Public Finance: Draft 2018 Budget Policy Statement

The Treasury has just released the draft Budget Policy Statement that lays out the government's medium-term priorities and policy goals that will guide the preparation of budgets for both the national and county government. The draft Budget Policy statement reflects the razor-sharp line that the treasury must walk to actualize the government's big four agenda in the medium term but still achieve its fiscal consolidation targets.

The Budget Policy Statement indicates that the government intends to implement an accommodative Fiscal policy stance in the medium term to reinforce economic growth. On top of the expansionary fiscal policy stance, the government plans to follow a consolidation path in the medium term in order to achieve the East African Community Monetary Union Protocol's fiscal deficit ceiling (including grants) of **3%** or a fiscal deficit ceiling (excluding grants) of **6%** by FY 21/22.

Figure 1: Government Fiscal Operations

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
	Act	Prel. Act	BPS'18	BPS'18	BPS'18	BPS'18	BPS'18
	KES Billion	**KES Billion**	**KES Billion**	**KES Billion**	**KES Billion**	**KES Billion**	**KES Billion**
TOTAL REVENUE	1,232.6	1,400.6	1,643.1	1,849.4	2,105.6	2,417.8	2,747.6
Total Revenue as a % of GDP	***18.4%***	***18.3%***	***19.0%***	***18.9%***	***19.0%***	***19.2%***	***19.1%***
YoY Growth	***11.3%***	***13.6%***	***17.3%***	***12.6%***	***13.9%***	***14.8%***	***13.6%***
EXPENDITURE AND NET LENDING	1,781.9	2,110.0	2,323.1	2,488.4	2,639.8	2,897.5	3,239.4
Expenditure & Net Lending as a % of GDP	***26.6%***	***27.6%***	***26.8%***	***25.4%***	***23.8%***	***23.0%***	***22.6%***
YoY Growth	***8.7%***	***18.4%***	***10.1%***	***7.1%***	***6.1%***	***9.8%***	***11.8%***
Fiscal Balance *(commitment basis excl. grants)*	-549.3	-709.4	-680.0	-639.0	-534.3	-479.7	-491.8
Fiscal Balance as a % of GDP	***-8.2%***	***-9.3%***	***-7.9%***	***-6.5%***	***-4.8%***	***-3.8%***	***-3.4%***
YoY Growth	***3.2%***	***29.1%***	***-4.1%***	***-6.0%***	***-16.4%***	***-10.2%***	***2.5%***
Public Debt	3,210.8	3,972.5	4,589.6	5,173.9	5,662.2	6,090.6	6,282.1
Fiscal Balance as a % of GDP	47.9%	51.9%	53.0%	52.8%	51.0%	48.3%	43.7%
Primary budget balance	-282.0	-411.9	-316.7	-217.7	-98.8	4.1	53.7
Nominal GDP	**6,709.7**	**7,658.1**	**8,654.6**	**9,790.8**	**11,100.8**	**12,620.8**	**14,363.9**

Sources: AIB, the National Treasury

Total Revenue is projected by Treasury to grow by **96.2%** or at a CAGR of **18.3%** from the **KES 1,400.6 Billion** penned in FY16/17 to **KES 2,747.6 Billion** by FY21/22**.** They envision the growth in total revenue in the medium term to be mainly driven by a growth in ordinary revenue collections. Income tax revenue and Value Added Tax revenue, that currently form at least **70%** of ordinary revenue, is expected to continue playing an integral part in growing ordinary tax revenue in the medium-term. The government plans to double income tax revenue from **KES 625.1 Billion** recorded in FY 16/17 to KES **1,259.6 Billion** by FY21/22**.** Medium-term Revenue mobilization plans communicated in the BPS 2018 strategy will also see the government target a substantial increase in Value Added Tax (VAT) from **KES 339.0 Billion** collected in FY 16/17 to **KES 665.5 Billion** by FY 21/22.

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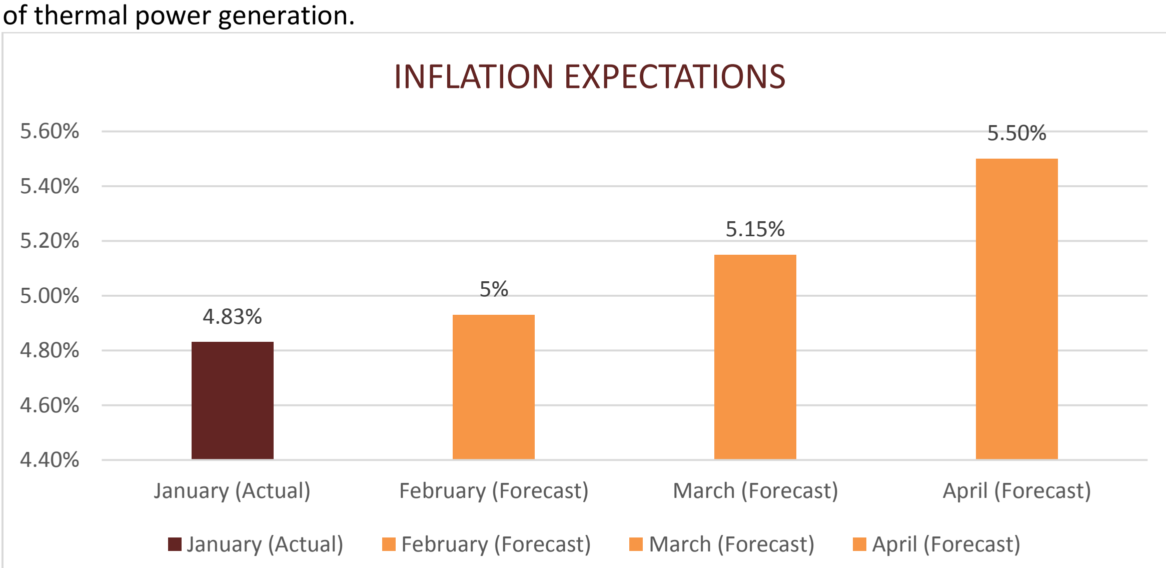
Expenditure and Net Lending is projected to grow by **53.5%** from **KES 2,110.0 Billion** registered in FY 16/17 to **KES 3,239.4 Billion** by FY 21/22. As has been the case in the past, the BPS envisions recurrent expenditure continuing to play a dominant role in the medium term expenditure spending. The recurrent expenditure is projected to increase from **55.9%** of expenditure and net lending in FY16/17 to approximately form **60%** of expenditure and net-lending for the rest of the medium term.

Fiscal Deficit and Public debt are projected to stabilise as a percentage of GDP and eventually decline over the medium term. The government expects deficits to stabilise on an absolute basis but decline as a percentage of GDP to reach its consolidation targets of **6%** (excluding grants) by FY19/20. Treasury also hopes to achieve a primary budget surplus by FY20/21. Public debt as a percentage of GDP is expected to stabilise around **50%** in the medium term and finally decline to **43.7%** of GDP by the end of FY 21/22.

Inflation

January registered an upswing in headline inflation. Inflation in January was 80 basis points above our expectations for January. Headline inflation, measured on a Year on Year **(YOY)** basis increased to **4.83%** in December from the **4.50%** recorded in November. The rise in headline inflation on a year on year (**YOY)** basis was mainly driven by the growth of both the Food and Transport inflation in January. The Food and Non-Alcoholic Beverages index grew by **4.71% YOY** in January 2018, while higher pump prices pushed the transport index to grow **6.8% (YOY)** in January.

Just like we have previously communicated in our 2017 Q4 Macro Report (click to view), our updated outlook on inflation reflects our new expectation of a depreciating Kenyan shilling, firming up of crude prices, updated weather forecasts and the cessation of maize subsidies. We opine that inflation will increase slowly but stay within CBK's target inflation limits of **2.5%** to **7.5%** moderated by the better food production in 2018. We also expect pump prices to play a more preeminent role in influencing inflation in 2018 and all through the medium term. We see non-food inflation trending upwards gradually driven up by the recovery of global crude prices as OPEC and Russia continue actualizing their coordinated planned supply cuts. The gradual increase in fuel prices will: propel the cost of agricultural output (diesel is heavily used); increase the prices of cooking fuels for the household; increase the cost of transportation; increase the costs of manufacturing inputs and increase the cost of thermal power generation.

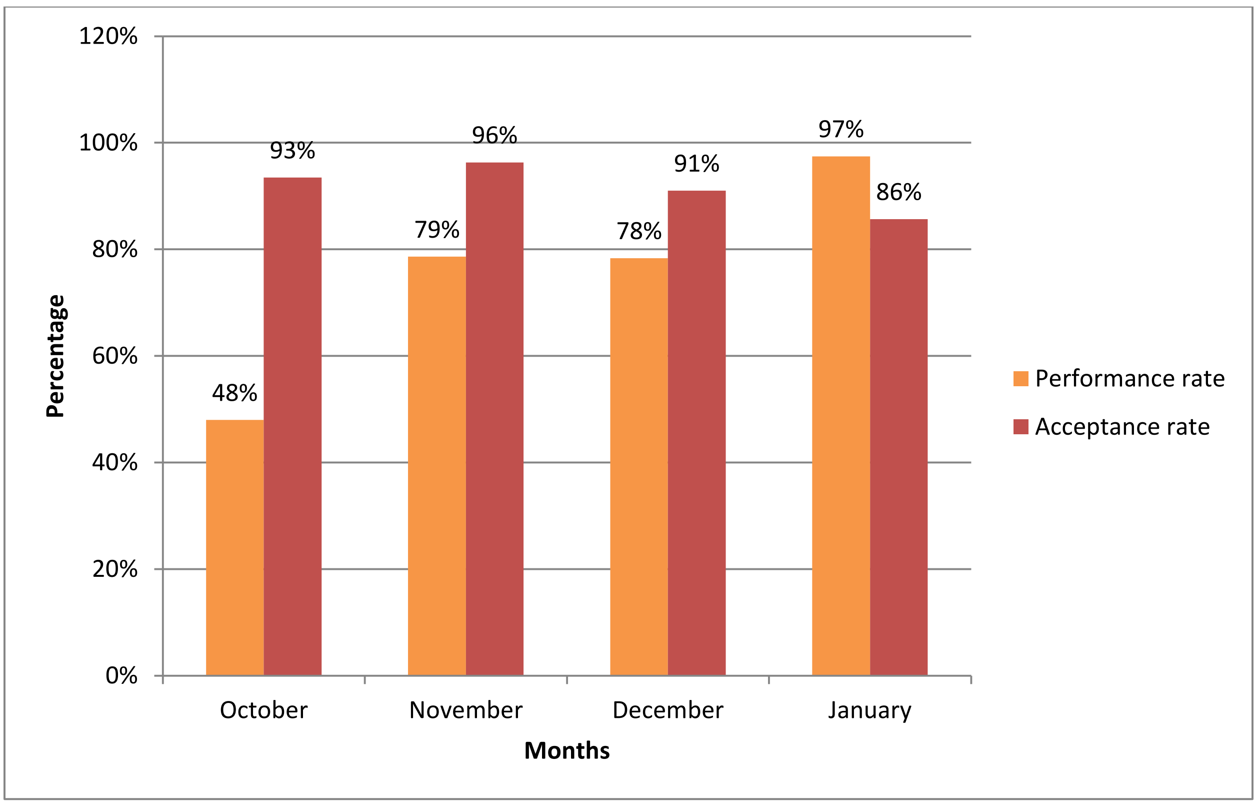


Source: KNBS, AIB

Liquidity Levels

The liquidity levels in January showed an improvement compared to liquidity levels in December. In January, the interbank market volumes registered a decrease to a monthly average of **KES 15.90 billion** traded compared to the monthly average of **KES 20.2 billion** traded in December. The weighted average interbank rate also declined to a monthly average of **6.15%** in January, down from the monthly average of **7.26%** recorded in December.

T-bill auctions recorded improved subscriptions in the month of January, indicating improved liquidity in the money market. T-bill average performance rate for the month of January registered an upswing to hit **97%,** which was an improvement on the average performance rate of **78%** recorded in December. Improved T-Bill subscriptions allowed the Central Bank to be more discerning at the auction leading to a weakening in acceptance rate, from **91%** average acceptance rate in December to a new average acceptance rate of **86%** in January.



Source: CBK, AIB

Our Medium Term Outlook

- **Fiscal slippage is a more likely outcome in the medium term than fiscal consolidation.** In the recent past tax buoyancy has been low. Actual tax revenue collection growth as a percentage of GDP has been declining and the government projections of a reversal of the trend in the short term are optimistic. We see revenue collection missing targets in the medium term and as a consequence, public debt will accelerate and fiscal deficit will widen in the medium term rather than stabilise.
- **Fiscal discipline outlined will be undermined by the political pressure**. In Kenya, fiscal spending remains a key political tool used by the ruling party to appease the key voting demographic. That's is why we envision government spending accelerating in the medium term spurred on by increased politically motivated infrastructure spending and spending on the president's Big Four Agenda projects. We don't realistically see the treasury influencing or asserting fiscal discipline in the medium term.
- **We expect Inflation will trend upwards** but remain within the upper range of CBK's inflation target of **2.5%** <inflation< **7.5%.** We see the rising global cost of crude oil and the resurgent dollar pushing up inflation in the medium term. In the medium term, we see government spending and strong household demand the main factors fanning inflation. We also see the weakening shilling as a contributing factor as economic recovery in the medium term increase the thirst for dollars to fund importation of petroleum products and other imported consumables.
- **Interest rates could increase over the medium term**. The interest rates have been generally stable over the last one year but we expect interest rates to be mainly pushed up by government deficit spending over the medium term. Governments in Sub Saharan Africa especially Kenya have benefited from generous global financing conditions that currently dominate. The global financing conditions are, however, generally expected to tighten gradually in the medium term as the global accommodative monetary policy are gradually unwound. We see both global and domestic investors demanding higher yields to compensate them for increased risk in view of the pending sovereign credit rating downgrade, increasing opportunity costs and the threat of inflation rising in the medium term.

Contacts

Research Desk

Victor Koech
koechv@aibcapital.com

Bonds Dealing Desk

Stephen Ngunje, Fixed Income Dealer
ngunjes@aibcapital.com

Crispus Otieno, Fixed Income Dealer
otienoc@aibcapital.com

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