NCBA

KENYA ECONOMIC UPDATE
JUNE 2022

NCBA

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Executive Summary

- *Global economic prospects have weakened dramatically since November, when we published our 2022 Economic Outlook. The Russia-Ukraine conflict has added a premium on commodities, turned up upward pressure on inflation and in turn accelerated financial tightening by central banks, derailing the recovery.*
- *As a result, baseline estimates now point to a much slower output growth of 3.0% in 2022, a downgrade of 1.5 percentage points from November estimates.*
- *The confluence of overlapping and interconnected shocks have accentuated vulnerabilities for Emerging Markets and Developing Economies (EMDEs). Tighter financial conditions coupled with a strong US dollar are aggravating an already precarious debt situation and undermining the much needed public spending.*
- *The outlook is further clouded by slower global demand, rising domestic inflation and interest rates as well as the persistent global anti-risk sentiment that has resulted in bouts of risk aversion.*
- *The shocks risk setting off another season of credit rating and/or outlook downgrades for EMDEs. Already, double digit yields on international bonds is a red flag for economies with significant external debt maturity concentration over the next two years. The emerging public debt risks may necessitate a new round of debt relief by the IMF, the World Bank and the G20 for vulnerable EMDEs.*
- *In Sub-Saharan Africa (SSA), governments will have to rethink their expenditure strategies as economic shocks crystalize amidst a weakened fiscal backdrop. Public debt has risen sharply over the last decade, compounded by the increase in social spending during the pandemic. About 45% of debt is externally funded and denominated in US dollars.*
- *For Kenya, the economy continues to reveal strong intrinsic vigor supported by sound domestic demand - a resilient consumer. However, the economy will shift to a slower growth gear reflecting headwinds from a weakening external sector, tightening local and external financial conditions, and climate change related shocks, rising commodity prices and the impact of the election related uncertainty on public investments.*
- *To this end, we now expect GDP to expand by 4.9% in 2022, slower than our earlier projection of 5.2%. Policy makers will have struggle to regain control over the inflation narrative given the persistence of supply shocks. At the same time, their responses have to be carefully choreographed to avoid triggering yet another recession but the tradeoffs will be difficult and sometimes, painful, given the limited scope for fiscal support.*

World Economic Update: Russia-Ukraine Conflict Softens Growth Prospects

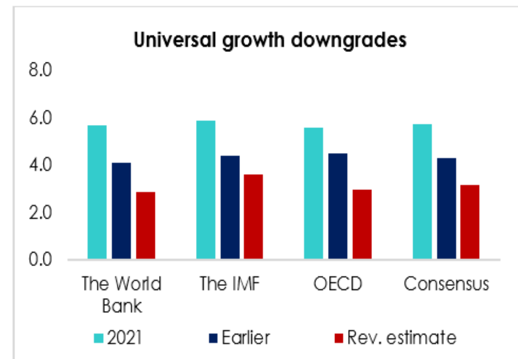
Just six months ago, when we published our Regional Economic Outlook for 2022, the world was on course for a strong albeit disparate recovery from the Covid-19 economic fallout, thanks to aggressive vaccination campaigns and unprecedented support from governments and central banks.

At the time, baseline projections pointed to a 4.5% growth in 2022, significantly above the historical average, the high base of 5.7%, notwithstanding. Then, key risks included high inflation, rising commodity prices and tighter monetary policies, all of which have now crystalized. Moreover, risks of an accelerated pandemic, contagion from china's property market rout and aggravated supply disruptions while present then, were considered moderate.

Increased fragilities

Today, global growth prospects have weakened significantly, buffeted by a myriad of potent and interconnected shockwaves including Russia's invasion of Ukraine, record global inflation and tightening financial conditions. Covid shocks are also still lingering although its effects on supply chains and growth are less severe.

Indeed, faced with these barrage of risks, baseline forecasts have now shifted dramatically to the downside.

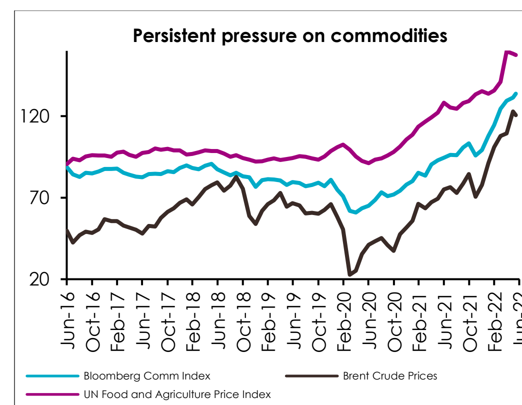


Source: The IMF, World Bank, OECD, Bloomberg

Median projections now place growth at about 3.2% in 2022, nearly 150bps below the initial baseline forecasts. Indicatively, while Russia and Ukraine may not be geographically significant, spillover effects of the ongoing crisis could withdraw over 1.0 percentage point off global growth in 2022.

1.0 Russia-Ukraine Crisis

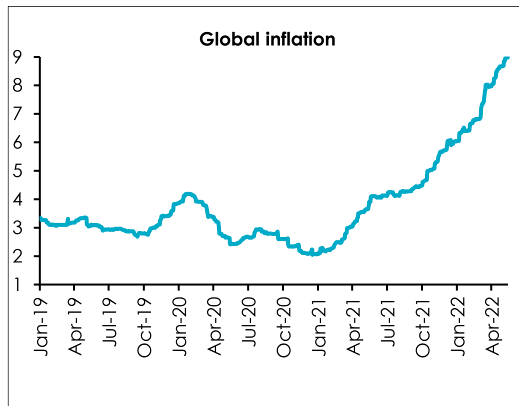
Geopolitical tensions in Eastern Europe, particularly the Russia-Ukraine conflict has added risk premium to commodity prices, which have turned up upward pressure on inflation and accelerated financial tightening by central banks.



Source: Bloomberg

Indeed, whilst the impact is disproportionate, depending on

a country's trade dynamics especially for food and fuel, the inflationary shock is broadly global.



Source: Bloomberg

By all accounts, the war is far-from-over. Whereas Vladimir Putin may have overestimated Russia's military strength, underestimated Ukraine's will to fight back and the West's response, the rest of the world, including Europe has failed to quickly wean itself off Russia, providing fodder for Putin's continued aggression.

That said, we see sustained premium on commodities from the structural shocks from the war.

For energy, the outlook is subject to uncertainty surrounding Russia's oil output – projected to decline by 2Mn barrels/day, OPEC+ production decision and the rate at which the US and other natural gas producers scale up output. OPEC's 0.8Mn barrel/day output increase in July and August, even if upheld, is not sufficient to offset the decline in output from Russia.

So far, global energy inventory levels are low, amplifying the potential for price volatility. We expect Brent prices to average about $115 a barrel in the second half of 2022.

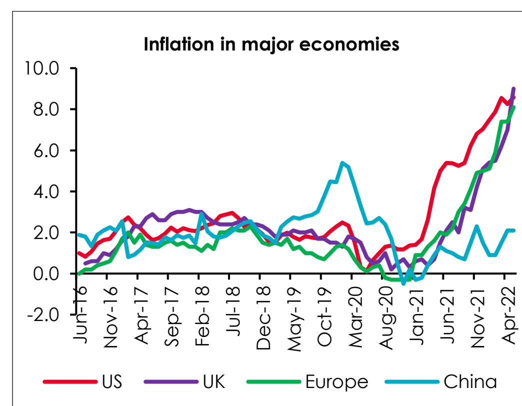
2.0 Covid-19 and Beijing's zero tolerance policy to prolong supply chain shocks

Covid cases are creeping back, although attendant economic fallout is mild, given, the current high global immunity. So far, 61% of the global population is fully vaccinated against the coronavirus.

Even then, Beijing continues to hold a disruptive Zero-Covid tolerance policy, which could prolong supply chain recovery. Considering China's unique role in global supply and manufacturing output growth, Beijing's Zero Covid tolerance policy will remain a source of strain for production and prices.

3.0 High inflation and waning consumer purchasing power

Prices have heated-up across the spectrum driven by the impact of earlier pandemic induced supply chain shocks, return of demand post lockdowns and more recently, the impact of the Russia-Ukraine crisis, which is disrupting the production and distribution of basic foods and energy.



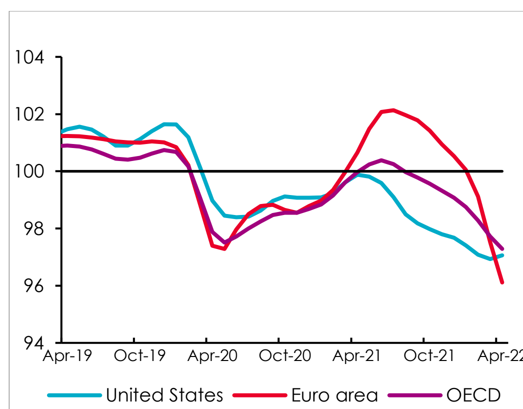
Source: OECD

Evidently, inflation pressures are far from abating. Energy costs are high, food production is under threat from climate related shocks and demand is still fairly strong as global consumption recovery post lockdowns returns.

Elevated inflation is eroding household real incomes, lowering standards of living and consumption, with profound shocks for low income countries, where personal savings are materially low.

The waning purchasing power presents an economic risk in the form of reduced consumer spending but also harbors potential for social instability as frustrations mount in jurisdictions where meaningful fiscal interventions are not feasible.

Waning consumer confidence, a key downside risk for growth



Source: OECD

In advanced economies like Europe, the proximity and reliance on Russia and Ukraine is remarkable. Even as it struggles to wean itself off its dependency on Russia, a prolonged crisis could tip the economy into another recession.

The general uncertainty from the crisis is deterring business investments and threatening to curb supply for years. As energy costs rise, industrial activity is being hurt; consumer spending is also slowing as inflation soars to record highs.

4.0 Central banks are determined to gain control of the inflation narrative – The tightening cycle

The battle for stable prices is proving exceedingly challenging for central banks as a prolonged inflation narrative adds psychological complexities to the conduct of monetary policy – 'de-anchoring' expectations which have feedback loops to consumer behavior.

Central banks are today treading unchartered waters. Persistent supply shocks and the wide spread comparisons to previous inflation eras will certainly make it much harder for central banks to regain control of the inflation narrative.

The firming specter of stagflation is adding to the policy complexities, with a real risk of policy mistakes.

All said, regulators have shown clear intent to fight back inflation by temporarily slowing down demand, through tighter financial conditions.

Expected interest rate changes is 2022

	Size	Current rate
Fed	+200 bps	1.50-1.75%
ECB	+50bps	-0.50%
BoE	+100bps	1.00%

Source: Bloomberg; Fed, ECB, BoE

The US Fed, the global policy leader has already fired at

inflation with 150bps in rate hikes since December of 2021. The BoE has also raised rates by 75bps and the ECB is expected to initiate the tightening cycle in July. As policy takers from the Fed, Emerging and Frontier economies will inevitably have to respond.

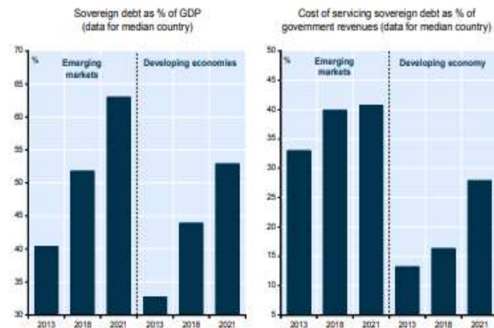
Overlapping shocks for Emerging and developing economies weaken growth outlook

The lethargy from the Russia-Ukraine war is broad-based. Even then, risks for emerging and developing markets are more profound. Persistent supply shocks are driving up inflation, hurting consumer spending and placing pressure on central banks to raise interest rates.

Meanwhile, heavy debt accumulation in recent years and during the pandemic have stretched public sector balance sheets with very little room for new interventions.

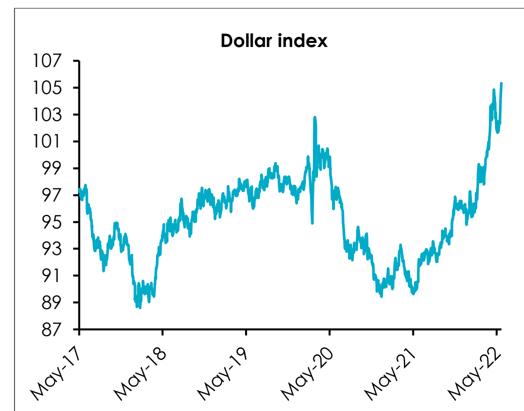
More profoundly, monetary tightening by advanced economies is piling up debt service costs, increasing borrowing costs and undermining debt sustainability.

Most economies will struggle to service external debt in the near term as rising costs inhibit refinancing and new issues.



This comes at a time of immense capital hemorrhage as persistent inflation raises interest rate prospects in advanced markets. The risks are compounded by a strong US dollar.

Greenback appreciation is bad news



Source: Bloomberg

Meanwhile, the Russia-Ukraine conflict has aggravated food insecurity concerns in many countries. At the same time, elevated commodity prices are hurting production, worsening inflation and weakening incomes.

Accordingly, growth in emerging and developing economies will slow down to 3.4% in 2022 from 6.6% in 2021, undershooting the historical average growth of 4.8%.

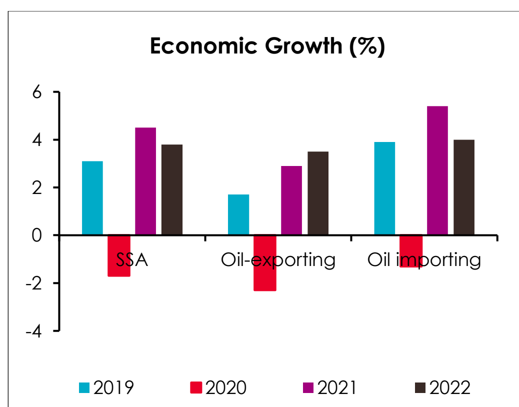
However, we expect the economic performance to diverge sharply across economies. Commodity

exporters will see a near term boost from higher prices although this will be offset by the pain in the over 70% EMDEs that depend on commodity imports.

We expect the combination of risks to set off another season of credit rating/outlook downgrades for emerging and frontier economies. Already, double digit yields on international bonds is a red flag for economies with significant external debt maturity concentration over the next two years.

Sub-Saharan Africa – Another commodity super-cycle or another shock?

Although miles away from Russia & Ukraine, Africa is disproportionately paying the price of the war. The crisis is causing hardship by pushing up the cost of living and compounding food security concerns for the continent.



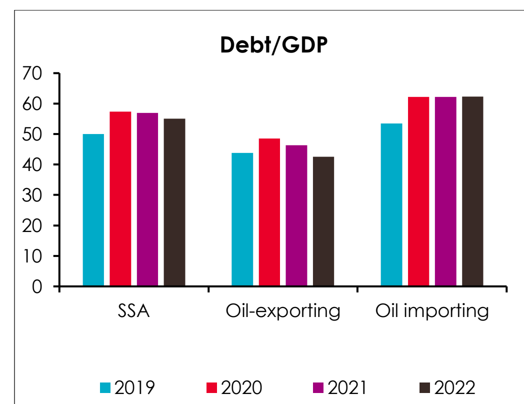
Source: The IMF

Naturally, given the continent's natural resources, the current commodity boon should be adding to the continent's upside. However, the return of the 'Africa Rising' narrative, is evidently farfetched. Despite high prices, poor governance, weak institutions, persistent conflicts and inadequate infrastructure will limit the attendant gains from the commodity super cycle.

On a positive note, the prospect of sustained high prices and the growing need for diversification may ratchet up energy investments in the region. No doubt, the Russia-Ukraine conflict is a rude awakening to economies with respect to sourcing of key commodities. Moreover, the growing need for self-sufficiency among nations will steer a rethink of resource management in the continent.

The debt dilemma

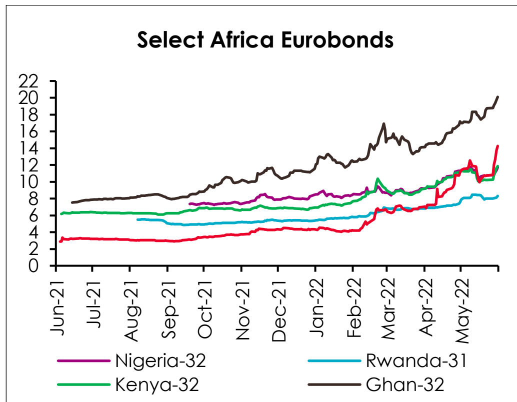
Governments across the continent may be compelled to rethink their expenditure strategies as economic shocks crystalize amidst a weakened fiscal backdrop.



Source: The IMF

Public debt has risen sharply over the last decade, compounded by the aggravated need for social spending during the pandemic. About 45% of the debt is externally funded and denominated in US dollar. The rising yields and US dollar,

therefore, will aggravate debt sustainability concerns for the region.



Source: Bloomberg

A prolonged crisis may necessitate another round of debt relief for the region to avert what seems like growing risks of default in the region. We expect the IMF and the World Bank, and the West generally to take on leading roles on this. We expect some slowdown from the more commercial lenders including China.

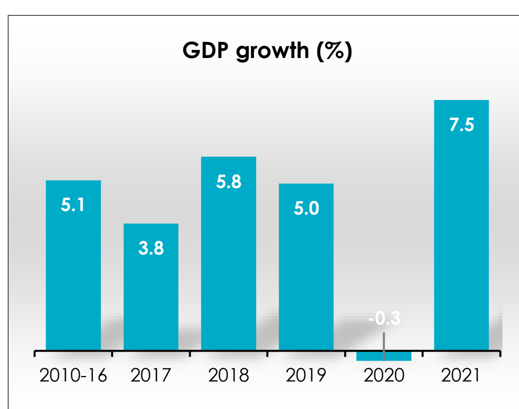
EAC-5 to outperform SSA but growth will be slower.

Kenya, Uganda, Rwanda, Tanzania and Burundi will remain fairly bright spots in the growingly wary global and regional narrative. For the countries the economies are fairly diversified, boats of relatively resilient consumers and will still benefit from the release of consumer and corporate demand pent up during lockdowns.

However, like the rest of the continent, rising commodity prices, elevated domestic inflation, tightening local and domestic credit markets and capital flight present remarkable downside risks to growth. Moreover, debt levels have risen significantly with little to no room for fiscal interventions to cushion economies against fresh shocks.

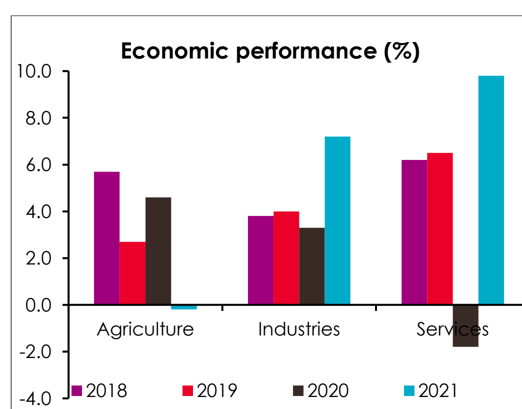
Kenya – Sustained Economic Growth but Heavy uncertainty is Clouding the Outlook

The economy overshot our baseline forecast of 6.5% to deliver a stellar 7.5% expansion in 2021. The performance tracked a waning pandemic over the course of 2021 as increased vaccination and targeted containment measures acted to forestall an escalation of the public health crisis.



Indeed, the recovery, though broad-based was uneven, diverging significantly across sectors. Services took growth leadership, on the back of a low base and upside from increased domestic demand.

Growth across sectors



Source: KNBS, the CBK

The release of pent up demand and easing supply and global supply chain bottlenecks anchored industrial activity in the period.

However, due to poor weather, agricultural output contracted in the period.

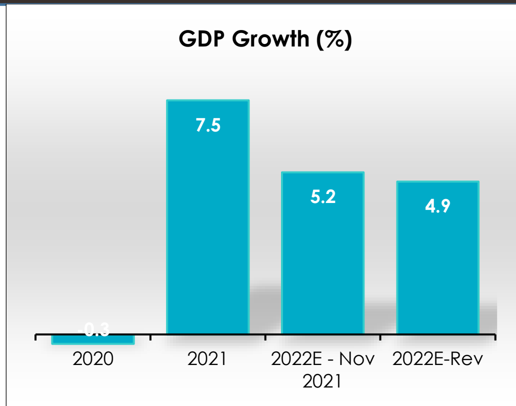
At the same time, healthy public expenditure complimented the gradual return of private sector activity.

Sustained momentum into 2022

Leading indicators including corporate earnings, tax collections, trade activity and even labor markets point to strong domestic demand, underlining the intrinsic economic vigor as the economy re-emerges from the pandemic.

However, with clouds gathering over the economy from the Russia-Ukraine crisis, a weakening external sector, tightening external financial conditions, domestic election angst and climate change related risks, we view risks to growth as tilted to the downside.

As a result, we are downgrading our baseline growth estimate for the year to 4.9% from our 5.2% estimate in issued in November.



Source: KNBS, NCBA Research

We expect the third quarter to withstand the worst of the shocks, aggravated by election related disruptions and lagged effects the Russia-Ukraine crisis, through commodity and credit channels.

Our expectations for the final quarter remains optimistic, buoyed by the prospect of a trend reversal in business investments and consumption post-election.

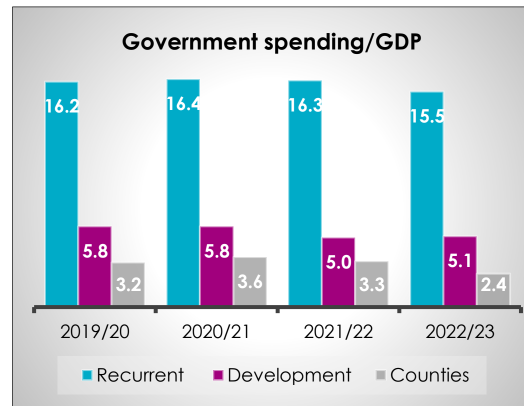
We are optimistic that a peaceful conclusion to the election process will precede strong transition dividends. For now, we believe that the election related premium is exaggerated by the barrage of economic shocks currently underway and an exaggerated political risk calculus based on a "misreading" of the historical record.

True, consumers are a resilient lot in Kenya and are likely to be able to support their consumption. However, potential shocks to income from mounting inflation and prospective job cuts may quickly weaken the prospects.

Key themes playing out

1. Improving but fragile fiscal position

We maintain our view that healthy public spending will remain a key anchor to growth.



Source: The National Treasury

On a brighter note, the fiscal position is improving, placing the sovereign on a path to restore fiscal space necessary for future spending. For the fiscal year 2021/22, we expect revenue collections to slightly overshoot Treasury's initial revenue target of KES 1,800Bn, suggesting that the deficit could narrow much quickly, if sustained.

Collections may improve further with high import bill and shilling depreciation and rising commodity prices. In fact, according to government stress tests for the 2022/23 fiscal estimates;

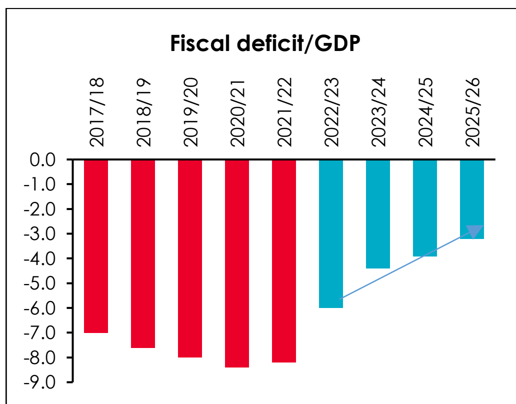
1. A 1.0 percentage point increase in inflation would result in a revenue increase of KES 9.2Bn and KES 6.1Bn increase in expenditure.
2. A 10% depreciation of the shilling to the US dollar would increase revenues and expenditure by 16.4Bn and 3.8Bn

3. A 10% increase in the value of imported goods would increase revenues by KES 9.4Bn, with no material effect on expenditure
4. A 1.0 percentage point decline in GDP growth would reduce revenues by KES 9.2BN and reduce expenditure by KES 5.6Bn
5. All four shocks concurrently, would increase revenues by KES 26.8Bn while expenditures would increase by KES 4.3Bn in 2022/23.
6. On balance, the shocks may result in a much lower deficit than earlier envisioned.

Impact in KES Bn	Rev	Exp	Deficit
1.0% point reduction in real GDP growth	-9.2	-5.6	-3.5
1.0% point increase in inflation	9.2	6.1	3.2
10% USDKES depreciation	16.4	3.8	12.7
10% increase in imports	9.4	0	9.4
All shocks combined	26.8	4.2	22.7

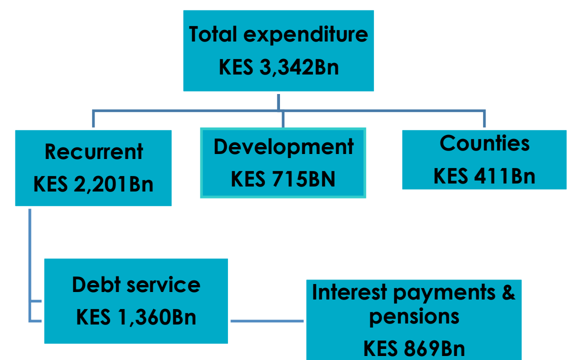
Source: Budget Policy Statement 2022

Fiscal consolidation path

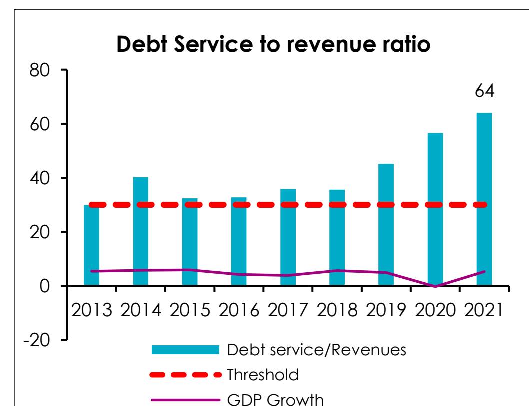


Under the current IMF program, we expect the government to remain on the said consolidation path, barring any material shocks. Moreover, the expiry of fuel subsidy in Q3 will provide more spending headroom. According to World bank reports, its costs the sovereign KES 6.6Bn every month to sustain the subsidy.

However, the deteriorating credit landscape has implications for the quality of public spending. We expect debt service obligations to take up more than 35% of the planned expenditure for FY2022/23 as interest rates rise, both locally and externally. Moreover, a weak shilling will add to servicing costs.

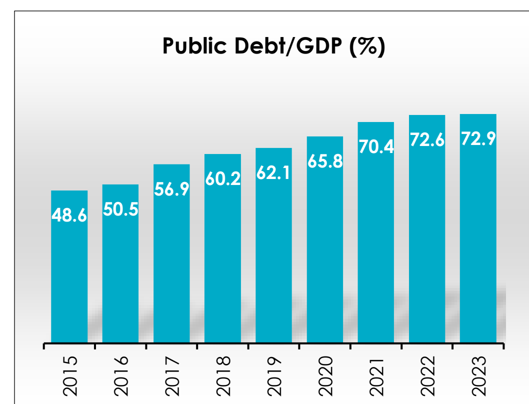


Increasing debt service obligations



Source: Budget Policy Statement 2022

Debt outlook



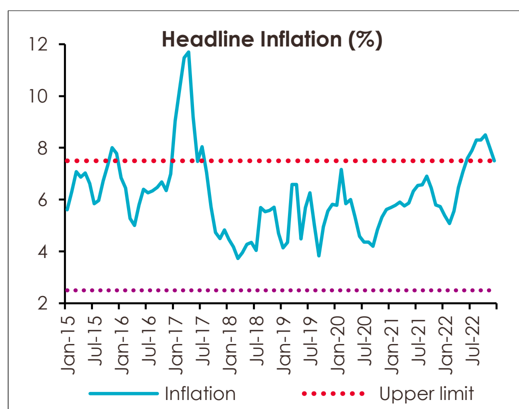
Source: The National Treasury, The IMF

Adherence to the consolidation path will help stabilize debt in 2022. However, the path of public debt remains subject to the evolution of the recent shocks. Any material shocks to revenues may steer government off the consolidation path, given the limited scope to cut expenditure.

2. Rising inflation and interest rates

Inflation has significantly deviated from the initial forecasts, driven by the spillover effects of the Russia-Ukraine crisis.

Price pressures are on the rise locally as food and energy prices hit record highs. With elevated inflation, the prospect of a cost of living crisis has increased. The risk is exacerbated by the growingly slim prospect of government intervention, given the squeeze on public resources.



Source: KNBS, NCBA Research

We expect food inflation to remain in double digits throughout this year, driven by prolonged disruptions in global food supply chains, domestic weather shocks, high input costs as well as rising costs of transportation and value addition.

Energy costs will also remain elevated, as global inventories narrow with reduced supply from Russia. A combination of higher prices and the withdrawal of local fuel subsidy will propel related inflation to double digits. A weak shilling will aggravate the specter of high inflation.

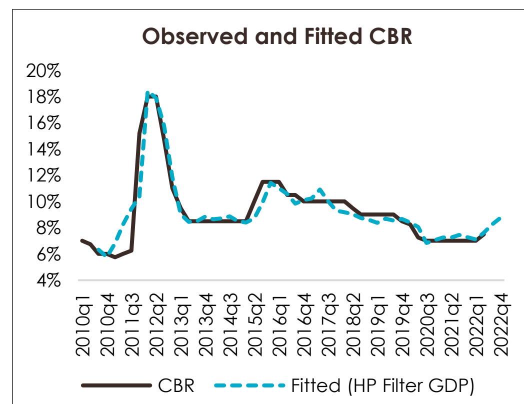
That said, we expect demand pressures to remain muted as inflation weakens purchasing power. Additionally, private credit could also slowdown as the risk landscape deteriorates.

Inflation & CBR forecasts

	Inflation	Rev-I	CBR	CBR-R
Mar-2022	6.0%	5.6%	7.0%	7.50%
Jun-2022	5.7%	7.6%	7.0%	7.50%
Sep-2022	5.5%	8.2%	7.0%	8.00%
Dec-2022	5.5%	7.9%	7.0%	8.50%

Source: KNBS, CBK, NCBA Research

Like its peers globally, the central bank will struggle to regain control of the inflation narrative. Besides the complexities from persistent supply shocks, the regulator is confronted by a rising coefficient of inflation expectations, which has the potential to entrench high inflation.



We expect the regulator to raise interest rates by a further 100bps this year, faster than we initially

projected. Even then there is a fair risk that inflation will remain uncomfortably high through the year.

3. Election related premium

The political event risk of August 2022, remains a top concern for investors. The angst, we believe is inflated by the ongoing confluence of economic and social shocks - Rising cost of living, high energy and input cost, elevated cost of capital, persistent uncertainty in external markets and the sovereign's limited ability to ease the pain for businesses and consumers. That said, we do not expect a structural shift in voting patterns.

Policy continuity?

The race to State House has narrowed to the two main candidates – Former Prime Minister Hon. Raila Odinga and Deputy President, Dr. William Ruto.

Thus far, the narrative from the two candidates has not materially deviated from the priorities under the Vision 2030. Moreover, we believe that the current pressure on public finances will limit scope for material policy shifts, in the near term.

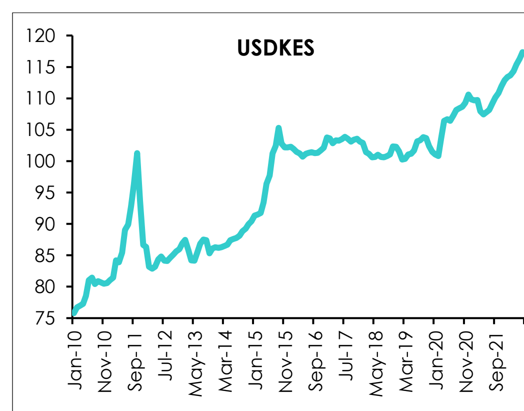
Institutions and the transition

Opinion polls, their accuracy in predicting the final outcome notwithstanding, points to a close contest between the two main parties. This equally raises the probability of a contested outcome.

That said, the Judiciary in 2017 demonstrated sufficient capacity to manage election disputes in a way that limits any disruptions to the economy. With the maturity demonstrated by the leadership and judiciary then, we are confident of a peaceful transition.

The Exchange Rate – The inevitable path

Recent shocks and their disproportionate effects on economies have resulted in immense foreign exchange volatility across the spectrum. The shilling has depreciated to record lows against the US dollar this year, with scope for a further bearish run.



Source: CBK

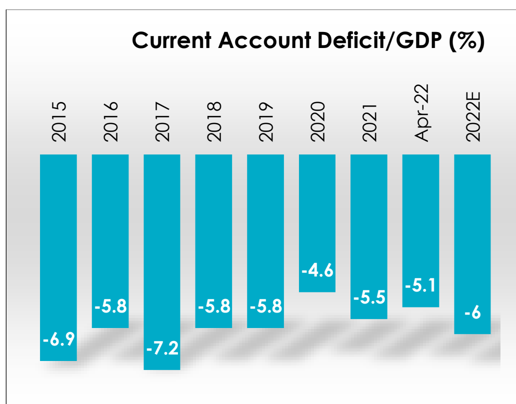
Increased uncertainty

Uncertainty stemming from the Russia-Ukraine war has shifted flows to safe havens, especially the US dollar. This is compounded by the carry opportunity on the greenback – rising yield and strengthening US dollar. In the local markets, foreign investors have withdrawn over US$600Mn in capital so far this year.

We expect the deteriorating sovereign credit outlook,

consistent with other highly leveraged emerging and frontier economies to underpin further capital reversal and diversion away from Kenya, for now. So far, domestic interest rates are still significantly low to attract any meaningful capital.

Similarly, the trade deficit has widened on the back of rising commodity prices across energy, food, metals and general inputs. In Q1 2022, the trade deficit widened by an additional US$570Mn to about US$3.5Bn. We expect the gap to have materially widened in Q2, where the full impact of the Russia Ukraine crisis begins to be felt.



Source: CBK, The IMF

Diaspora remittances have quickly become Kenya's highest source of foreign currency inflows contributing about $4.0Bn annually. Whereas the flows have offered some respite, the deficit in the market is still markedly significant.

Healthy reserves but bigger buffers required

Despite increased volatility, the central bank's reserves have remained above $8.0Bn so far this year, covering over 4.8 months of imports. However, their deployment has been limited by rising external debt service costs as well as challenges in external fund raising, a key source of dollars for the CBK. The current levels of radical uncertainty will require the regulator to maintain a high FX reserve buffer, close to 5.0 months of imports.

Accordingly, we expect the currency to continue adjusting unfavorably to the global shocks.

USDKES	Nov. Est	Rev. Est
Mar-2022	114.00	114.32
Jun - 2022	116.30	117.70
Sept - 2022	117.00	119.30
Dec -2022	117.20	120.65

Source: CBK, NCBA Research

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