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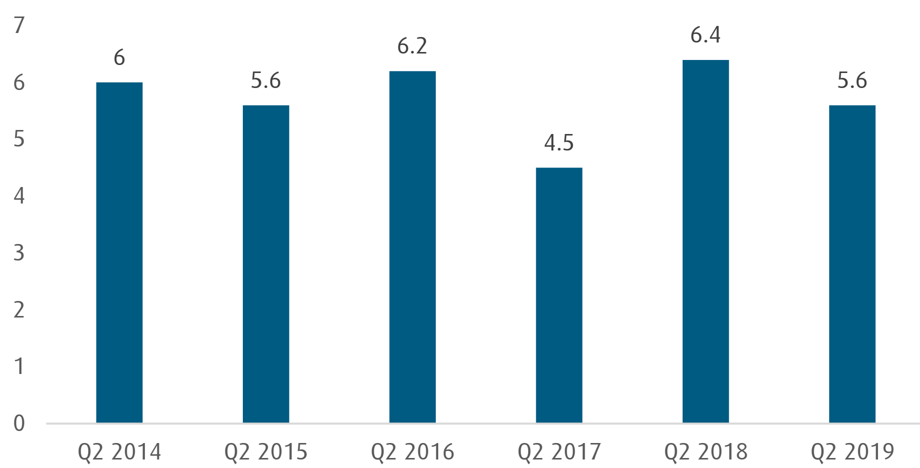
September 2019

Kenya Economy Update: *The growth puzzle*

Kenya's economy has continued to demonstrate some level of resilience. Indeed, the broad-based economic growth has averaged 5.6 percent for the last five years outperforming the average growth rate of 4.7 percent in the period 2008 to 2012 and 4.6 percent in the period 2002 to 2007. In the second quarter of 2019, real Gross Domestic Product (GDP) is estimated to have expanded by 5.6 percent, which was lower than the 6.4 percent growth printed in a similar quarter of 2018.

Chart 1: Second Quarter GDP Growth Rates (%)



Source: KNBS

During the second quarter, nearly all sectors, with the exception of mining, real estate and construction, recorded output slowdown. Growth momentum in the agricultural sector, which accounts for a third of Kenya's annual economic output, slowed down to 4.1 percent, which compared unfavourably to the 6.5 percent growth printed in a similar quarter of 2018. Because Kenya's agricultural sector remains rain-fed, output growth patterns typically reflect rainfall patterns. In this case, delayed long rains that somewhat curtailed agricultural production. However, agricultural output is still expected to remain under duress in 2019 through to first half of 2020. on account of changing weather patterns. Output momentum in the manufacturing sector, another bedrock of the economy, slowed down to 4.2 percent, lower than the 4.7 percent printed in a similar period of 2018.

Manufacturing output growth has continued to print below 5.0 percent for the last five years, suggesting structural problems feeding into the sector. Output growth in the sector is still largely expected to remain soft in 2019 and could post modest recovery in 2020. Output in the trade sector also declined to 5.8 percent, which largely speaks to a weakening demand side. While output growth rate in the tourism sector softened to 10.6 percent in the period under review (lower than the 15.4 percent printed in the second quarter of 2018), it continued to post double-digit growth rates, which suggests that the sector could post a rebound in the second half of 2019 through to 2020. Real estate and construction recorded output growth momentum during the quarter supported by the second phase of the Standard Gauge Railway (SGR) project, which extends from Nairobi to Naivasha, as well as strong activity levels in the residential space. However, the commercial space, suffering under the weight of supply glut, will likely print an output slowdown in the second half of 2019 through to 2020. The ICT sector, which is dominated by mobile payments (led my M-Pesa), continued to post strong output momentum. As mobile payments become even more ubiquitous, output in this sector will remain strong in 2019 through to 2020.

Table 1: GDP by Key Activities, Growth Rates (%)

	Q2 2016	Q2 2017	Q2 2018	Q2 2019
Agriculture	7.6	0.7	6.5	4.1
Mining and Quarrying	9.4	4.3	2.9	5.7
Manufacturing	4.9	1	4.7	4.2
Electricity and Water Supply	11.5	8.3	8.4	5.6
Construction	7.3	9.1	5.4	7.2
Trade	1.8	5	6.2	5.8
Tourism	14	12.3	15.4	10.6
Transport and Storage	5.9	6.5	8.4	7.2
ICT	9	11.5	11	11.6
Real Estate	8.9	6.3	4.6	5.4

Source: KNBS

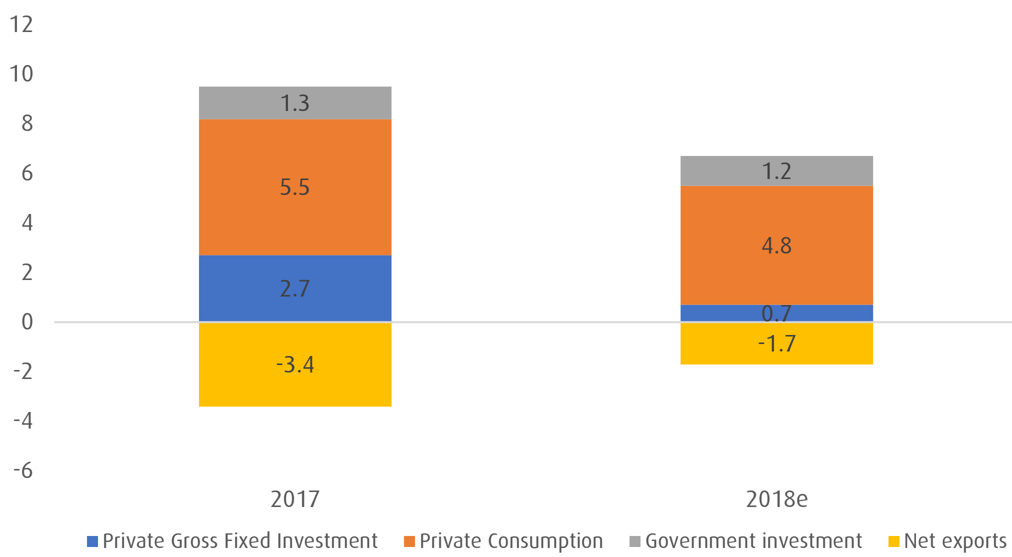
The economic growth puzzle

Broadly, Kenya's economic output will come under pressure in 2019. The International Monetary Fund (IMF) has downgraded its output forecast to 5.6 percent[1] in 2019, from 6.1 percent[2]. However, the fund bullishly expects economic output to expand by 6.0 percent in 2020. The National Treasury, on the other hand, projects economic output to expand by 6.1 percent[3] in 2019. It further projects output to print at 6.2 percent in 2020. The National Treasury premises its ambitious projections on an equally ambitious expenditure programmes that target the Big Four Agenda items.

[1] IMF Sub-Saharan Africa Regional Economic Outlook October 2019
[2] IMF Sub-Saharan Africa Regional Economic Outlook October 2018
[3] 2019 Budget Policy Statement for the Medium Term Expenditure Framework (MTEF) Fiscal Years 2019-2022

However, while economic output growth projections are printing north of five percent, there is somewhat a disconnect between real GDP growth rates and household economic well-being. First, demand-side remains weak, and indeed, there was an evident contraction in consumption in 2018 (see Chart 2 below). Broadly, private sector activities, from investments to consumption contracted in 2018. Economic output appears to have been supported by government activities, most notably the SGR construction.

Chart 2: Growth rates in consumption activities (%)



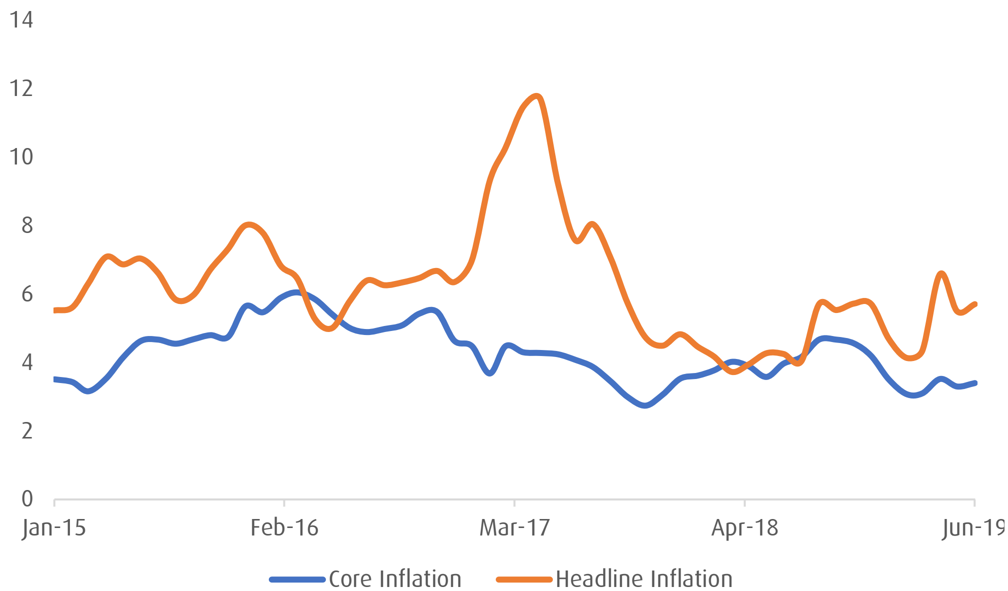
Source: World Bank Kenya Economic Update (April 2019)

Price levels

Consumer prices: core inflation remains too soft

In terms of price levels, headline inflation, which measures annual growth in food and fuel prices, has remained below the upper target of the Central Bank of Kenya (CBK) of 7.5 percent on account of stable food prices, despite somewhat elevated pump prices of refined petroleum products. However, while inflation is expected to remain below target in the second half of 2019, it could come under pressure from the monetary side in 2020 given that Parliament has moved to delete Section 33(B) of the Banking Act, which capped interest rates and consequently stifled money creation from the credit side.

Chart 3: Headline inflation versus core inflation (%)



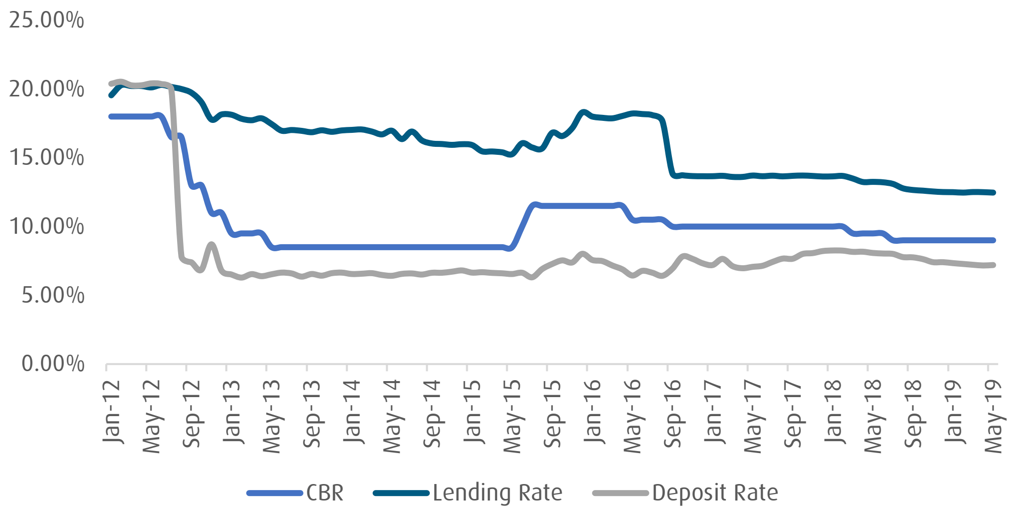
Source: CBK, KNBS, Callstreet Research and Analytics

While headline inflation has remained within the Government's target range, core inflation, which measures price growth in non-food and non-fuel items and therefore a better reflection of price levels, has remained muted since 2015. This suggests that the demand-side of the economy remains weak (as further supported by Chart 2 above). **This presents another economic growth puzzle.**

Price of money: interest rates remained stable

Interest rates have come down since the promulgation of the Banking (Amendment) Act, 2016 in September 2016, which capped the price of loans at 4 percentage points above the Central Bank of Kenya's benchmark rate, the Central Bank Rate (CBR). In 2019, commercial banks' lending rates stood at 13 percent, while they paid an average of 8 percent to acquire deposits.

Chart 4: Commercial banks' interest rates



Source: CBK

The Government has been the biggest beneficiary of the interest rate caps, with its borrowing costs softening significantly. For instance, the cost of borrowing money for 91-days slumped from a high of 21 percent to around 6 percent in 2019. Additionally, the cost of borrowing for more than 10 years has also remained below 13 percent. However, with Parliament lifting the Banking (Amendment) Act, 2016, the cost of borrowing for both the private sector and the Government is now set to rise in 2020.

Chart 5: 91-day Treasury bill weighted average rate

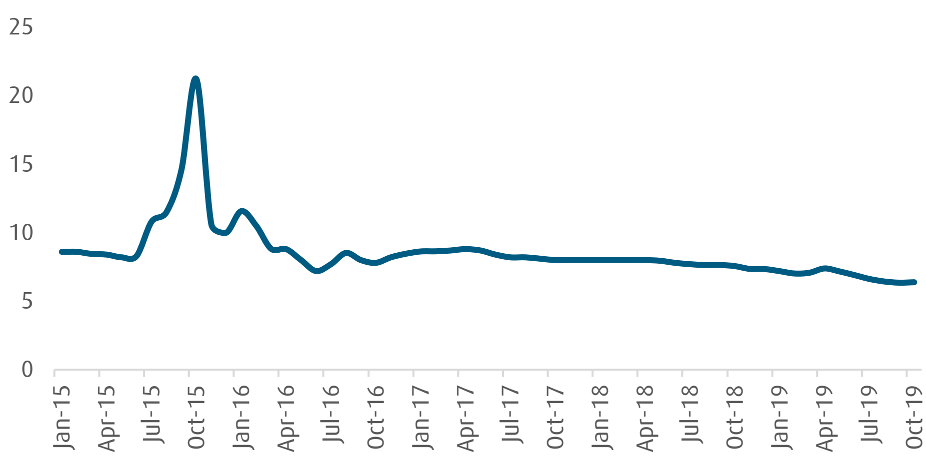
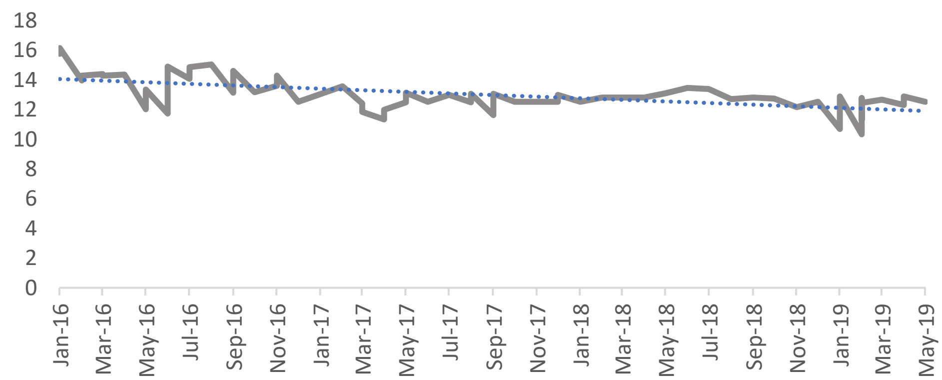


Chart 6: Cost of domestic debt issuance with tenors above one year



Source: CBK

Exchange rates

The Kenya Shilling (KES) price of foreign exchange (FX) has been under pressure especially in 2019. For instance, the mean exchange rate between KES and United States Dollar (USD) remained range-bound between 100 and 105. There was slight volatility in the exchange rates especially in the first half of 2019, which was the result of two key factors: (i) there were sustained portfolio outflows out of the stock market, partly on account of portfolio rebalancing by foreign funds; and (ii) an overhang caused by the redemption of the 2019 5-year Eurobond issue, which was redeemed in late June 2019 to the tune of about USD800mn, which took a bite off Kenya's official usable FX reserves. Official usable reserves are still expected to be stable at around 5.8 months of import cover. Consequently, it is largely expected to remain stable at similar levels in the last quarter of 2019 through to 2020.

Chart 7: Mean USD-KES nominal exchange rates

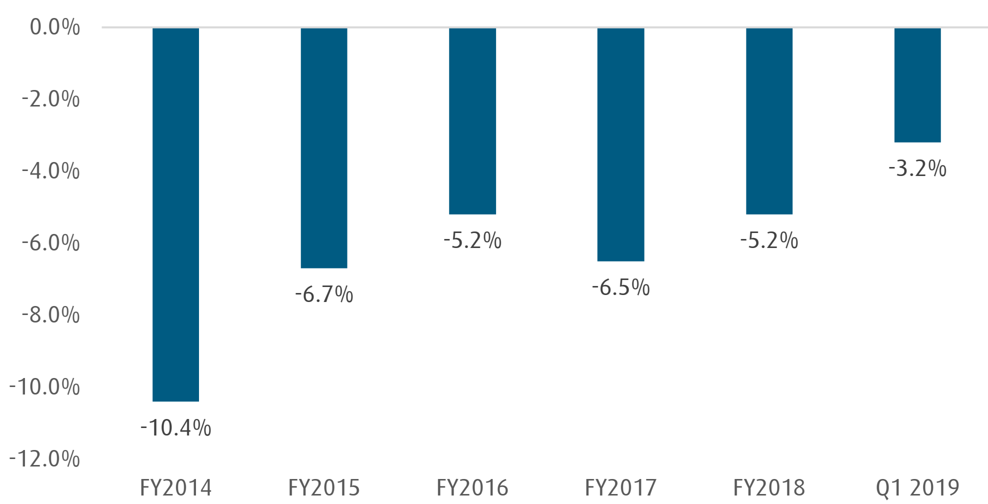
Source: CBK

External position: Kenya records improvements in trade balance

Kenya's external position continues to record improvements in 2019. In the first quarter of 2019, overall current account deficit narrowed down to 3.2 percent of GDP, from 5.2 percent in FY2018 (see Chart 4 below). According to the Kenya National Bureau of Statistics (KNBS), the narrowing of the current account deficit was supported by increase in net service inflows and **decrease in merchandise trade deficit**. Indeed, merchandise trade balance shrunk from a deficit of Sh248. 3 billion in the first quarter of 2018 to a deficit of Sh239.0 billion in the first quarter of 2019.

The decline in merchandize trade deficit is being mainly driven by a reduction SGR related imports of industrial machinery as well as petroleum products due to stable global oil prices (which has continued to benefit net importing countries like Kenya). However, the improving current account deficit is not being supported by an equivalent growth in exports and masks the slack in the country's export position. **This is another economic growth puzzle**. Data from KNBS shows that total exports in Q1 2019 declined by 3.1 percent year-on-year to the equivalent of USD13 billion. Ordinarily, it would be of great benefit to the country's external position if the decrease in merchandize imports was being followed by an increase in merchandize exports. This suggests that the narrowing of current account deficit may not be sustainable.

Chart 8: Current account deficit (% of GDP)

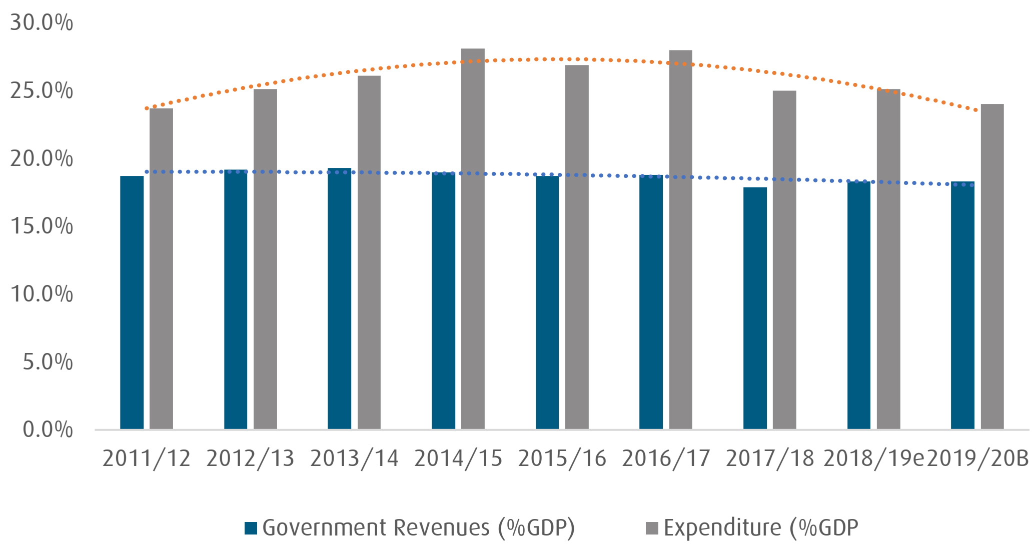


Source: KNBS, Callstreet Research and Analytics

Fiscal developments: the puzzle of deficit spending and aggressive taxes

For the fiscal year 2019/20, Kenya outlined quite aggressive Sh3 trillion spending plans. The proposed spending plan, is to be financed via Sh2 trillion and upto Sh700 billion of revenues and gross borrowings respectively. On the face it, it appears like the Government wanted to stimulate the economy through fiscal expansion, hence the wide deficit spending. However, to cure a weak fiscal trajectory, Treasury unveiled aggressive taxation plans. The Treasury even raised excise duty on a number of products, mostly alcoholic products and cigarettes.

Chart 9: Graphical representation of Government's fiscal operations



Source: The National Treasury, Callstreet Research and Analytics

So while on one side Treasury is stepping on accelerator, on the other side it is stepping on the brakes. This amounts to fiscal confusion. The Kenyan economy appears at standstill and in need of a stimulus boost via tax cuts. With a USD7bn in deficit, the country will definitely be in the international debt markets again next year. Domestically, the debt market is set for further deepening, which will continue crowding out private sector. In fact, I think the Government maybe benefitting from the rate caps at the expense of the private sector. First, lending to central government by commercial banks has continued to outpace private sector credit growth. Second, the government's domestic borrowing costs have continued to glide downwards.

Debt service still remains a pain for the country

While Kenya's total debt service is set to decline by 16 percent in the current fiscal year 2019/20, interest payments on public debt, both internal and external, are set to rise by 25 perpcent year-on-year Sh441.bn (USD.4.4bn). Total debt redemptions for current fiscal year will decline by 47 percent year-on-year to Sh255bn (USD.2.5bn). In sum, while debt service will stand at Sh696.5bn (USD.7bn), compared to Sh832bn (USD8.3bn) in FY2018/19, it still remains elevated if viewed against revenue collections.

Figures in KES	FY2018/19 (Revised Estimates)	FY2019/20 (Estimates)
Interest		
Internal	248,607,707,475	290,539,913,601
External	103,717,567,879	150,941,240,485
Sub-Total	352,325,275,354	441,481,154,086
Redemptions		
Internal	220,352,450,865	123,690,535,723
External	259,402,466,103	131,382,472,178
Sub-Total	479,754,916,968	255,073,007,901
Total: INTEREST & REDEMPTION	832,080,192,322	696,554,161,987

Source: Treasury

China dominates list of creditors

When it comes to external interest payments, China, Trade and Development Bank (TDB) and sovereign eurobonds dominate the list. Interest payments on Chinese loans (China Exim Bank), in total, is projected at Sh38bn (USD380mn). Interest on the TDB syndication is projected at Sh17bn (USD170mn) while interest on Eurobonds is seen at Sh32bn (USD320mn). In total, these three entities, with nearly USD1bn in projected interest payments, will account for 20 percent of total interest payments. On the redemption side, China (China Exim Bank and China Development Bank) and TDB dominate. In total, Sh77bn (USD700mn) worth of projected redemptions will go towards these two creditors, accounting for a third of all projected redemptions. In total, a staggering USD1.7bn worth of projected external debt service will go towards these three commercial creditors. With the fiscus appearing too congested at the moment, Kenya will still be looking to tap into the Eurobond market to refinance some of these USD obligations.

Monetary developments: retail and businesses suffer from lack from credit

Domestic credit supply has remained muted due to supply-side constraints occasioned by the interest rate caps. However, while interest rates caps have played a role, the government's aggressive fiscal stance has the largest part to play. Consequently, private sector credit growth has plummeted from highs of above 20 percent to below 5 percent. This 'crowding out' effect has in turn been transmitted into the real economy and has negatively impacted output as businesses, especially small and medium enterprises (SMEs), and households (retail) struggle to secure funding for day-to-day maintenance.

Chart 10: Annual private sector growth momentum

Source: CBK, Callstreet Research and Analytics

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