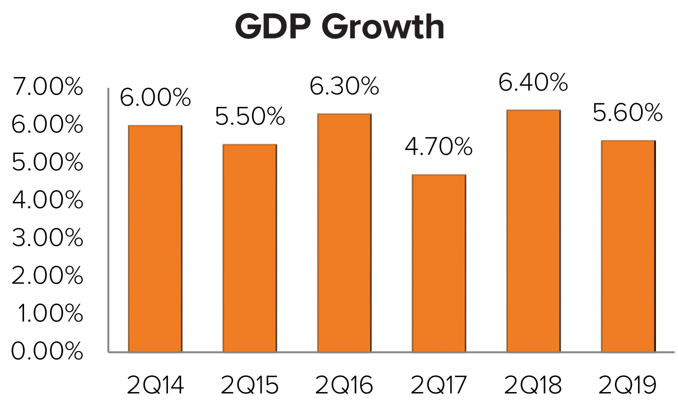

# Kenya Macroeconomic Outlook

**Reduced growth likely to decrease government revenue:** Economic growth slowed in 1H19 mainly due to unfavorable weather conditions which affected the performance of the agricultural sector. 2019 growth is expected to come in lower than that in 2018. The reduced growth is likely to affect the achievement of government's revenue targets.




**Low food prices to keep inflation subdued:** Inflation remained subdued in 3Q19, a trend that is expected to continue into 4Q19. Core inflation remains muted due to subdued demand. This is a reason for concern as it indicates that demand is muted which will negatively affect economic growth.

**Stable shilling as demand pressures subside:** During 3Q19, CBK supported the shilling by mopping up excess liquidity and selling dollars into the market. The Kenyan shilling lost 1.5% against the USD closing the quarter at 103.88. We view the recent depreciation as temporary and attribute it mainly to the demonetization efforts, thus in October, we expect the shilling to remain stable, and possibly gain some ground against the USD.

**Yields to remain relatively unchanged with a downward bias:** During the month, the stability of the Kenyan shilling during this demonetization period was the focus of CBK. The bank therefore accepted aggressive bids as it sought to mop up the excess liquidity.In 4Q19, elevated liquidity, Limited pressure on government borrowing program, low inflation and a stable shilling should keep rates subdued.

Date: 11th October 2019

Sovereign Credit Rating (outlook):

Moody's: B2 (stable)
Fitch: B+ (stable)
S&P: B+ (stable)

Sep Inflation: 3.83%

91-Day T-Bill (11th Oct-19): 6.37%

182-Day T-Bill (11th Oct-19): 7.25%

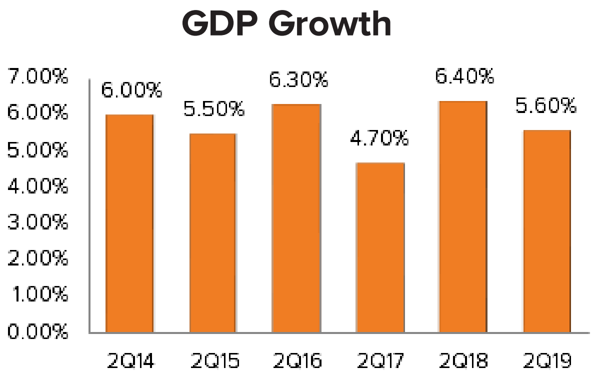
364-Day T-Bill (11th Oct-19): 9.79%

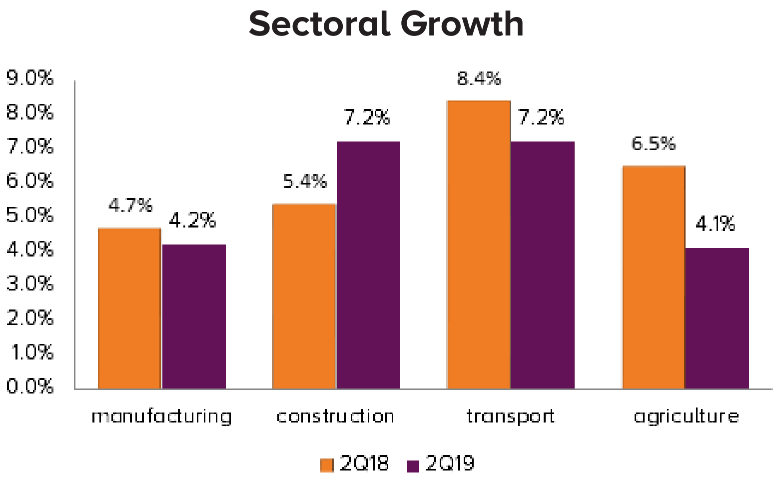
Analyst
Sarah Wanga
+254711047105
wangas@aibcapital.com

## GDP: Reduced growth likely to decrease government revenue

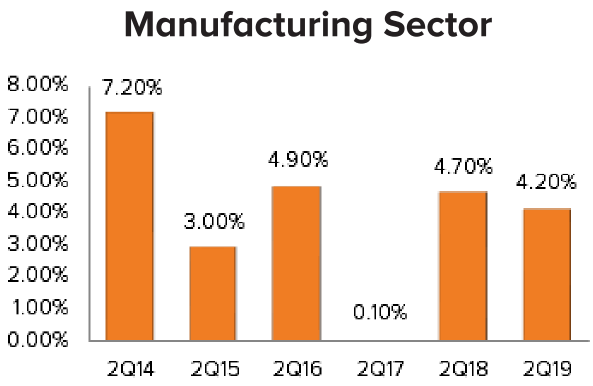
Economic growth slowed in 1H19 mainly due to unfavorable weather conditions which affected the performance of the agricultural sector. The manufacturing sector also declined due to a decrease in agro-processing.

GDP growth declined to 5.6% in 2Q19 from 6.4% recorded in 2Q18 due to reduced performance in the agriculture, manufacturing, and transportation sectors.



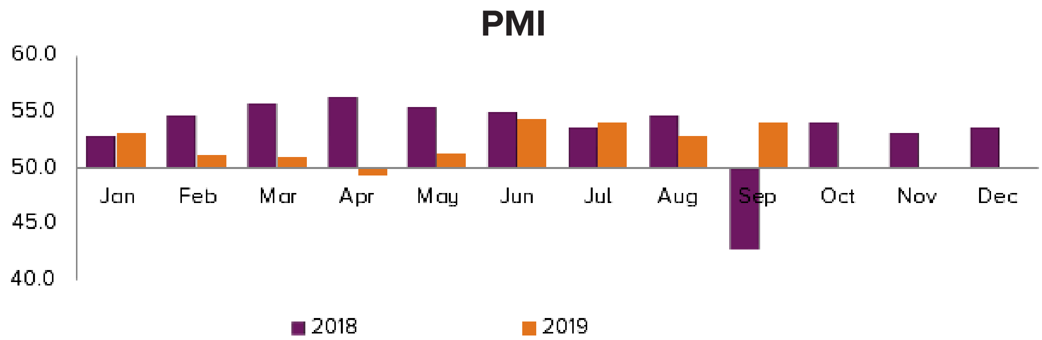




Growth in the Manufacturing sector declined to 4.2% in 2Q19 from 4.7% in 2Q18 due to a slowdown in the manufacturing of tobacco products and processing and preservation of fish.




The recent slowdown in the manufacturing sector is negative for the economy. The sector currently contributes 7.7% to GDP (down from 9.3% in 2016), with the government aiming to increase its contribution to 15% of GDP. Some of the measures that have been set up to achieve this include setting up Special Economic Zones (SEZ). The construction of the SEZ was to begin in August and target six counties (Lamu, Mombasa, Kisumu, Uasin Gichu, Kiambu and Naivasha in Nakuru County). Given the delays implementation of these initiatives, we believe that the government is unlikely to achieve this ambitious target.

We expect a pick-up in the manufacturing sector growth as the latest PMI data shows that activity in the sector has increased. We attribute this to improved access to credit which has allowed businesses to ramp up production.




The reduced growth is likely to affect the achievement of government's revenue targets. Reduced growth in the Manufacturing sector over the past few years has led to the sector contributing less to revenue (20.9% in FY2016/17 to 18.2 in FY2018/19).

Meanwhile, Information and communication which contributes 1.3% to GDP currently accounts for 15% of the government's revenue.

| | Revenue Contribution 2018/19 | GDP Contribution 2018 |
|---|---|---|
| Agriculture | 2.6% | 34.2% |
| Manufacturing | 18.2% | 7.7% |
| Electricity, gas, steam | 3.8% | 2.5% |
| Construction | 5.0% | 5.5% |
| Wholesale and Retail | 6.7% | 7.5% |
| Transportation and Storage | 4.6% | 8.0% |
| Information and Communication | 15.0% | 1.3% |
| Financial and assurance | 18.4% | 6.0% |
| o/w banks | 14.1% | |
| o/w insurance | 4.4% | |
| Real estate activities | 2.8% | 7.0% |
| professional and technical | 3.8% | 1.8% |
| public administration | 1.4% | |
| Education | 2.5% | 4.3% |
| Others | 21.9% | |
| Totals | 100% | 100% |

To increase revenue, the government has increased taxes in the following sectors:

### → Real Estate

The 2019 finance bill proposed to increase capital gains tax from 5% to 12.5%. There has been a slowdown in the sector thus higher taxes is likely to lead to a further decline in revenues.

### → Information and communication

Demand tends to be inelastic thus unlike other sectors, an increase in tax rates has historically led to an increase in revenue. This year the taxes haven't been increased in the sector.

### → Manufacturing sector

The government has increased duty on cigarettes and alcoholic beverages.

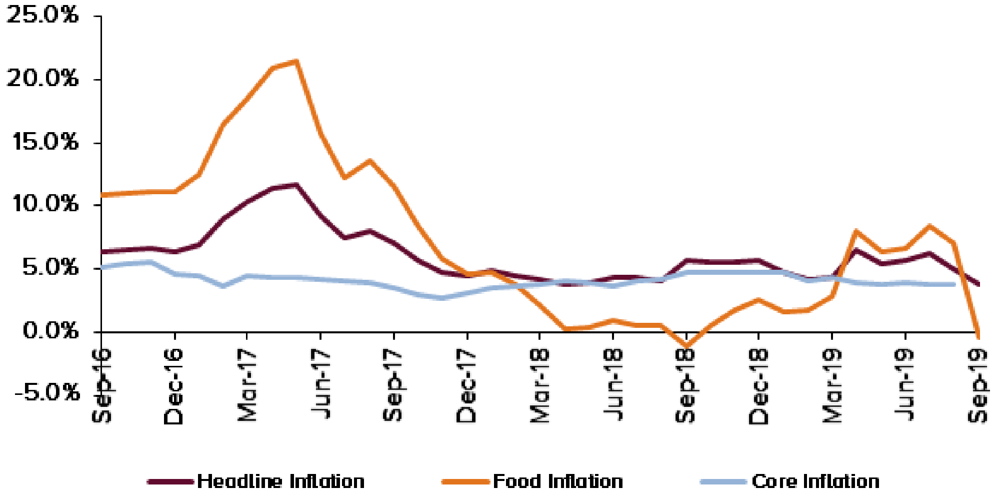
### → Digital economy

It may be difficult for the government to tax income from this source. Special rules may be required to detail the operational mechanics of how the taxation will be undertaken.

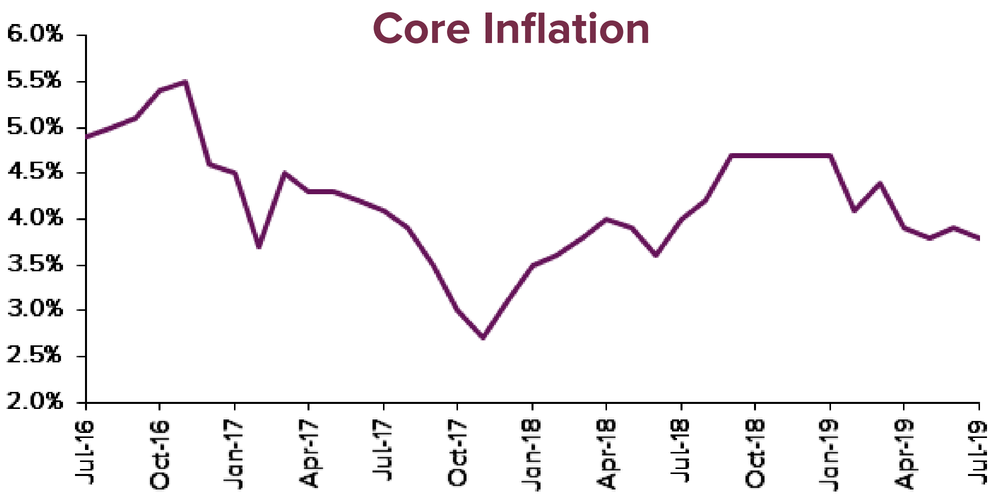
**GDP Outlook:** 2019 growth is expected to come in lower than that in 2018. The World Bank forecasts growth at 5.7% while CBK's forecast puts it at 6.0% versus the 6.3% recorded in 2018. This is likely to be driven by a slowdown in the agricultural sector as the country received depressed rainfall during the long rains season.

## Inflation: Low food prices to keep inflation subdued

During the quarter, inflation increased to 6.27% in July then decreased to 5.0% in August before plummeting to 3.8% in September. Food inflation remained subdued during the period while core inflation remained below 4%.




**Core inflation remains muted due to subdued demand:** Core inflation has remained below 5% since May 2016. It has maintained a downward trend since March this year even as private sector credit growth accelerated. This should be a reason for concern as it indicates that demand is muted which will negatively affect economic growth. A more accommodative monetary policy may be needed to stimulate growth.




**Inflation Outlook:** In the 4Q19, we expect inflation to remain subdued on the back of low food prices. According to the Kenya Meteorological department, most parts of the country are expected to receive enhanced rainfall during the short rains season. This should be positive for food production and should keep food inflation subdued

## Currency: Stable shilling as demand pressures subside

The shilling has come under pressure since June as demand for the dollar increased. During the quarter, CBK supported the shilling by mopping up excess liquidity and selling dollars into the market (decreased the Bank's forex reserves).

During the quarter, the Kenyan shilling lost 1.5% against the USD stand at 103.88. This is attributable to increased demand for the dollar which we partly attribute to the demonetization process that began in June 2019.

### Currency

| | QoQ | YTD | 2018 |
|---|---|---|---|
| USD | -2% | -2% | 1% |
| Euro | 2% | 3% | 6% |
| Pound | 2% | 1% | 8% |

| | QoQ | YTD | 2018 |
|---|---|---|---|
| ZAR | 5.3% | 3.2% | 18.0% |
| UGX | -1.8% | -2.7% | 3.4% |
| TZS | -1.7% | -2.0% | -3.8% |

**Demonetization:** On 31st May 2019, CBK announced that it would be issuing new generation notes and that all the old KES 1,000 bank notes in circulation, valued at KES 217.6 billion, would cease to be legal tender and be withdrawn from the market by 1st October 2019.

| Denomination | Pieces (m) | % of total notes |
|---|---|---|
| 1000 | 193,826 | 80% |
| 500 | 16,769 | 7% |
| 200 | 11,586 | 5% |
| 100 | 12,985 | 5% |
| 50 | 5,305 | 2% |
| 20 | 198 | 0% |
| 10 | 119 | 0% |
| | **240,788** | **100%** |

CBK collected more 97% of the notes in circulation. This is lower than the amount collected by India (in 2016 it withdrew 86% of cash out of circulation in an economy that is close to 90% cash-reliant) which managed to collect c.99% of its demonetized notes in the less than 2 months window that it had given its citizens. CBK can now print new notes to replace the 3% (KES 7.39 billion) of the 1000 notes that didn't return. CBK's liabilities has reduced by KES 7.39 billion thus the Bank can now print new money and circulate it without increasing inflation.

**Balance of Payment:** According to the latest balance of payment figures, the country's overall balance of payment position improved to a surplus of KES 94.5Bn in 2Q19 from a deficit of KES 33.6Bn recorded in 2Q18. This was supported by the increase in the financial account surplus on account of an inflow of the proceeds from the Eurobond.

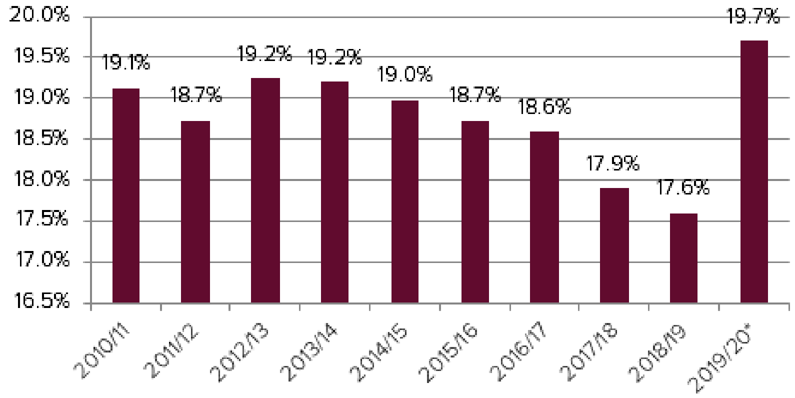
The current account deficit narrowed to 107.6Bn in 2Q19 from 122.0Bn in 2Q18. This was driven by a 1.7% decrease in the trade deficit to KES 272.9Bn in 2Q19 and an 8.1% increase in diaspora remittances to KES 80.79Bn. During the period, the export and import bill decreased by 2% and 7% respectively. We are concerned that the recent decline in the country's import bill may be attributed to delays at the port that has discouraged the importation of goods. This is negative for the economy as it affects producers who might be importing to increase production. A positive decrease in the import bill should come from substitution of products from local manufacturers. Meanwhile, Kenya's reliance on primary commodities has led to a decrease in earnings as global commodity prices decline.

**Currency Outlook:** We view the recent depreciation as temporary and attribute it mainly to the demonetization efforts, thus in October, we expect the shilling to remain stable, and possibly gain some ground against the USD. The main risks to the foreign exchange market in 2019 relate to continued uncertainties in the global financial markets with regard to the pace of normalization of monetary policy in advanced economies especially in the U.S. and the Brexit resolution

## **Fiscal Policy**: *Government is unlikely to achieve its targeted fiscal consolidation*

The government's revenue targets have always been ambitious thus KRA has consistently failed to meet its target. This year is unlikely to be different as revenue as a percentage of GDP has continued to decline while the government has set the current year's target at 19.7% of GDP.

### Revenue as % of GDP




The country's fiscal deficit has increased from 4.1% of GDP in FY 2010/11 to a high of 8.8% of GDP in FY2016/17. This year the government has projected that the deficit will decline to 7.0% of GDP.

### Deficit as % of GDP

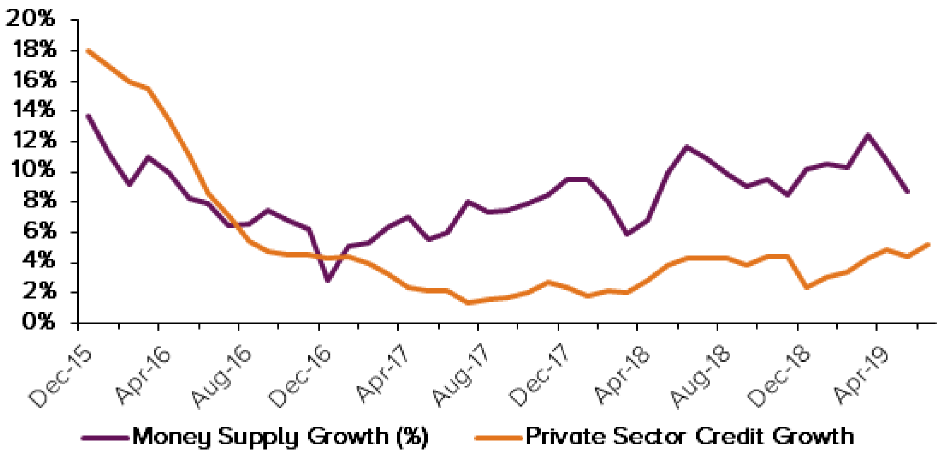

To reduce the deficit, the government intends to decrease expenditure. The measures taken so far include delayed implementation of a number of projects, restrictions on international travel, job cuts, hiring freezes and pay increase restrictions. We, however, don't think these measures will achieve the desired result as revenue is expected to decline thereby offsetting any reduction in expenditure.

## **Monetary Policy:** *CBK should adopt an accommodative policy to support growth*

CBK's Monetary Policy Committee met on 23rd September and elected to maintain the CBR at 9.00% on the back of a stable macro-economic environment. In its statement, the MPC noted that the prospective tightening of fiscal policy would provide scope for accommodative monetary policy in the near term, a possible indicator that they could lower rates in the near term.

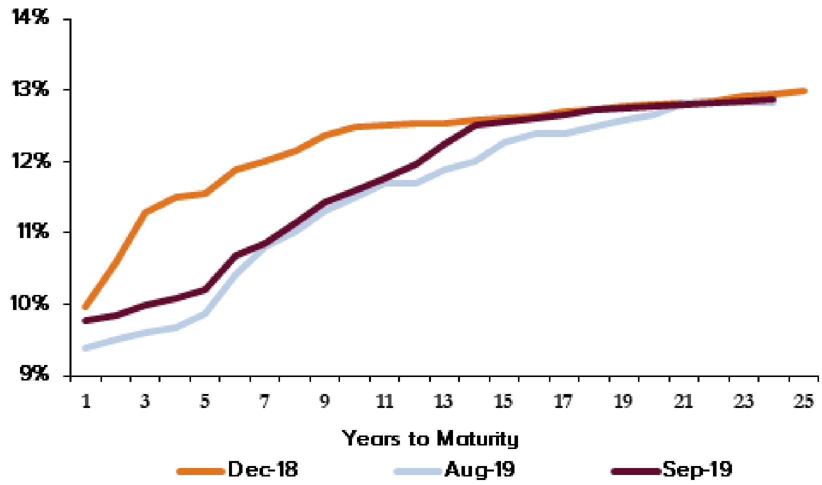
**What does an accommodative monetary policy stance look like in the current rate cap environment?** Under an accommodative monetary policy stance, a central bank reduces its benchmark rate in a bid to stimulate growth. In Kenya, under the rate cap environment, the immediate effect of a decrease in CBR would be reduced credit to the private sector as the lower cap would reduce the risk premium for banks thus increasing demand for government paper. Banks would eventually resume lending to the private sector after risk free rates decline. On the other hand, if CBK was to increase the CBR, this immediately increases the risk premium and would spur the growth of credit to the private sector.

**Private sector credit growth expected to increase:** Although the rate cap is unlikely to be repealed, CBK expects commercial banks to continue lending to the private sector. They have seen an uptick in loans to the Micro Small and Medium Enterprises (MSMEs), a trend that is expected to continue.



## Fixed Income: *Yields to remain relatively unchanged with a downward bias*

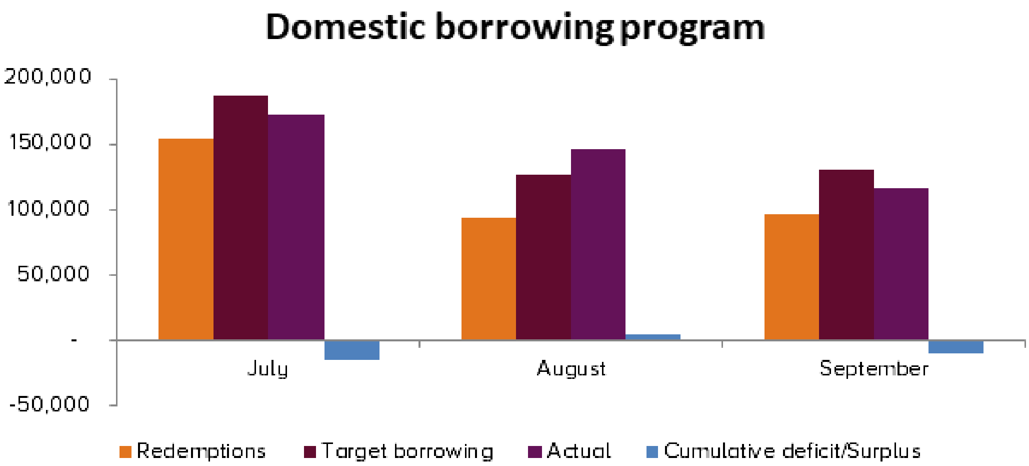
During the month, the stability of the Kenyan shilling during this demonetization period was the focus of CBK. The bank therefore accepted aggressive bids as it sought to mop up the excess liquidity. The short-term yields increased as CBK sought to mop-up excess liquidity. The government delayed payments to counties as it sought to manage the liquidity position.



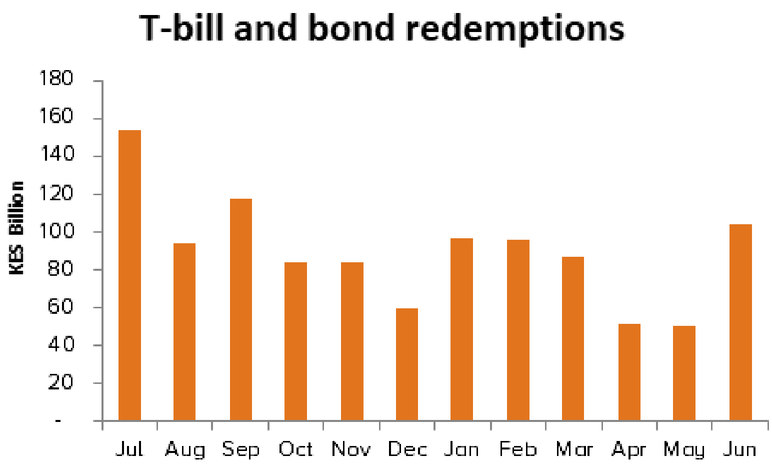

We expect yields to remain relatively unchanged with a downward bias on the back of:

- Elevated Liquidity: Money market liquidity is expected to remain elevated. The government recently disbursed cash to counties which has increased liquidity. High liquidity coupled with commercial bank's relatively subdued private sector credit growth (single digit growth versus above 20% growth in early 2015) should lead to high subscription rates, thereby allowing CBK to reject aggressive bids. This is likely to be on the short end of the yield curve as demand for long term bonds is likely to remain muted.

- Limited pressure on government borrowing program: During the first 3 months of the fiscal year, the government accepted a total of KES 435.3 billion against maturities of KES 345.2 billion, resulting in a net borrowing target of KES 90.1 billion (22% of the target borrowing of KES 397 billion).




According to the budget policy statement the government intends to increase its domestic borrowing target from KES 454 billion from the initial target of KES 397 billion. Given that there are still nine more months left in the fiscal year, this is unlikely to exert pressure on the government's domestic borrowing program. Redemptions during the coming months shouldn't exert much pressure.




➜ A stable macroeconomic environment: During 4Q19, inflation is expected to remain within CBK's target range as food and core inflation remain subdued. Meanwhile the shilling is expected to remain stable as supply and demand remain well matched.

The key risk to this outlook is our expectation of revenue shortfalls that may necessitate an increase in domestic borrowing to plug the gap. However, this is unlikely to have an immediate impact on rates.


**CONTACTS:**

**Research Desk**
Sarah Wanga
wangas@aibcapital.com
(+254) 711047105

Victor Koech
koechv@aibcapital.com
(+254) 711047133

**Equities Dealing**
Bernard Kung'u
kungub@aibcapital.com
(+254) 711047108

Benard Gichuru
gichurub@aibcapital.com
(+254) 711047111

Brian Tanui
tanuib@aibcapital.com
(+254) 711047124

**Bond Dealing**
Crispus Otieno
otienoc@aibcapital.com
(+254) 711047113

Titus Marenye
marenyet@aibcapital.com
(+254) 711047118

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