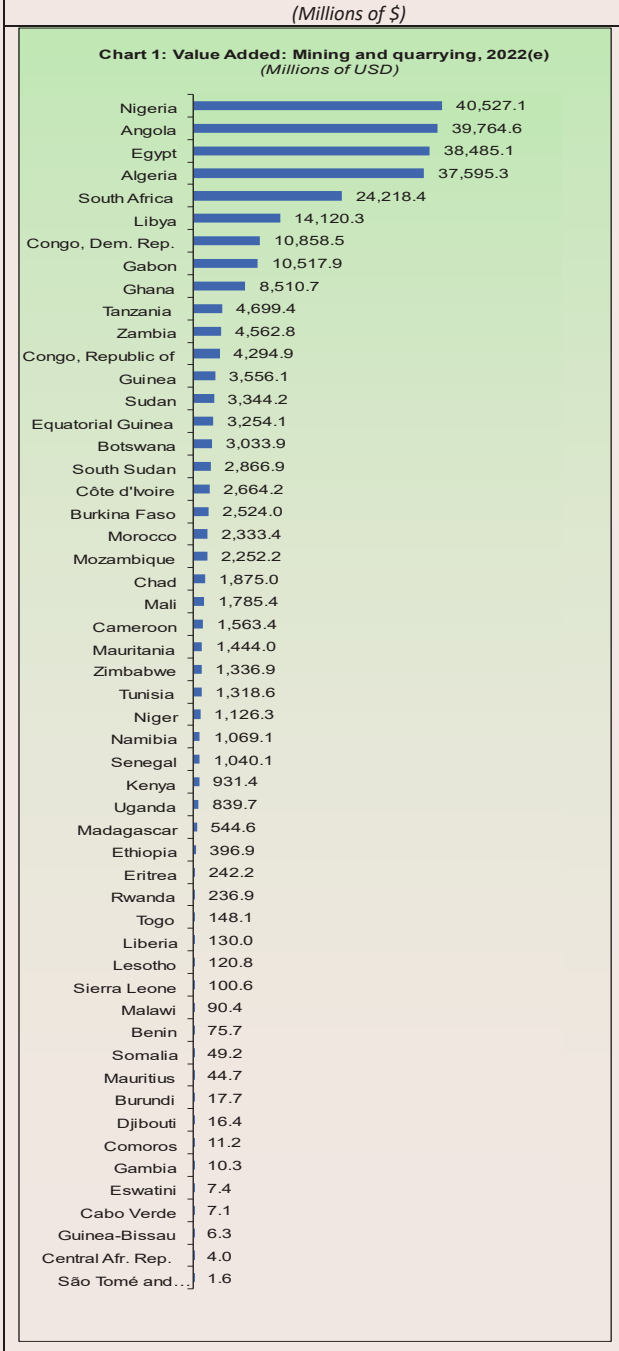


Chart 2: Value Added: Mining and quarrying, 2022(e)
(% of GDP)

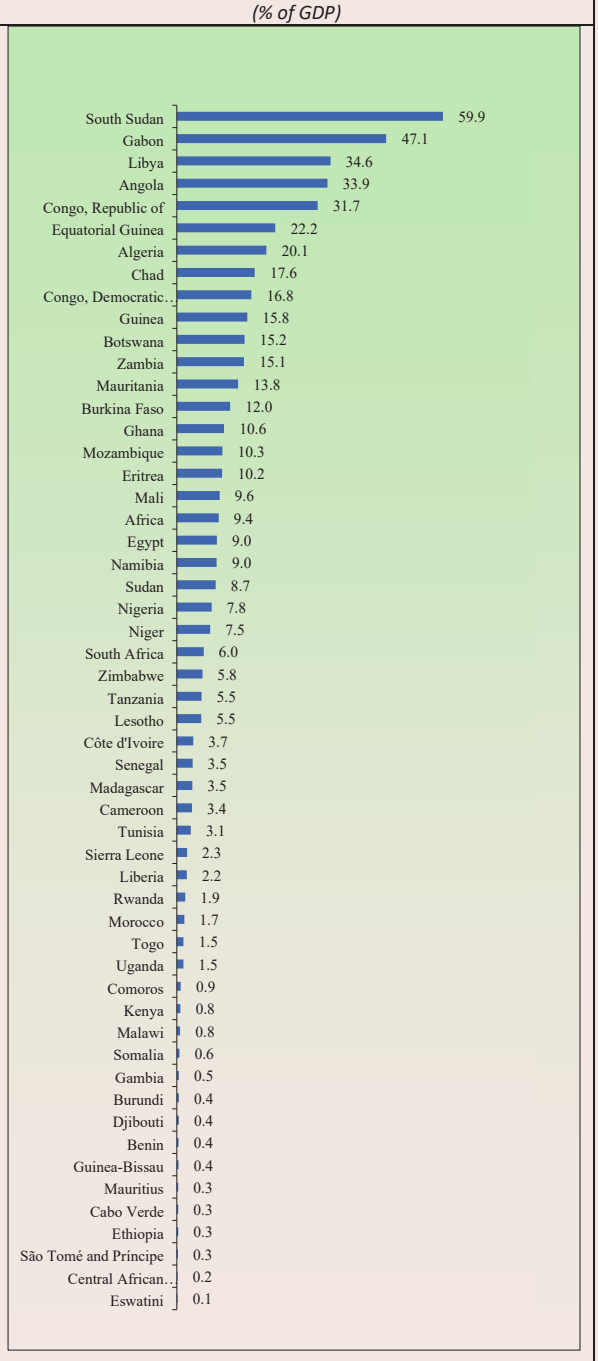


Figure A1.3: Forest land and non-renewable assets

Chart 2: Value Added: Mining and quarrying, 2022(e)
(Millions of $)

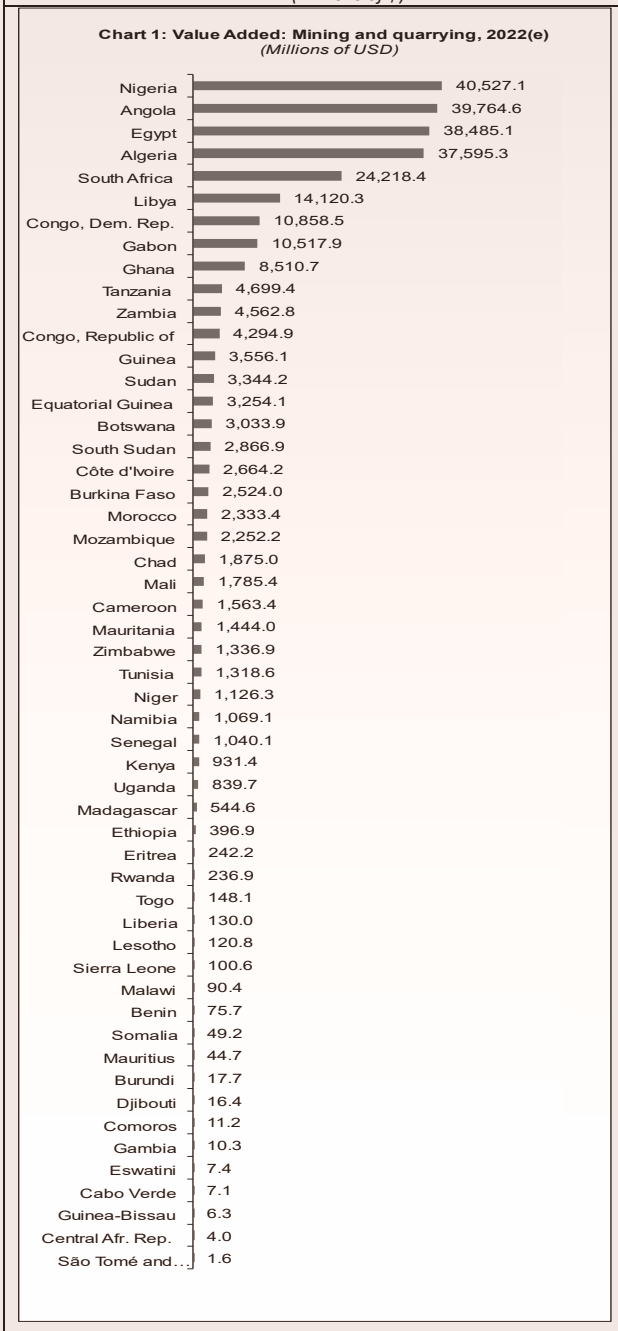
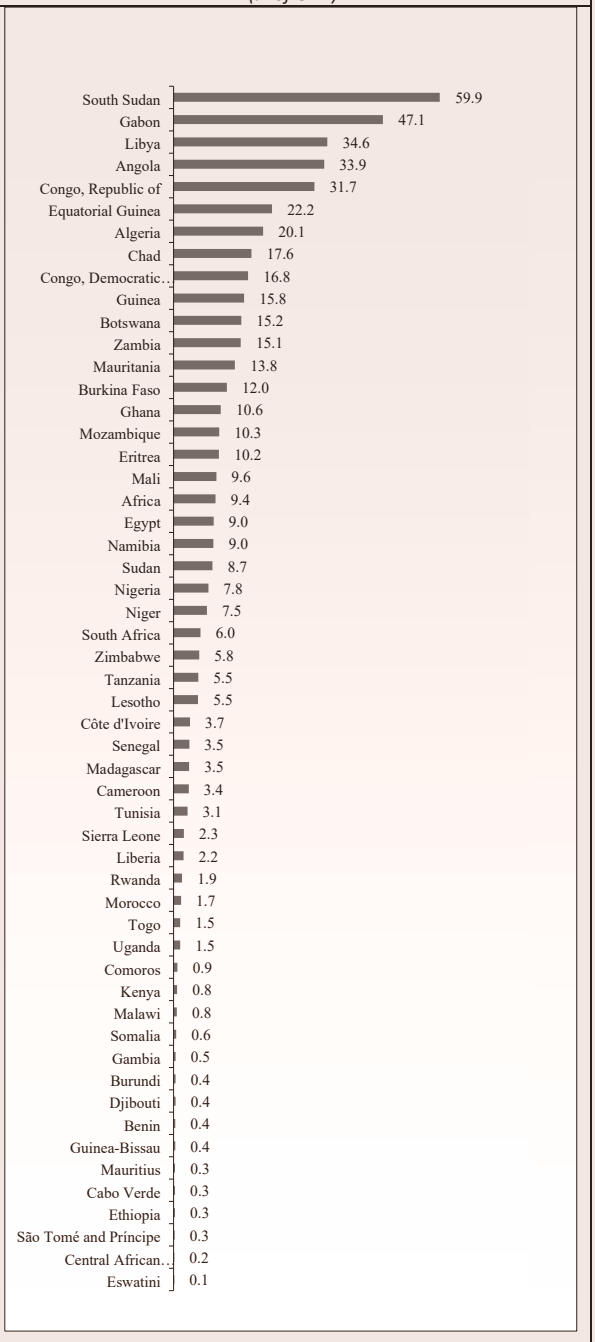


Chart 2: Value Added: Mining and quarrying, 2022(e)
(% of GDP)



ANNEX 1: KENYA SELECTED INDICATORS

Indicators	Unit	2010	2015	2018	2019	2020	2021	2022 (e)	2023 (p)	2024 (p)
National Accounts										
GNI at Current Prices	Million US $	38,612	62,312	86,419	96,298	98,773	110,252	...	...	...
GNI per Capita	US$	930	1,330	1,730	1,890	1,900	2,080	...	...	...
GDP at Current Prices	Million US $	40,000	70,370	92,211	100,328	100,930	110,520	115,228	122,204	133,993
GDP at 2010 Constant prices	Million US $	40,000	50,747	57,994	61,010	60,817	65,378	68,948	72,843	77,214
Real GDP Growth Rate	%	8.4	5.0	5.6	5.2	-0.3	7.5	5.5	5.6	6.0
Real per Capita GDP Growth Rate	%	5.4	2.7	3.5	3.1	-2.3	5.4	3.5	3.6	3.9
Value Added: Mining and quarrying	Million US $	496	897	680	713	719	839	931	...	...
Value Added: Mining and quarrying	% GDP	1.1	1.3	0.7	0.7	0.7	0.8	0.8	...	...
Value Added: Fishing	Million US $	275	412	504	564	594	737	663	...	...
Value Added: Fishing	% GDP	0.6	0.6	0.5	0.6	0.6	0.7	0.6	...	...
Prices and Money										
Inflation (CPI)	%	4.1	6.6	4.7	5.2	5.4	6.1	7.6	8.6	5.9
Exchange Rate (Annual Average)	local currency/US$	79.2	97.8	101.3	102.0	106.2	109.5	117.7	126.6	130.9
Government Finance										
Total Revenue and Grants	% GDP	20.5	18.7	17.4	17.7	17.1	16.1	17.5	17.2	16.9
Total Expenditure and Net Lending	% GDP	26.3	27.0	25.0	25.0	24.7	24.4	23.8	23.3	22.3
Overall Deficit (-) / Surplus (+)	% GDP	-5.8	-8.3	-7.7	-7.3	-7.7	-8.2	-6.3	-6.1	-5.4
External Sector										
Terms of Trade Growth	%	-0.9	6.1	-9.9	-0.1	10.2	-2.2	-6.7	3.3	0.6
Current Account Balance	Million US $	-2,367	-4,437	-4,990	-5,256	-4,804	-6,027	-6,963	-6,315	-6,663
Current Account Balance	% GDP	-5.9	-6.3	-5.4	-5.2	-4.8	-5.5	-6.0	-5.2	-5.0
Debt and Financial Flows										
Debt Service	% exports	9.8	18.7	36.2	53.1	49.8	45.2	43.2	47.3	56.0
External Debt	% GDP	28.0	46.7	50.5	52.0	56.9	58.2	59.1	62.0	66.4
Net Total Financial Flows	Million US $	1,504	2,605	3,519	3,167	4,518	3,762	...	...	...
Net Official Development Assistance	Million US $	1,631	2,464	2,491	3,172	3,990	3,143	...	...	...
Net Foreign Direct Investment	Million US $	1,198	1,464	1,139	1,098	717	448	...	...	...
Demography										
Total Population	Millions	41.5	46.9	50.0	51.0	52.0	53.0	54.0	55.1	56.2
Population Growth Rate	%	2.9	2.2	2.1	2.0	2.0	2.0	1.9	2.0	2.0
Urban population	% of total	23.5	25.9	27.6	28.2	28.8	29.4	30.1	30.7	31.4
Life Expectancy at Birth	Years	60.6	61.9	62.7	62.9	62.7	61.4	62.1	63.3	64.1
Fertility Rate	births per woman	4.4	3.8	3.6	3.5	3.4	3.3	3.3	3.2	3.2
Poverty and Income Distribution										
Pop. living below national poverty line	% of total population	...	36.1	...	...	...	...	...	...	...
Population living below $2.15 a day	% of total population	...	29.4	...	...	...	...	...	...	...
Gini Index	%	...	40.8	...	...	...	...	...	...	...
Labor Indicators										
Labor Force participation (total)	%	73.7	74.3	74.1	73.9	73.2	73.9	74.4	74.4	...
Labour Force participation (youth)	%	46.4	45.3	43.2	42.2	41.8	41.8	42.3	42.3	...
Unemployment rate (total)	%	2.8	2.8	4.2	5.0	5.6	5.6	5.5	5.5	5.4
Unemployment rate (youth)	%	7.1	7.3	10.7	12.4	13.8	13.5	13.4	13.4	13.4
Natural Resources rents										
Total natural resources rents	% GDP	2.7	2.7	1.3	1.2	1.2	...	...	...	...
Oil rents	% GDP	...	...	0.0	0.0	0.0	...	...	...	...
Natural gas rents	% GDP	...	...	...	...	...	...	...	...	...
Mineral rents	% GDP	0.1	0.0	0.0	0.0	0.0	...	...	...	...
Forest rents	% GDP	2.6	2.7	1.3	1.2	1.2	...	...	...	...
Coal rents	% GDP	...	...	...	...	...	...	...	...	...
Natural Capital Renewable Resources										
Arable land	1000 hectare	5,500.0	5,800.0	5,800.0	5,800.0	5,800.0	...	...	...	...
Agricultural land	1000 hectare	27,320.0	27,630.0	27,630.0	27,630.0	27,630.0	...	...	...	...
Other land	1000 hectare	25,977.7	25,761.6	25,672.9	25,672.9	25,672.9	...	...	...	...
Forest land	1000 hectare	3,616.3	3,522.4	3,611.1	3,611.1	3,611.1	...	...	...	...
Planted Forest	1000 hectare	152.8	152.8	152.8	152.8	152.8	...	...	...	...
Annual freshwater withdrawals, total	% of internal resources	15.5	15.6	19.5	19.5	...	...	...	...	...
Total Fisheries Production	metric tons	152,801.0	184,425.0	142,173.0	145,471.0	143,810.0	...	...	...	...
Climate Finance and Green Growth										
Total Climate Finance*	Million US $	...	...	...	...	1,991.3	...	...	...	...
Green Growth Index**	%	49.4	50.1	50.5	51.2	51.1	51.1	...	...	...

(e) Estimations (p) Projections

** Source: Climate Policy Initiative (www.climatepolicyinitiative.org)*

***Source: Global Green Growth Institute (GGGI). The scores for the Green Growth Index range from 1 to 100, with 1 having the lowest or very low performance and 100 having the highest or very high performance*



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