REGIONAL ECONOMIC UPDATE MAY 2020

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Executive Summary

Global economic outlook has changed dramatically over the last three months. Earlier optimism from the de-escalation of Sino-US trade tensions has quickly given way to the first black swan in modern history – the COVID-19 pandemic, tipping the global economy into a deep and synchronized recession.

Advanced economies, which had taken over the cyclical leadership of global growth, have borne the brunt of the public health epidemic, which has swiftly morphed into an economic and financial crisis. To be sure, the US, UK, Europe and Japan contracted sharply in the first quarter as prolonged social distancing measures knocked out the steam from services, the bulwark of the economies. Labor markets have remarkably weakened, with the unemployment rate rising to double digits in some of these markets.

Emerging markets, the prior engines of global growth, have to confront a combination of public health risks, weak domestic and external demand, plummeting commodity prices and tight international credit markets. This has complicated policy response in most economies and may therefore aggravate the impact of the pandemic and delay recovery.

The response by governments and central banks in advanced economies is unprecedented. However, the combination of supply, demand and confidence shocks have made it difficult to engineer appropriate policy interventions, away from traditional easing measures. In fact, doubts over the efficacy of the responses have increased and fears mounted over the potential of increased money supply amidst persistent production freeze leading to fresh shocks.

Moreover, the current levels of government deficits have raised fears of a fresh wave of debt crisis especially in emerging markets.

Closer home, Sub-Saharan Africa will slip into its first recession in modern history. More diversified economies that had previously insulated the region from negative growth are now faced with an unprecedented loss in domestic demand as a result of social distancing measures. At the same time, more severe shocks to commodities will further undermine the already precarious state of commodity powered economies.

In this update, we downgrade economic growth for Kenya, Uganda, Tanzania and Rwanda to an average of 2.4% from an early forecast of 6.6% and the pre-crisis growth of 6.8%. The positive growth will mostly be underpinned by sound agricultural output which accounts for a-quarter of the region's GDP. That said, the extent of the fallout will vary depending on the nature of social distancing measures in place, the available fiscal space and efficacy of monetary interventions. For Kenya and Rwanda, higher exposure to external financial markets may limit scope for fiscal intervention leading to deeper output losses.

Even as economies gradually reopen, potential structural shocks from prolonged social distancing measures, loss of demand and weak confidence will make recovery slower and potentially painful.

COVID-19 EXPOSES EAST AFRICA'S VULNERABILITIES AS THE WORLD SLIPS INTO THE WORST GLOBAL RECESSION IN MODERN HISTORY

Introduction

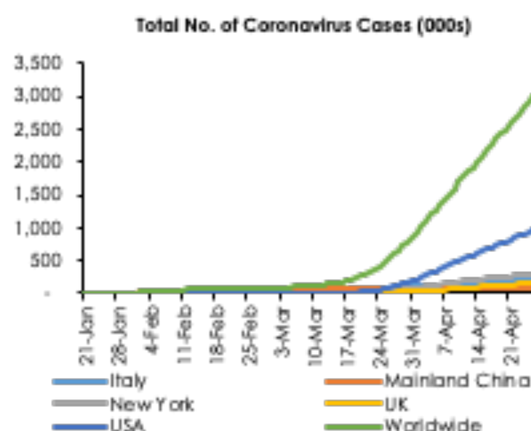
Global economic outlook has changed dramatically over the last three months. Earlier optimism from the late 2019 de-escalation of the Sino-US trade tensions has quickly given way to what may be the first black swan of this generation–The COVID-19 pandemic.

This Coronavirus outbreak, its pace of contagion and the uncertainty over its characteristics and duration has shaken supply chains, global demand, investor and consumer confidence in ways that were unimaginable until a few weeks ago. Public health systems, businesses and economic models are being tested like never before.

Even as economies gradually reopen, after prolonged lockdowns, persistent uncertainty coupled with longer lasting effects of the pandemic will keep the global economy on course for its weakest growth in nearly nine decades. The recovery thereafter, whenever it comes, will be equally slow!

Global epidemiological curve

So far, over 4.013 Million people have tested positive for the virus and fatalities have soared to over 270,000. Just under 1.15Million people have recovered from the virus. On a brighter note, the daily tally of hospitalization and deaths have slowed in current hotspots. However, the global infection curve is far from flattening. As emerging and developing countries enhance their testing capacity, the pace of new infections could remain high.



Source: Bloomberg

While the curve has flattened in China and may have begun to level in Europe and the US, the current hotspots, together with asymptomatic cases remains an epidemiological wild card, with potential to skew perception about actual infectiousness and to reignite contagion.

Recession or Depression? – Depends on severity and duration of crisis and stimulus efficacy

Until recently, most people may never have imagined that a public health crisis could leave a trail of economic and financial disruptions of the magnitude witnessed today.

The COVID-19 outbreak coupled with painful yet necessary measures taken by governments to save lives, including lock downs, have tipped the global economy into a recession, far lethal than the financial crisis of 2008/09.

The IMF estimates that global GDP will contract by 3.0% in 2020. This is subject to uncertainty over the duration of the pandemic and effectiveness of policy responses.

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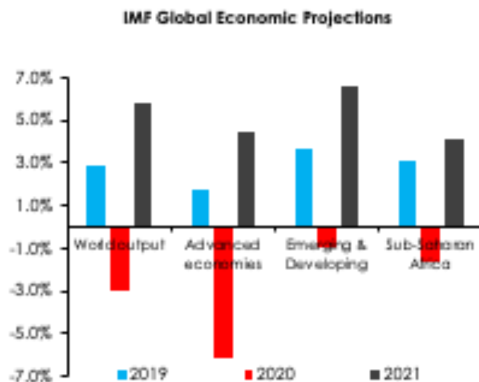


Source: The IMF

A prolonged crisis and ineffective policies, according to the IMF, could reduce global GDP by up to 8.0% this year. Governments and central banks have launched record stimuli to shield their economies from the unprecedented shocks. While these interventions may not avert a recession in 2020, they will minimize the second-round effects of the crisis and buttress a quicker recovery.

Industrial output crippled by weak demand and supply chain disruption

Preliminary data is already revealing a disastrous hit on consumption, factory output and employment across the world. The near-term negative effects of contraction in new orders, persistent supply chain disruptions including record lead times as well and reduced staff head count on manufacturing are severe. This has been exacerbated by lagged effects of the 2018-19 trade wars.

Source: JP Morgan, Bloomberg

Whereas, there are some green shoots out of Asia, with the gradual re-opening of factories in China, productivity shutdown in other countries and the potential shifts in consumer behavior post covid-19 will delay the return to normal in the export driven economy. In some estimates, we only get a 90% economy back!

Services worst hit by the pandemic and resultant social distancing measures

The once-buoyant consumer, the driving force of most developed markets is looking more vulnerable as wealth and disposable incomes shrink amidst record global labor and stock market losses.

Moreover, containment measures including government mandated closure of non-essential businesses has meant harsh and immediate shocks to some businesses especially in the hospitality sector.

The degree of damage to the global economy is becoming apparent. China, which was first hit by the virus, and where response was much faster, contracted by 6.8% in the first quarter following a double-digit slump in retail sales, industrial production and fixed investments. The US and Euro area GDP also contracted by a record 3.5% and 3.8% respectively in the period.

More pain for merchandise trade as global supply chains, demand slumps

Additional strain for global trade from the unprecedented supply chain disruptions is already unfolding. The impact of the Covid-19 pandemic on global trade volumes will exceed the drag brought on by the global financial crisis of 2008/2009.

The World Trade Organization estimates that merchandise trade, which was already dampened by the recent surge in protectionism, will plummet by between 13% and 32% in 2020. The double digit decline in volumes will be synchronized across all regions but most profoundly in Asia and North America.

The slump in trade volumes may be aggravated by a strong US dollar.

Source: Bloomberg

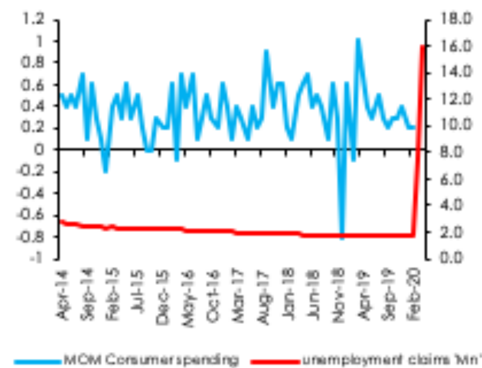
Traditionally, there has been an observed negative correlation between global trade volumes and US dollar movements as approximately 80% of global trade is denominated in US dollars. The US dollar index rose to a three-year high in April bolstered by its safe haven appeal – liquidity and flexibility.

US most hit by abrupt stoppage as consumer spending nose-dives

About 33% of the current global COVID19 count is in the US.

This has meant tougher containment measures and stronger policy interventions to minimize the health and economic fallout.

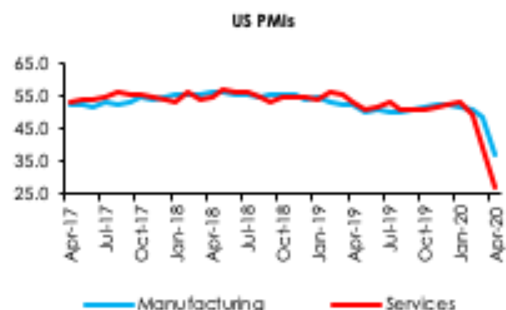
Preliminary data from the US reveals a hard landing for the economy. So far, the world's top economy has lost about 23 million jobs, equivalent to 6.7% of the entire US' population. Moreover, the quick substitution of labor with technology suggests that some job may be extinct when the pandemic is finally over.



Source: Bloomberg

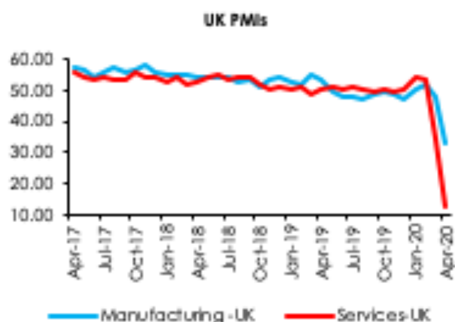
While the government has rolled out measures to support households and businesses hurt by the pandemic, it is obvious that consumer spending which accounts for about 75% of the economy will remain weak. This means a generally slow uptick in activity and labor markets.

Industrial and manufacturing PMI are at record lows and business confidence remains significantly weak.



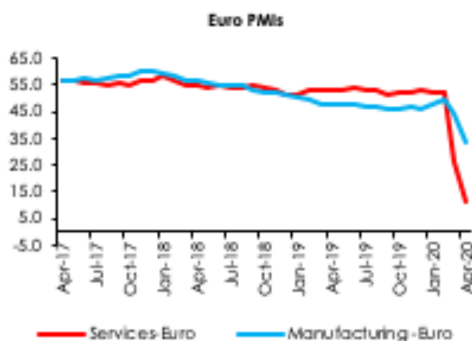
Source: JP Morgan, Bloomberg

In the UK, early indications suggest that GDP could fall as much as 7.5% in 2020. Consumer confidence is at record low, manufacturing, production, constructions have contracted at unprecedented pace due to the lock down and trade balance has considerably widened.



Source: JP Morgan, Bloomberg

Europe, which was already in a fragile state, is expected to record its worst recession in years as the region battles the worst of the virus.



Source: JP Morgan, Bloomberg

The economies that are dependent on exports to Asia are expected to bleed most among the advanced economies. This is compounded by delayed response to the pandemic and pre-existing structural economic challenges.

The scale of the necessary interventions to leave most economies especially emerging and developing economies vulnerable

'Experiments' during this pandemic have not been limited to a search for cure or/and vaccine and nationwide work from home arrangements. Faced with a situation with no modern precedent, policy makers have also been pushed into unchartered waters as they explore economic and behavioral measures that will minimize the amplitude of the human and economic fallout from the COVID-19 pandemic.

In addition to unprecedented countrywide lockdowns, governments are increasingly squeezing their fiscal space, already weakened by record debt levels. To this end, the G20 will inject over US$ 5Trillon, in excess of 6.0% of global GDP into their ailing economies. US alone has announced a rescue package of over $2trillion that would widen its deficit to about 15% of GDP according to the Congressional Budget Office.

Whereas this may lessen the economic fallout in the short term, the long-term fiscal health of many countries will remain delicate. The need to fight the virus, provide disaster relief to persons and businesses and keep aggregate demand as close to potential as possible has narrowed scope for a fiscal retrenchment.

Indeed, responses will be refined and adjusted over time depending on both the pandemic dynamics and better understanding of the virus. On a positive note, should interest rates remain lower for longer, then public debt may remain sustainable despite the growth in debt ratios.

This may be true for developed markets. For emerging and developing markets, however, the widening of credit spreads, potential increase in domestic interest rates and tighter international credit markets presents a credible risk to fiscal sustainability.

Weak local revenues and the global slump in commodity prices exacerbates this fragility.

For most developing economies, fiscal sustainability may now be solely dependent on debt relief from external financiers and increased support from development partners.

The crisis may lend credence to doubts over monetary policy efficacy

Central banks have ratcheted up their emergency response to the coronavirus recession, wading further into unchartered territory.

In addition to zero interest rates and extended scope of bond purchases, the US Fed in its boldest move yet, has pledged $2.3 Trillion in support of local government on the frontline of health crisis and to prop up small and mid-sized businesses. In UK, the BoE will increase the lending line to the government albeit temporarily to finance its massive COVID-19 spending plans, in some form of monetary financing.

As central banks fire away their limited firepower, the efficacy of monetary policy will be further tested during this crisis. For sure, stimulating demand amidst weak confidence and prolonged production freeze and unemployment will be challenging. For most consumers, spending may remain limited to essentials, until confidence is significantly restored.

All said, sustained productivity freeze due to quarantine measures might limit the impact of the fiscal and monetary bazookas being fired at the crisis. While this may limit the second-round effects of the pandemic on the global economy, questions are emerging on its potential to fuel inflation.

Unexpected geopolitical twist - China at risk of global isolation

Undoubtedly, the collaborative front forged in 2008/09 as the global economy teetered on the edge of the abyss helped minimize the fallout from the crisis and accelerated the recovery. However, today, this erstwhile cooperation has given way to competitive global politics with regards to governance.

This has been aggravated by the fact that the pandemic outpaced the international response capacity leading to disjointed and disruptive measures by individual countries in an effort to curb the spread.

Growing mistrust amongst nations may aggravate the already fragile global governance structures. The ongoing mutual criticism between Washington and Beijing risks aggravating trade tensions, even as the pandemic strains commitments under the December deal.

As the "World" blames China for missteps that led to the pandemic, China has touted its initial success at containing the virus as proof of the superiority of its authoritarian governance structures, a position that Donald Trump's (mis)management of the crisis might have lent some credence to.

Further, China has been using its earlier experience to offer public health advice and sending medical equipment and expertise to countries that need in need.

That said, the outbreak has amplified concerns about the global supply chain's reliance on China, a risk already exposed by the recent trade wars. This has seen a considerable inward shift by governments. Even though, assuming that consumers remain rational, China may still have an edge in global supply. A material weakness in the Chinese economy could reduce its global influence on governance.

For now, however, the greatest risk for China today is the prospect of isolation. The pandemic is reshaping global alliances which has once again proven to be a major economic and political risk to many countries.

COVID-19 - Another existential threat to the European Union?

The fragile European Union faces increased disintegration risk given its failure to quickly respond to requests for help by some member states and the disharmony that may have delayed a coordinated response to the pandemic notably Italy.

At the same time, the different degrees of economic fallout have highlighted the uniqueness of the economies and the need for personalized policy responses to crisis. A persistent standoff between a camp of financially ailing southern European Union states led by Italy on one side and the Netherlands acting as the bulwark of the fiscally conservative north on the other, may have to some degree worsened the human and economic losses from the pandemic.

These developments may in future increase demands for independence, further testing the sustainability of the cohesion. The crisis may raise dissatisfaction in some lower income countries with potential for regime change.

In emerging and developed economies, the pandemic may also instigate regime change as socio-economic vulnerabilities aggravate the loss of confidence in some regimes.

Meanwhile, the management of the pandemic will be a key factor in US politics and may be a make or break for the Trump administration. The economic fallout, though not due to economic mismanagement may be costly for Mr. Trump's re-election quest.

Emerging and developing markets – health impact may be limited in some countries but economic pains will be dire

Emerging economies which have been the engine of global growth in the post financial crisis era will contract for the first time in decades.

Source: The IMF

Shocks from the COVID-19 pandemic are proving severe and could be longer lasting. No doubt, policy makers are faced with a daunting tradeoff between health with a weak health infrastructure on one hand and protecting wealth on the other.

Whereas infection rates specifically in Africa have remained relatively low, the economic fallout is already pronounced. However, faced with collapsing exports, dwindling remittances and tightening credit conditions, the economies lack capacity to roll out policy interventions similar to their developed peers.

Preventing a health crisis has taken precedence

While Africa may be behind the curve in COVID 19 infections, there is optimism that the health impact of COVID-19 will be much less than in China, US or Europe. This is predicated on the region's favorable demographics characterized by a youthful population and its geography – warmer weather.

Even then, governments have adopted equally harsh mitigation measures of social distancing some universal and others targeted at isolated subsets of the population.

While this could limit contagion, their economic costs are severe. Economies' operating capacity has reduced, with unprecedented loss in output.

The cost of social distancing is worse in developing markets where the bulk of the population is employed in informal sector and earn daily wages.

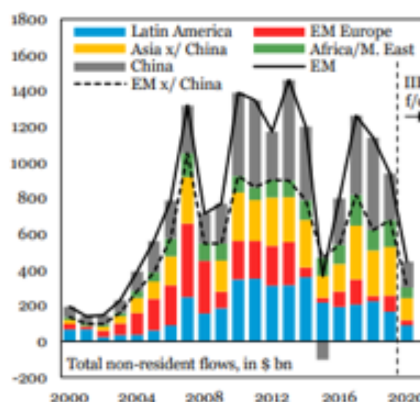
The persistence of social distancing and other mitigation policies and the uncertainty over the duration may amplify the downturn and result in structural shocks that may make recovery painfully slow. Supply chains may be substantially reshaped and efficiencies reduced with the loss of scale. Aggregate demand has weakened beyond the initial supply shocks and financial stability is at stake as households and business struggle to pay debts.

Policy challenges – Limited scope for fiscal policy and effectiveness for monetary policy

Governments across the region face mounting revenue losses amid increased spending pressure and social transfers. This is exacerbated by additional hardships from a sharp decline in commodity prices and capital flows.

Source: Bloomberg

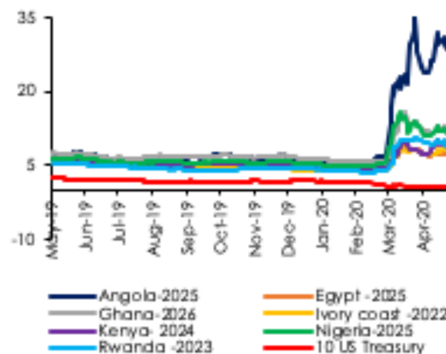
Sudden stop in EM flows -Non-resident flows will fall sharply driven in part by capital flows



Source: international Institute of Finance

While many governments have announced some sort of relief for business and individuals, more is still desired. However, weak fiscal space, challenges around future ability to tax the population and commit revenues to servicing debt is making it more challenging for sovereigns to access international capital markets.

The above speed and magnitude of capital flows signal how difficult it is for governments and corporations to finance their transitory income losses due to the pandemic. The credit spreads tell the story.



Source: Bloomberg

This comes on a backdrop of record debt levels which may make economies even more vulnerable to market disruptions during and after the pandemic.

The pass through from the financial channels

Further shocks to emerging and developed economies stem from the financial channel, as a strong dollar aggravates debt strains in emerging markets.

This has led to a barrage of credit rating downgrades both for sovereigns and corporates across emerging and developing markets. Moody's downgraded South Africa Sovereign credit rating to junk status reflecting continuously deterioration in fiscal strength and structurally very weak growth. Kenya was also downgraded to negative outlook from stable on account of fiscal concerns.

Monetary easing may be less effective

Central banks have within their scope and mandate responded appropriately by reducing interest rates and availing more liquidity to banks for on lending. Others have temporarily flexed restructuring regulation to limit the impact of deteriorating quality of assets on bank balance sheets.

However, the interventions may be less effective given the nature of economic shocks from this pandemic. On one hand, cautious of their ability to service loans and reduced economic activity, borrowers may shelve new credit requests or perhaps limit it to working capital needs. On the other hand, uncertain about the future, lenders will prefer to stay liquid and therefore tighten taps of new credit.

Summary

The COVID-19 pandemic and the resultant social distancing measures have tipped the global economy into a recession, far worse than the financial crisis of the 2007/08.

Governments and central banks have teed up support for the economy through extra-ordinary stimuli. While this is welcome, efficiency in averting a recession or steering a sharp recovery remains suspect.

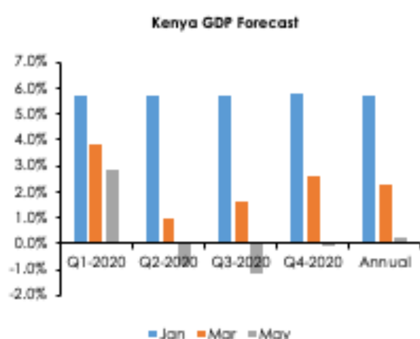
On a brighter note, sentiment initially sparked by the flood of stimulus by global central banks and governments is being further fueled by hopes of a flattening COVID-19 curve as Europe and US report fewer cases of new infection, hospitalization and deaths.

Gradual yet, cautious reopening of economies may set the economies on a recovery path although this may be slow. Investors will remain wary of potential fresh outbreak as governments relax restrictions.

Moreover, businesses that were already fragile may be tipped over the edge and recovery will be long and painful. The potential drastic change in consumer behavior, prolonged social distancing traits post crisis and a slow recovery in labor markets will potentially add to a much slower recovery after the pandemic. The shock on business and consumer confidence may be longer lasting than initially anticipated, potentially precipitating a U or L-shaped recovery in growth.

Kenya - First recession in recent history and a longer road to recovery

As data across the world continue to reveal the severity of the economic impact of the COVID-19 pandemic, we downgrade Kenyan's growth forecast to 0.2% from our January forecast of 5.7% and 2.3% in March. This reflects the unprecedented loss in output as production capacity falls across most sectors as a result of prolonged COVID-19 containment measures.



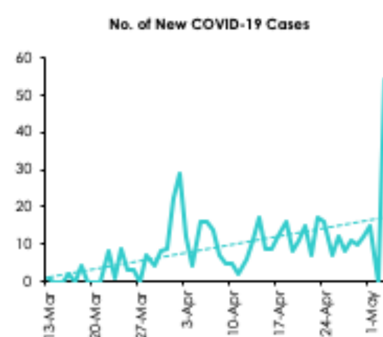
Source: NCBA Research

In a more optimistic scenario, growth could decelerate to 1.5% assuming that the government manages to stem the virus and activity rebounds from the third quarter. However, the pandemic may push the economy into its worst recession since 1970, should the government scale up the current mitigation measures and keep them in place through the third quarter. In this case, growth contracts by 2.4%.

Source: World Bank

Epidemiological evolution uncertain but risks of a health crisis remains

Thscae rate of COVID-19 contagion in Kenya has been relatively slow, according to government's statistics. So far, 700 people have tested positive for the virus with 29 fatalities. 197 persons have recovered.



Source: Ministry of Health, Kenya

Unfortunately, only slightly over 32,938 people have been tested for the lethal virus. Extrapolate this to a larger sample, the picture may be dire. Statistics in Kenya and across the world show that nearly 70% of COVID-19 patients are asymptomatic suggesting that the number could rise exponentially with mass testing.

This is aggravated by challenges in enforcing social distancing measures especially in the crowded low-income settlements where community infections may be unprecedented.

The risk of a health crisis is therefore still profound and may see the government uphold the social distancing rules and travel restrictions in place until testing has been expanded to a sample, large enough to provide some confidence that reopening the economy will not aggravate human losses.

The Economic pains of COVID-19, no sector spared!

As public health takes precedence, the economic tradeoffs are perilous. The pandemic and the horizontal interdiction measures announced by the government to contain the contagion is exacerbating pre-existing economic fragilities. Prior to the crisis, there was significant contention over GDP statistics given the divergence in the output numbers and business earnings and consumer sentiment.

The fallout from the crisis is already apparent across nearly all sectors, whether directly or from second round effects.

Source: Stanbic

To be sure, what was initially a supply shock has quickly morphed into a significant demand and confidence shock. Warnings from the World Health Organization that the worst is yet to come could see the recessionary pressures persist into 2021.

Aggravated fiscal vulnerability to weaken public spending beyond health and social insurance

The significant loss of revenues due to slower economic activity and government tax relief amidst increased spending needs may further weaken the already fragile fiscal standing.

We expect that the fiscal deficit will grow to about 10.4% of GDP representing a 3.0 percentage points increase over 2019. Financing the gap risks pushing debt ratio to unsustainable levels in the absence of an aggressive restructuring of public debt.

Source: IMF

The lack of fiscal space has complicated effective policy responses to the crisis and may result in a slow and potentially painful recovery.

In assessing the severity of the pandemic on the Kenyan economy and the potential geometry of recovery, we look at three scenarios. These are subject to the uncertain duration of the pandemic and the government's capacity to engineer a strong stimulus.

For the Base case – The economy grows by 0.2% after slipping into a recession in Q3

- Current horizontal interdiction measures flatten the curve sooner averting a lockdow
- Policy interventions are effective but effects delayed
- Given the potential socio-economic tensions and the economic fallout, the government starts to cautiously relax local travel restrictions in June.
- Return to normalcy is gradual and social distancing continues to the end of Q3 and potentially the rest of the year
- Some work home arrangements remain to year end or beyond
- Global travel restrictions are sustained and gradually reopened from the last quarter
- Output is displaced with a sharp dip in Q2 followed by a gradual recovery in Q3 and Q4

Most optimistic scenario: GDP growth slows to 1.5% in 2020

- Containment measures are in time and adequate and contagion is quickly disrupted with no risks of fresh outbreak
- The country mirrors China and lifts restrictions as soon as the curve flattens
- Economic interventions are in time and effective in cushioning the real economy averting deeper structural supply shocks
- Consumption and investments are temporarily disrupted in Q2 followed by a quick rebound supported by fiscal and monetary stimuli.
- Some economic losses are longer lasting and pre-existing imbalances delay reversion to the mean.
- Globally, the contagion is arrested and travel restrictions cautiously and slowly lifted.
- Kenya avoids a recession as GDP growth picks up in the third quarter

Worst-case scenario

- Current containment measures are late and fail to arrest contagion
- Social distancing measures are escalated to a countrywide lockdown that is prolonged into Q3.
- Risk of fresh infections delays return to work and restoration of productivity
- Productivity losses are prolonged resulting in deeper structural supply and demand shocks.
- Extended real economy freeze results in longer lasting structural shocks
- Policy interventions are delayed, inadequate and/or ineffective with some missteps
- Easing of travel restrictions measures is followed by a fresh global outbreak necessitating more severe and prolonged containment measures.
- Normalcy is delayed until 2021
- The economy experiences a mild recession as GDP growth falls to -2.4%

Is there scope for further interventions?

For sure, the confluence of risks presented by the pandemic have complicated choices for policy makers. In fact, the effectiveness of the current interventions, a blend of both traditional and unorthodox resz`` `zponses in arresting the COVID-19 induced shocks remains a subject of debate in policy circles, academia and markets.

Although welcome, one strand of literature is arguing that the excessive liquidity provided by both central banks and governments amidst prolonged production shut down could result in a global stagflation. However, for now, weak demand due to heightened uncertainty should keep inflation low wit a fair risk of deflation.

For Kenya, the narrow fiscal space means that interventions beyond public health and social insurance will be limited. This is unlikely to sufficiently compensate for the loss in domestic demand from reduced private sector spending and investments as well as high unemployment.

For the first time in history, government revenues are expected to contract due to the combination of zero or negative growth and the effects of government intervention measures. Unclear of any debt wavers for Kenya, widening the deficit beyond 10% could see debt rise sharply towards 70% of GDP. This may reduce any incentive for government to boost spending in areas beyond social protection.

Monetary policy may have room but intermediation agents may lack scope

Unlike fiscal policy, monetary policy has considerable room to support government efforts in keeping output growth as close to potential as possible.

Weak demand coupled with low fuel prices should offset pressure from potential food supply shocks, keeping inflation within the statutory target band.

Inflation	Jan	Mar	May
Q1-2020	5.1%	6.6%	6.1%
Q2-2020	4.7%	6.2%	5.6%
Q3-2020	6.2%	6.2%	5.7%
Q4-2020	5.7%	6.2%	5.4%
Annual Average	5.2%	5.7%	5.3%

Source: NCBA Research

That said, we think that the central bank will reduce the policy rate by an additional 100bps this year.

CBR	Jan	Mar	May
Q1-2020	8.5%	7.25%	6.1%
Q2-2020	8.0%	6.75%	6.75%
Q3-2020	7.5%	6.25%	6.25%
Q4-2020	7.5%	6.25%	6.25%

Source: NCBA Research

Persistent depreciation of the exchange rate and perhaps some concerns over financial sector stability may limit further interest rate reduction and shift intervention more towards direct liquidity support.

The intermediation challenge

Despite the obvious easing scope, the intermediation agents face increased challenges from the secondary effects of the pandemic and the subsequent interventions by the government.

Today, commercial banks are increasingly exposed to erosion in credit quality that could result in substantially weak balance sheets. The risk to asset quality is aggravated by the growing moral hazard in line with the changes in restructuring and credit bureau information sharing guidelines.

While ongoing loan restructuring may delay the implosion from deteriorating asset quality, prospects of a surge in bad loans and immediate liquidity risks may undermine fresh lending.

As a result, credit markets could tighten further bringing to question effectiveness of any further rate cuts. Private sector credit growth could weaken further and potentially turn negative in 2020. Even then, liquidity provision for banks will be fundamental in minimizing the second-round effects of the crisis on the financial system.

Fiscal dominance to push yields up, further weakening monetary easing transmission

As the fiscal deficit widens and external markets tighten, increased local borrowing will provide liquidity holders with a safer, positive return investment. Cognizant of investor's risk perception, the government is already offering more appealing papers and tenors to attract funds from the market.

As demand for liquidity in banks and businesses increase, competition for available liquidity will inevitably push yields higher. However, we think that despite the fiscal fragilities, adjustment in yields will be somewhat smooth. To this end, we expect the short end of the curve to adjust higher by about 100bps this quarter. As yields rise, banks will have little incentive to lend to the high-risk private sector.

The Exchange rate – shilling losses to accelerate but may be capped under 11- for our baseline case

As the stabilizer between quickly shifting economic expectations, the shilling has weakened sharply since the COVID-19 outbreak as economies seek to maintain some stability.

This reflects a sharp deterioration in dollar liquidity due to dwindling agriculture export earnings, capital flows and diaspora remittances amidst heightened global demand for the US dollar, given its safe-haven characteristics. Equally, with limited restrictions on dividend payment, the shilling's moves may also have been a function of the cyclical dividend payments.

Inflation	Jan	Mar	May
Q1-2020	102.76	102.31	105.50
Q2-2020	103.04	103.41	106.50
Q3-2020	103.29	104.38	106.00
Q4-2020	103.62	105.16	105.80

Source: NCBA Research

Central bank support through deployment of FX reserves has uncharacteristically been low. Persistent uncertainty and lack of clarity on public debt restructuring means that this will remain lethargic in the short term.

That said, given the shilling's historical performance, we believe that the worst should already be priced in and that further losses will be limited. Barring a material shift in COVID-related shocks, we believe that the shilling may stabilize around 106.50-107.50 in Q2 with potential for mild gains in Q3 as economic activity rebounds.

Although subject to increased compliance, exports especially agricultural could start to recover as US and Europe gradually reopen.

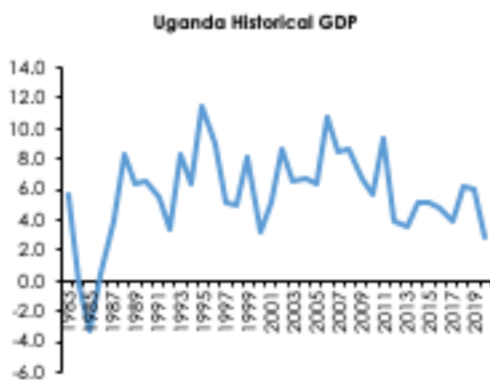
Conclusion

Like the rest of the world, the COVID-19 pandemic has presented Kenya with a public health, economic and potentially financial crisis. Whereas the government and the central bank are stepping up interventions to limit the economic fallout, scope and effectiveness remains arguable. The country is therefore at risk of its first ever recession. The severity will depend on the duration of the crisis, the capacity of the health care system to manage the epidemic and the timeliness and scope of government intervention.

The pace of recovery may therefore be slow given some longer lasting effects of the pandemic and the pre-crisis structural imbalances, now worsened by the pandemic. Moreover, with increased fiscal vulnerability, government spending which has underpinned growth over the last decade will markedly soften. While, technically, the recovery may be sharp, the 'real' reversion to normal will be slow given the risk of fresh or deeper structural imbalances. This could worsen the disparities in growth verses business and consumer sentiment that has typified economic conversation in recent years.

Uganda – Aggressive and extended social distancing policies to weaken output

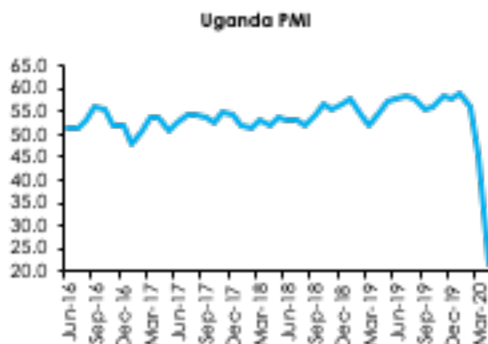
We downgrade Uganda's growth forecast for 2020 to 2.8% from our earlier projection of 5.8% as COVID-19 pandemic and the government's aggressive containment measures weaken domestic demand, investments and exports. This marks the weakest growth since 1986.



Source: World Bank

Spillover effects of public spending which had powered domestic demand have subsided as the government delays project financing in response to the COVID-induced uncertainty. The lockdown has interrupted supply of labor while supply chain disruptions have delayed raw materials for mega infrastructure projects.

At the same time, private investments have lost momentum as uncertainty mounts, business confidence dwindles and credit markets tighten.



Source: Stanbic

Similarly, the ongoing countrywide lockdown has dampened consumer spending occasioning a marked slack in the service sector. So far demand remains restricted to essentials including food and health, and the capacity is suboptimal.

Industries on the other hand remain under the weight of supply chain disruptions, with potentially higher damage for the landlocked Uganda, declining demand both locally and within the regional trade partners especially Congo and Southern Sudan.

On a brighter note, agriculture is expected to steer the economy off a recession supported by favorable weather. However, risks from locust invasion and weaker export markets may reduce the upside for the sector which account for a quarter of GDP.

Fair confidence in the government's aversion of a public health crisis

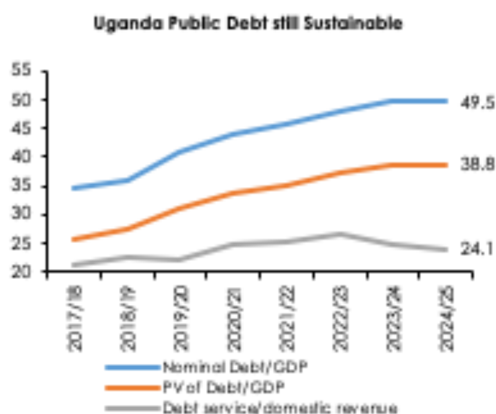
Uganda has thus far reported 97 cases of COVID-19 infections with no fatalities and 55 recoveries. Whereas the testing capacity like for most economies in the region is doubtful, the quick and aggressive social distancing response by the government may help arrest contagion and underpin a quicker reversion to normalcy at least for intercountry activity. Enforcement of social distancing measures have been strict, limiting community infections.

A faster recovery in Uganda will be supported by loose monetary and fiscal policies and public confidence in the government's ability to manage any risks of a secondary outbreak.

Availability of fiscal space and monetary easing scope may support faster recovery

With the viability of earlier tax projections now in question, governments have to mull other policy incentives or increased borrowing to support their economies. Shortfalls due to current lull in economic activity for Uganda will mean that a substantial portion of the recurrent debt may have to be financed through debt.

Current public debt ratio may allow for wider deficit



Source: Ministry of Finance, Uganda

Although rising, Uganda's public debt remains in fairly good shape. As a low-income country, potential debt relief could help the government enhance fiscal space that will allow it reduce its vulnerabilities from the pandemic. This will free funds to help cushion the most vulnerable and enhance public health systems while somewhat cushioning domestic demand.

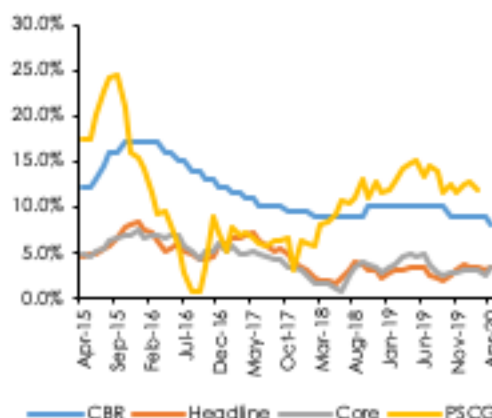
Uganda's fiscal deficit was projected to rise to 8.68% from 6.63% a year earlier, in line with its aggressive infrastructure pipeline in transport and energy.

However, with an average 70% external deficit financing, the souring environment may cause a marked increase in debt service obligations. However, given that 64% of external debt is multilateral and 35% bilateral, negotiating debt restructures without significantly denting her credit profile may be easier than Kenya for instance. Once again, its low-income profile may help, given the global push towards debt relief for poor countries.

However, a strong US dollar heralds some debt servicing pressure. 35% of external debt is denominated in US dollar, which is still fairly significant given Uganda's levels of reserves and persistent balance of payment pressure. Low oil prices may be a welcome respite for balance of payment dynamics in the short run, however this could weaken exploration prospects for its vast oil reserves.

Monetary policy has sufficient headroom and credibility but balance sheet risks may undermine pass through

Predictability of monetary policy and its responsiveness has lent strong credence to the conduct of monetary policy in Uganda. Benign financial conditions have helped complement public investments in stimulating domestic demand. To be sure, private sector credit growth has in the last twelve months assumed the traditional negative correlation between the CBR and growth in lending.



Source: Bank of Uganda

Over the period, the credit risk environment also improved remarkably as the government enhanced its payment of arrears increasing liquidity and bolstering commercial bank's asset quality. NPL ration dropped from double digits to just under 6.0%.

Credit risk is however likely to re-emerge as a challenge to effective intermediation going forward as the pandemic cause unprecedented pace of loan degradation. This could see NPL's increase once again to double digits although this may be subject to Central bank's restructuring guidelines over the year. Even then, the impact of job losses, shift in consumer behavior and supply chain shocks will undoubtedly see a surge in NPLs.

Accordingly, whereas low inflation will provide scope for further easing, it is obvious that growth in demand on this backdrop may be limited.

	Inflation		CBR	
	Jan Est	May Est	Jan Est	May Est
Q1-2020	3.40%	3.00%	9.00%	9.00%
Q2-2020	2.90%	2.90%	9.00%	7.00%
Q3-2020	3.40%	3.40%	10.00%	7.00%
Q4-2020	3.30%	4.20%	10.00%	7.00%

Source: NCBA Research

On a brighter note, enhanced liquidity for banks may limit risks of financial distress as a result of the weaknesses in asset quality.

Currency weakness to limit scope for easing

Whereas exchange rate is not a policy target, its implications for stability and business and economic sentiment in Uganda cannot be gainsaid. This has encouraged a fairly proactive support for the shilling by the BoU in recent years especially through encouragement of cyclical capital flows.

For now, the shilling has come under intense pressure, naturally as a result of a globally resurgent US dollar on safety demands amidst heightened fear of COVID-19 impact on Uganda.

Source: Bank of Uganda, Bloomberg

While the shilling has somewhat stabilized in recent days after the sharp knee jerk adjustment in March/April, it is obvious that it will remain vulnerable to the fragile sentiment. Even then, we believe that the worst should be priced in and movements for the rest of the year should be fairly mild.

Yields remain sufficiently high to support capital flows especially if the flattening of COVID-19 curve in advanced economies is sustained. Some noise will be inevitable but we believe that losses may be capped at 3850 for now.

Tanzania – Limited social distancing measures may have some short term benefit but risks intense public health induced economic crisis

Bold or reckless? Time will tell! As governments mull over which is a better trade off, wealth or health, Tanzania seems more inclined towards cocooning its economy against the evident lethal costs of social distancing.

Despite having one of the steepest curves of COVID infection in East Africa so far and the highest number of fatalities, it remains largely business as usual. Public gathering remains a norm, Churches and mosque remain largely open for community worship and work home arrangements are limited.

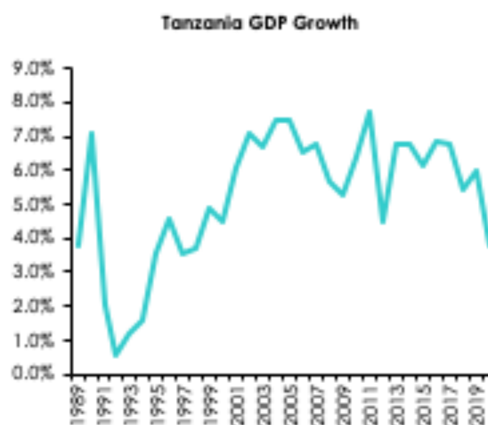
On one hand, should the full potential of the health impact of COVID-19 pandemic, currently unknown, prove less fatal in the region, then Tanzanian administration may be hailed for its bold action that may save the economy and its people from the devastating effects of social distancing

On the other hand, should the effect prove more damaging, replicating the evolution in Italy and US albeit to a smaller extend, then the economic repercussions may be deadly!

Relative resilience but risks tilted to the downside

Limited social distancing policies, steady government spending and strong agriculture output will significantly limit the immediate COVID-19 hit on the economy. However, snowball effects of a global and regional slow down, weak exports, impact of supply chain disruptions and potentially more stringent social distancing measures may trigger a sharper downturn in the second half.

We downgrade Tanzania GDP growth to 3.5% in 2020 from our earlier 6.2% projection in January. While the first quarter is still expected to deliver strong growth, public health concerns may trigger a sharper downturn in the second half of the year.

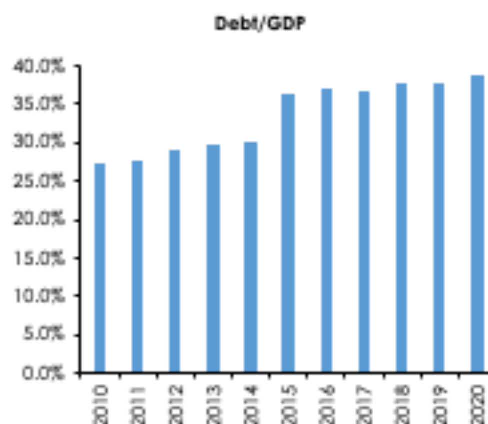


Source: World Bank

Strong fiscal space should allow for sustained public spending

With business largely as usual, the government has made little to no tax concessions to businesses and individuals. This will sustain stable revenues albeit at a decelerated pace given the impact on the expansive hospitality and tourism sector and agricultural exports.

On a brighter note, low public debt ratio should allow the government to run a much wider deficit should risk to growth from an accelerated pace of contagion crystalize.



Source: IMF

Given that mega development projects are financed by bilateral or multilateral debt and should be sustained in the short run. This gives government sufficient scope to ramp up social and economic protection in the event that COVID-19 infections hits crisis.

Government revenues in Tanzania are estimated at 13.8% of GDP of which 10.3% is recurrent spending. Over the last five years, Tanzania has kept the deficit low at an average of 2.8% of GDP.

Whereas increased spending may provide little upside in a lockdown, it should quicken recovery from the expected shocks.

Source: IMF

Monetary policy could support further easing but banking sector fragmentation remains a challenge

Monetary policy has remained largely accommodative. Over the last three years, the central bank of Tanzania has enhanced liquidity support for banks not only by reducing the cash reserve requirements but ensuring continued liquidity support for liquidity deficient banks.

For the central bank, price stability will not be a challenge this year. Sufficient food reserves and favorable weather will keep food inflation muted.

At the same time, the global slump in oil prices promises marked fuel cost disinflation and local demand pressure remain largely subdued.

	Inflation (Rev)	Inflation (Prev)	SMR (Rev)	SMR (Prev)
Q1-2020	4.10%	4.00%	7.00%	7.00%
Q2-2020	4.50%	3.80%	6.00%	7.00%
Q3-2020	4.30%	3.50%	6.00%	6.50%
Q4-2020	4.00%	3.70%	6.00%	6.50%

Source: NCBA Research

This should allow the regulator to ease the policy rate (SMR) further in 2020 to ensure sufficient liquidity for banks. So far, the situation has not warranted the drop but should see some reduction in the June and in the third quarter.

However, a fragmented financial system may limit efficiencies in passing the signals through increased lending. Moreover, increased credit risk and a fairly big legacy bad book will undermine appetite for the private sector in spite of benign financial conditions.

Foreign exchange risks limited for now

Strong foreign exchange reserves, tighter surveillance and margin controls have kept the shilling relatively stable against the US dollar. The currency has also been insulated by its relatively closed capital account, with little outflows relative to its regional peers. This is despite the decline in hard currency liquidity following the slump in tourism earnings due to COVID-19 related global travel restrictions.

On the demand side, global supply chain disruptions have meant slightly muted dollar demand, limiting the current pressure.

Source: Bank of Tanzania

The shilling may depreciate marginally this year as sentiment sour and dollar inflows from tourism, agriculture and remittances plummet.

However, export diversification should induce some resilience in the foreign exchange reserves currently at 6.4 months of imports. Non-traditional exports have seen a considerable surge in the last year, notably gold. After the policy related lull of 2017-19, the government has ramped up exports for the mineral taking advantage of the current heavy global demand and prices.

Relative to its peers, Tanzania's external debt service remains low, giving the central bank the much needed flexibility in deploying the foreign exchange reserves in support of the shilling.

USD/TZS	Previous	Revised
Q1-2020	2306	2306
Q2-2020	2310	2334
Q3-2020	2318	2330
Q4-2020	2330	2325

Rwanda: COVID 19 places sharp breaks on the enviable growth momentum

The global COVID-19 outbreak has brought Rwanda's economy to a standstill. To contain contagion and limit long term structural damages to the economy, the government effected a countrywide lockdown, restricting movement across the country and the border. This has had devastating broad-based effects on the economy. Given the uncertainty of its duration, the economic damage may be dire and recovery, potentially slow. The lockdown compounded the pains from the initial supply chain shocks.

We downgrade Rwanda's GDP growth to 3.1% in 2020, the slowest in 22 years from our earlier forecast of 7.8%.

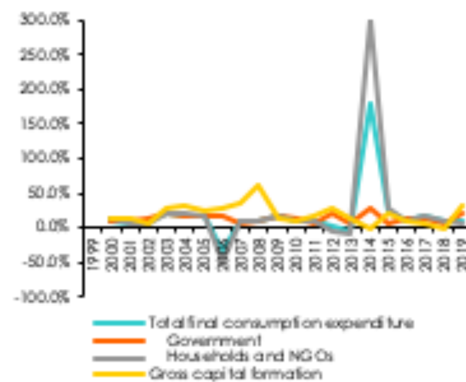
Source: World Bank

Services especially transport, hotels and restaurants, education have been the most affected by the lockdown. Trade has also slowed remarkably consistent with the slump in local and external demand. Trade and services account for 15% and 50% of economic activity, respectively.

Meanwhile, industries' effective capacity has considerably shrunk and will remain a factor of demand, supply chain efficiencies and policy support.

Consumer spending to decline but public spending may provide some cushion

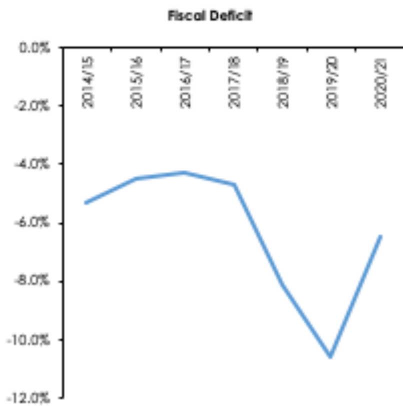
Rwanda economy is primarily driven by household & NGO spending. This may decline appreciably consistent with labor market weaknesses as capacity fall across industries and opportunities for self-employment shrink under lockdown.



Source: National Institute of Statistics

Government spending may offer some respite. The government will temporarily jerk up the fiscal deficit to cushion the economy from the severe COVID-19 induced shocks. Moreover, donor support may increase somewhat with the global efforts to help contain re-infection risks from lower income countries, with weak health infrastructure.

So far the Rwanda has received over $150Mn in aid aimed at offsetting balance of payment pressure, health system capacity upgrade and provision of social insurance for the most vulnerable,



Source: IMF

However, this may present a delicate balancing act for the government given the pass through from the volatile international capital markets. Rwanda has dependent substantially on external financing to finance its deficit. So far, about 85% of the deficit is externally financed.

While donor funding is likely to increase, it remains uncertain whether the additional financing will be able to fully offset the potential gap due to limited access to external debt markets.

Source: Bloomberg

While accelerating bilateral funding may help, the proportionate support may not fully cover the deficit. However, Rwanda stands to benefit from the global push for low income countries' debt relief.

Public debt remains fairly manageable although acceleration towards 50% of GDP may result in significant financial strains in future. Therefore, it is imperative that fiscal rebalancing is tactful to ensure other services, which require marked liquidity support remains crowded in.

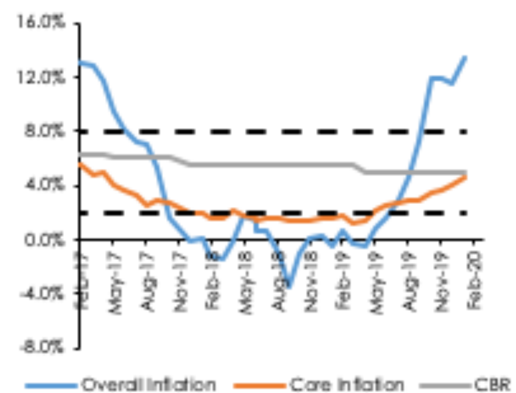
Domestic debt market for Rwanda is still underdeveloped and lacks the scale to finance the government's ambitious development goals.

FDIs have been a significant source of investments for Rwanda. These may loosen as multinationals consolidate operations to reduce solvency risks induced by the ongoing public health crisis.

Monetary easing to provide cushion against short term liquidity support

In response to the COVID-19 economic shocks, the central bank has loosened financial conditions significantly to ensure output growth remains strong and positive and financial sector stability is not compromised.

To be sure, the BNR reduced CBR by 50bps, cut the CRR by 100bps and extended the tenor for liquidity support facilities from overnight to a maximum of 12 months at a base rate of CBR.



Source: National Institute of Statistics

Given the uncertainty over the duration of the crisis and the persistent need for support, the central bank may loosen conditions further later in the year. Inflation has been a challenge but with declining demand pressures, pressure will substantially reduce bring inflation closer to the 5.0% medium term target.

	Inflation (Rev)	Inflation (Prev)	CBR (Rev)	CBR (Prev)
Q1-2020	8.00%	8.70%	5.00%	5.00%
Q2-2020	9.30%	8.50%	4.50%	5.00%
Q3-2020	4.40%	5.60%	4.50%	5.00%
Q4-2020	5.00%	5.50%	4.50%	5.00%

Source: NCBA Research

While this is a welcome respite lending will remain slow. On the demand side, the dearth of economic activity has reduced the demand for loans. Meanwhile, the credit supply agents remain wary of the customer's diminishing ability to serve their loans. This is seen the credit taps tighten, the support from the central banks notwithstanding.

The central bank relaxed the loan repayment conditions to allow banks to restructure outstanding loans of businesses facing cash flow deficits. Accordingly, credit growth could in the near term turn negative aggravating the pains from the covid-19 shocks.

The Franc will maintain gradual depreciation

The central bank will continue to operate a managed-float exchange rate regime. This will allow for a gradual depreciation of the Franc in coming days.

Balance of payment pressures have increased under the current economic landscape. Decline in export earning – tourism, agricultural and minerals, weaker FDIs, remittances and Capital flows has significantly reduced dollar liquidity in the market.

On the flip side, hard currency demand will remain weak due to slack in economic activity. Potential temporary shift from capital intensive project to social support may also weaken public sector demand for US dollars.

This should minimize pressure on the Franc allowing for a mild devaluation. It is important to remember that Rwanda still runs a significant current account deficit. The IMF projects slightly over 600bps widening in the current account deficit to 16.0% of GDP. This should see the Franc depreciate significantly beyond the 5.0% target for the year.

	USD/RWF (Prev)	USD/RWF (Rev)
Q1-2020	949	950
Q2-2020	961	970
Q3-2020	973	990
Q4-2020	980	1020

Source: NCBA Research

NCBA Research

Head Office: NCBA Centre, Mara & Ragati Roads, Upper Hill,

P O Box 30437 00100, Nairobi, Kenya

Direct Line: +254 020 288 4548 or +254 020 288 4725

Email: faith.atiti@ncbagroup.com or stephanie.kimani@ncbagroup.com

Telex: 23205 (COMAFBANK); SWIFT BIC: CBAFKENX; Reuters Dealing: CBAF; Reuters Information: CBAN

Website: www.ncbagroup.com

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