Parliamentary Budget Office
Enhancing the Legislative and Oversight Role of the Kenyan Parliament

Half Year Economic & Fiscal Update, August 2018

This brief is a supplement to the monthly bulletin which details key economic and budget developments in a given month. The half year update gives a more detailed analysis of economic performance in the course of the financial year. It is intended to keep stakeholders especially the legislators updated on the latest trends in the economy.

A season of recovery but corruption a stumbling block...

The first half of 2018 has been a period of recovery for the economy. Good rainfall performance enhanced food production redeeming the country from the drought conditions of 2017. Furthermore, after a season of political uncertainty, the business environment improved significantly leading to increased private sector activity. This is indicated by an increase of the Purchasing Managers' Index (PMI) from 52.9 in January 2018 to 55 in June 2018[1].

Broad macroeconomic stability was also experienced with a low and stable inflation estimated at 4.35 percent in July 2018; a stable exchange rate and improved external position on account of increased foreign remittances as well as increased export and tourist earnings which boosted foreign exchange reserves. This has been instrumental for the second term of the current administration as the government puts in place mechanisms to implement the 'big four' agenda. On the flipside, credit to the private sector remained subdued despite an expansionary monetary policy and has prompted discussions on how to restructure the interest rate capping law.

The government is in the process of implementing the 'big four' agenda, but its success will largely be determined by efficient budget implementation as well as how well we fight corruption

Economic Growth

The economy grew by 5.7 percent in the first quarter of 2018; largely driven by an increase in real GDP growth in Agriculture, Wholesale & Retail Trade, Real Estate and Manufacturing sectors (Table 1). The growth in these sectors is attributed to favorable weather conditions resulting in increased

The economy performed well in the first half of 2018, buoyed by improved performance of the agriculture and manufacturing sectors.

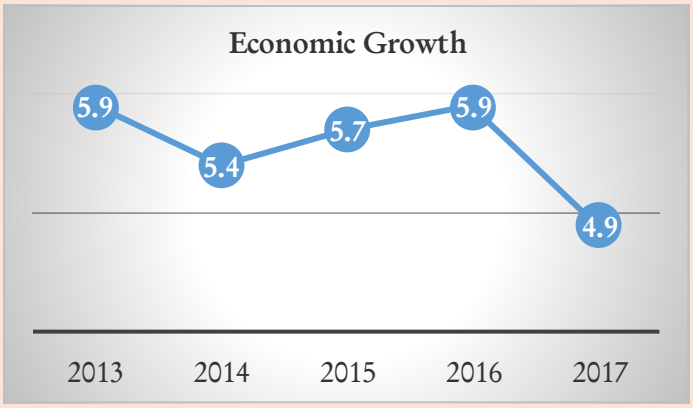
[1] PMI is normally used to monitor performance in the manufacturing sector. An index of above 50 indicates an improvement in business conditions. The data is by IHS Markit /Stanbic Bank Kenya.

agriculture production (tea, horticulture, milk); increased manufacture of food products, leather products as well as galvanized sheets.

In the macroeconomic framework underpinning the 2018/19 budget, it is projected that the economy will grow by 5.8 percent[2] in 2018; a significant increase from the 4.9 percent economic growth experienced in 2017. However, it should be noted that though the macroeconomic fundamentals are poised to remain stable within the year, there are some headwinds which may adversely affect growth. Inflation has remained low and stable since the beginning of the year but may face headwinds from increased electricity tariffs, proposed commencement of the VAT on petroleum products from September 2018, as well as increased oil prices. Foreign exchange reserves have increased significantly, ensuring exchange rate stability but may be depleted on account of maturing debt in this financial year.

Macroeconomic stability is expected to be a key driver of growth in 2018 though there are underlying risks to inflation from increased electricity tariffs as well as increasing oil prices

Figure 1: Trend in Economic growth (2013-2017)



Source: KNBS

[2] Budget Policy Statement, 2018

On monetary and fiscal policy, the Authorities are pursuing expansionary monetary policy as indicated by the recent reduction of the central bank policy rate to 9.0 percent[3] in a bid to stimulate credit expansion to the private sector. However, it remains to be seen if this will stimulate increased lending to the private sector which has remained below target despite a similar move in March 2018 when the Central Bank reduced the policy rate from 10.0 to 9.5 percent. Notably, the interest rates capping law as currently structured remains a challenge to credit expansion to the private sector as banks have become more cautious lenders. As such, the outlook for private sector investment remains uncertain despite the CBK interventions. Fiscal Policy is also on an expansionist trajectory with focus on mega infrastructure projects. Indeed, it is expected that the projected economic growth of 5.8 percent will be driven by increased performance of the agricultural sector, ongoing infrastructure investments as well as manufacturing. Other sectors poised to boost economic growth include the accommodation and restaurant sector particularly in the last quarter of the year due to a likelihood of increased tourist arrivals based on seasonal patterns as well as a somewhat improved security situation.

Credit to the private sector has continued to underperform despite lowering of the Central Bank Rate

There are significant downside risks which may impede performance in each of these sectors. In the agriculture sector, risks emanate from the invasion of army worms, high cost of key inputs, inadequate extension services, poor infrastructure as well as poor implementation of agriculture projects, which are all likely to negatively affect food production. Poor implementation of projects is indeed a concern that cuts across all sectors including manufacturing and which may affect timely implementation of ongoing infrastructural investments. Therefore, considering all these dynamics, it is highly unlikely that economic growth will reach 5.8 percent in 2018 as

The agriculture sector continues to face challenges from armyworms, high input costs inadequate extension services and poor implementation of agriculture related projects which may hinder the sector's growth performance.

[3] Monetary Policy Committee decision on 30th July 2018

projected by the National Treasury, and we estimate it may average 5.5 percent instead[4].

Table 1: Real GDP growth rates for selected sectors (Percentage)

Sector	2015		2016		2017		2018
	Q1	Q2	Q1	Q2	Q1	Q2	Q1
Agriculture	7.8	4.4	4.5	7.7	1.0	0.8	5.2
Mining	9.1	13.8	5.5	9.1	7.1	6.0	4.5
Manufacturing	2.9	3.0	1.2	4.6	1.3	-0.2	2.3
Electricity & Water	9.8	11.9	10.6	11.8	6.1	6.0	5.1
Construction	12.9	12.2	9.2	7.2	8.2	9.5	7.2
Wholesale & Retail Trade	5.5	4.8	3.5	2.1	4.8	5.4	6.3
Accommodation & Restaurant	-10.5	-1.9	8.2	14.1	24.5	12.6	13.5
Transport & Storage	8.3	9.0	8.8	6.9	9.4	8.0	7.1
Information & Communication	8.9	8.3	10.6	8.9	12.5	10.8	12.0
Financial & Insurance	10.0	8.7	8.8	8.5	5.3	3.5	2.6
Real Estate	6.3	6.9	9.6	8.9	6.1	6.0	6.8
Education	4.4	4.7	5.8	5.3	5.7	5.9	6.7
Health	5.2	6.1	4.1	5.2	4.7	6.7	5.7
Overall GDP	**5.7**	**5.5**	**5.4**	**6.3**	**4.8**	**4.7**	**5.7**

Source: KNBS

GDP growth is mostly accounted for by the accommodation and restaurant sector as well as the information and communication sector.

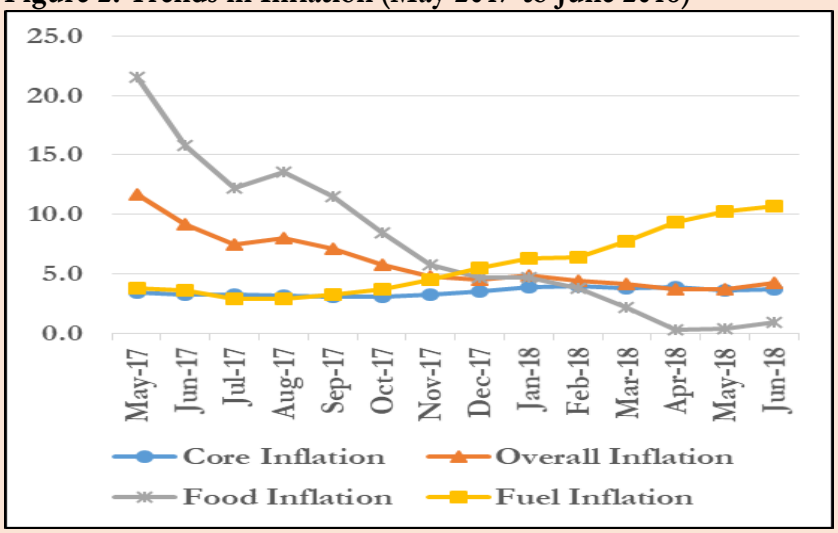
[4] CBK (6.2%), African Development Bank (5.6%), World Bank (5.8%) based on strong performance in agriculture and tourism sectors, increased business investments attributed to a peaceful political situation.

Inflation

At 4.2 percent, inflation has been within target in the first half of 2018. This is mainly attributed to declining food inflation due to sufficient food production and lower food prices in the market. On the contrary, fuel inflation has been on the rise due to increased fuel prices locally as well as internationally.

Inflation remained low in the first half of the year but faced headwinds from high fuel prices

Figure 2: Trends in Inflation (May 2017 to June 2018)



Source: KNBS

In the first half of the year, the largest share of contribution to inflation was by the Housing, Water, Electricity, Gas and other fuels index probably due to the rise in international fuel prices.

Table 2: Percentage Contribution to Overall Inflation

Category	Dec17	Jan17	Feb18	Mar18	Apr18	May18	Jun 18
Food & Nonalcoholic Beverages	38.5	35.7	30.7	17.8	2.1	2.6	6.5
Alcoholic Beverages, Tobacco & Narcotics	1.4	1.3	1.4	1.2	1.3	1.0	1.1
Clothing & Footwear	5.0	5.6	6.3	6.4	7.9	6.8	6.2
Housing, Water, Electricity, Gas and other Fuels	21.4	22.1	23.4	37.0	49.5	54.1	52.1
Furnishings, Household Equipment and Routine Maintenance	4.6	4.7	5.9	5.9	6.5	6.0	5.7
Health	3.5	2.8	2.3	2.3	2.5	2.7	2.7
Transport	11.5	12.4	13.4	12.9	13.9	13.1	13.0
Communication	0.5	0.5	0.7	0.7	0.7	0.7	0.7
Recreation & Culture	0.8	0.8	0.8	0.7	0.7	0.7	0.7
Education	2.3	3.6	3.6	3.6	3.7	3.4	3.2
Restaurants & Hotels	6.8	6.6	6.9	6.7	6.2	4.7	4.3
Miscellaneous Goods & Services	3.7	3.9	4.6	4.7	4.9	4.1	3.7
TOTAL	100	100	100	100	100	100	100

Source: KNBS, PBO

In the second half of the year, the risks to inflation are likely to emanate firstly, from the higher electricity prices on account of the revised electricity tariffs structure by the energy and regulatory commission which has increased electricity bills for a section of consumers. Projects relating to renewable sources of energy are expected to bring costs down within the year but this remains to be seen and will largely depend on how well these projects are implemented. High electricity bills may spill over to higher production costs resulting in a general increase in process of consumer goods across the board. Secondly, the proposed implementation of the 16 percent

VAT on petroleum products is also likely to propel fuel inflation to higher levels especially resulting to increased cost of transportation. On the other hand, there are expectations for reduced oil prices internationally due to increased oil production from Non-OPEC members such as US, Brazil, Canada, Australia, Kazakhstan and the UK.[5]. Thus, the risk of high inflation is likely to emanate from domestic shocks.

Exchange Rate

During the first half of 2018, the Kenya Shilling strengthened against all major currencies; appreciating by 200 basis points, 300 basis points and 400 basis points against the US Dollar, Sterling Pound and the Euro to trade at Kshs/$. 100.8, Kshs/£. 133.5 and Kshs/€. 117.5, respectively. The strengthening of the shilling against major international currencies is mainly attributed to increased remittances as well as improved export earnings from principal exports such as Coffee, Tea and Horticulture due to improved weather performance that boosted production.

The Kenya Shilling strengthened in the first half of the year mainly due to increased export earnings

Diaspora remittances have increased significantly this year, and were estimated at 254 Million US dollars at end of May, 2018 up from 142.4 Million US dollar in December, 2017. The continued rise of remittances is occasioned by global economy recovery especially in North America as well as increased uptake of financial products by the diaspora that commercial banks have developed. The increased foreign remittances as well as the USD 989.8 Million precautionary facility by the IMF (available until September 2018) have significantly contributed to the stability of the Kenya shilling. As at end of June 2018, forex reserves were estimated at USD 8.7 Billion (equivalent to 5.8 months of import cover).

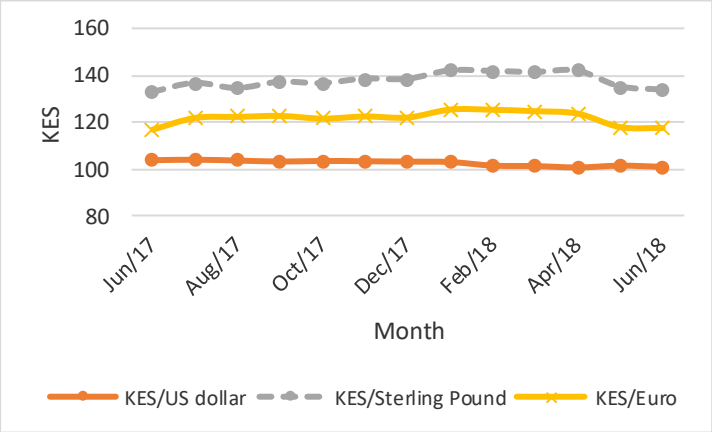
Increased diaspora remittances will continue providing stability to the Kenya shilling but forex reserves may be depleted through debt repayments as well as possibility of higher import bill for government infrastructure related projects

Going forward, it is believed that the Kenya Shilling may come under pressure to trade above Kshs. 102 against the dollar in the coming months. This will be as a result of depleting foreign exchange reserves due to retiring

[5] OPEC Oil Market Report, June 2018

of maturing debts as well as higher import bill on account of government related projects such as SGR Phase II. Kshs. 78.7 Billion for Standard Chartered Syndicated Loan, 78.3 Billion for Sovereign Bond and Kshs. 37.2 Billion for Trade Development Bank (TDB) syndicated loan are expected to mature this financial year along with Treasury Bonds totaling more than Kshs. 150 Billion. In addition, the import bill is likely to trend upwards due to the raw materials the Government requires to fund the huge infrastructure projects. Going forward, there are high chances inflationary risks.

Figure 3: Performance of the Ksh against major international currencies



Source: CBK, 2018

The Kenya Shilling remains stable against all major currencies

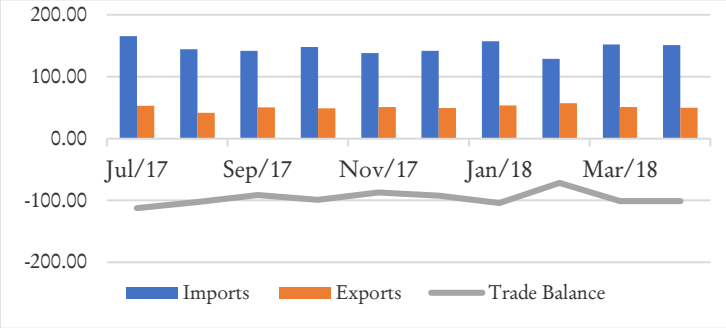
External Sector

The current account balance recorded a deficit of Kshs. 107.8 Billion in the first three months of the year from Kshs. 129.7 Billion the previous year, signaling the narrowing of the current account deficit. This was supported by an increase in export earnings.

The current account balance has improved, mostly on account of an improved trade balance

However, during the second quarter of 2018, there is a likelihood that the current account deficit widened up further due to increase in import bill on account of imports of machinery especially equipment to SGR project and other related infrastructure projects.

Figure 4: Trends in Trade Balance (July 2017- April 2018)



Source: KNBS

The capital account flows decreased by Kshs. 1,522 Million to Kshs. 8,406 Million in the first three months as compared to a similar period in the previous year. The trend is expected to continue as it is occasioned by increased foreign outflows due to high interest payments as the country continues to service its external debts.

Flows to the financial account increased to Kshs. 323,751 Million in the first quarter of 2018 compared to Kshs. 82,745.5 Million in the last quarter of 2017. The financial flows were mainly as a result of proceeds from the Euro Bond. However, in the second quarter of 2018, financial account flows are expected to decrease as the country shall use some of the proceeds from Eurobond to settle maturing debts.

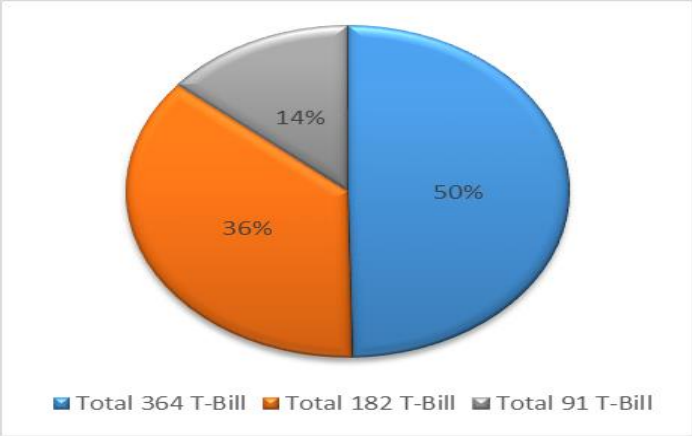
There was increased financial inflows due to proceeds from loans but this is expected to be reversed as interest payments and debt payments kick in

Short Term Borrowing and the National Debt

Between January and June, a total of Ksh. 624 Billion was offered to the domestic market and a positive bid response of Ksh. 869.7 Billion was received. However, approximately Ksh. 677.3 Billion only was accepted, with the 364 T-Bill accounting for 50% of amounts borrowed followed by the 182 days T-bill. It is important to note that the government overshot the domestic borrowing target by Kshs.24.97 billion (actual borrowing of Kshs.273.71 billion compared to a target of Kshs.248.74 billion).

Short term borrowing has helped the government meet its financial needs and is preferred to external borrowing which carries higher risks. However, domestic debt redemptions are slowly increasing.

Figure 5: Composition of Short Term Borrowing

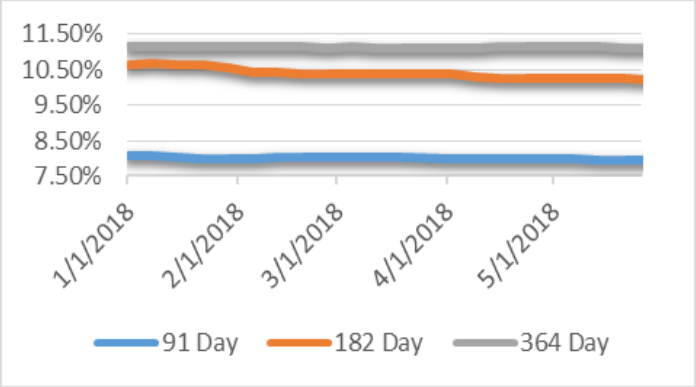


Source: CBK

By June 2018, interest rates for all T-bills continued to decline, reflecting favorable market conditions for government borrowing. The average half year interest rates of 8.08%, 10.33% and 11.09% for the 91, 182 and 364 T bill respectively implying that the rates are well below the risk bands[6] for the FY 2017/18.

[6] For the FY 2017/18 Interest Rates are anticipated to remain stable between 9.32% p.a - 12.7% p.a, 11.93% p.a 13.8% p.a and 13.25% p.a - 14% p.a, for the 91 Days, 182 Days and 364 T-Bills.

Figure 6: 91, 182 & 364 Day T- Bill Interest Rate movement Jan – June, 2018



Source: CBK

By end of June, public debt had reached Ksh. 5.04 Trillion comprising of External Debt worth Ksh. 2.56 Trillion (51%) and Domestic Debt worth Ksh. 2.48 Trillion (49%). External debt is primarily influenced by Chinese related debt that has reached Ksh. 558.8 Billion (rising from Ksh. 80.9 Billion in 5 years on account of heavy infrastructural investments), concessional World Bank debt worth Ksh. 583.2 Billion and debt from commercial banks worth Ksh. 968.9 Billion. Domestic debt on the other hand, is primarily owned by banks (55%) and Non-banks & residents (44%), worth Ksh. 1.4 Trillion and Ksh. 1.1 Trillion, respectively.

The country's external debt comprises of Chinese related debt (Ksh. 558.8 Billion), World Bank debt (Ksh. 583.2 Billion and debt from commercial banks (Ksh. 968.9 Billion).

In the Budget Estimates for the FY 2018/19, total Consolidated Fund Services expenses (mandatory expenditures) have reached Ksh. 962.5 Billion having risen from Ksh. 726.9 Billion in FY 2017/18. This will account for 49% of total revenue and is expected to constrain the resources available for other Government Operations. The growth is primarily influenced by the following debt redemptions to be incurred in the FY 2018/19: Standard Chartered syndicated loan - Ksh. 78.7 Billion, Debut International Sovereign Bond – Ksh. 78.3 Billion, International Development Assistance – Ksh. 14.6 Billion, TDB syndicated loan – Ksh. 37.2 Billion among others.

Total consolidated services account for 49 % of total national revenue primarily due to debt expenses likely to be incurred in the 2018/19 financial year.

Risks to the debt outlook will largely emanate from lower than expected revenue performance amidst expenditure pressures from the ongoing infrastructure projects which could contribute to a widening of the fiscal deficit beyond the planned limits. This is a perennial occurrence which has made it difficult for the country to achieve a lower fiscal target. Any revenue shortfalls are easier met through domestic borrowing because it is relatively low-risk compared to external debt. However, high domestic borrowing also has detrimental effects such as

Risks to debt outlook emanate from revenue underperformance amidst expenditure pressures.

Interest Rates

In the first half of 2018, the Central Bank lowered the Central Bank (CBR) rate to 9.5 percent, denoting an expansionary monetary policy stance aimed at enhancing credit expansion to the private sector. In July 2018, the CBR was reduced further to 9.0 percent. However, the benefits of these reductions are yet to be seen as banks remain cautious about lending to the private sector.

Lending rates are low but this has not increased private sector credit access.

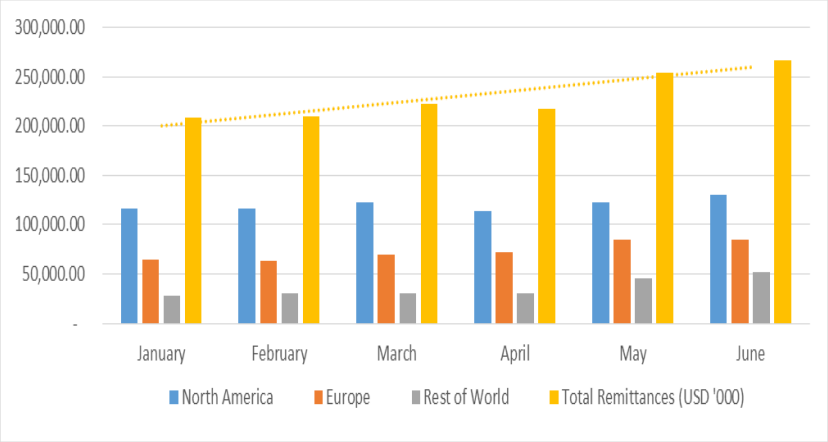
Going forward, ongoing discussions surrounding restructuring of the interest rate capping law should be structured in such a way that will unlock low credit access by the private sector while at the same time protecting consumers from extremely high lending rates which necessitated interest rate capping in the first instance.

Diaspora Remittances

Monthly diaspora remittances have become a critical source of forex reserves, alongside official development assistance, foreign direct investment and export expansion, and are a major stabilizing factor for exchange rate pricing. By the end of June 2018, diaspora remittances continued to show a positive trend and were estimated at USD 266.2 Million (Approx. Ksh. 26.8 Billion) primarily due to increased remittances from Europe (have increased by 30% since January). Europe and North America Accounted for 32% and 52% of half year remittances, respectively. In the coming months, a positive forecast is anticipated. This is however subject to effects of BREXIT, transfer costs and availability of investment opportunities.

Diaspora remittances increased significantly in the first half of 2018 and look poised to increase further.

Figure 8: Diaspora Remittance movement, Jan – June, 2018



Source: CBK

Cash Disbursement to Counties

By the end of June 2018, available statistics indicate that county governments had received the total equitable share amount of Ksh. 302 Billion from the National Government. However, only Ksh. 218.75 Billion had been released to counties by the May 2018, indicating that Ksh. 83.25 Billion was released to counties in the last month of the financial year. Late exchequer releases with a huge lump sum being released at the end of the financial year renders

Delayed exchequer releases to counties are an impediment to efficient county budget implementation.

the budget process unpredictable, leading to poor absorption particularly for development expenditures.

Going forward, delayed exchequer releases may continue to be a risk to county budget implementation particularly if revenue collection underperforms. It should be noted however that counties are also facing internal challenges in terms of incoherent planning and delayed budget preparation and implementation which may hinder service delivery.

Adhering to timelines in the budget planning, coherent and comprehensive planning as well as enhancing Own Source Revenue (OSR) collection may address the challenges faced by counties.

Counties are facing internal challenges in terms of incoherent planning and delayed budget implementation which may hinder service delivery

Fiscal Sector

For the Financial year ending June, 2018 the total revenue collection was Ksh. 172.40 Billion short of target revenue to stand Ksh. 1.49 Trillion. However, this was a slight improvement compared to the previous financial year when total revenue collection was Ksh. 1.4 Trillion. On the other hand, the total expenditures stood at Ksh. 2.11 Trillion which was lower than the target amount of Ksh. 2.33 Trillion and this is as a result of low absorption of recurrent and development expenditures.[7]

Indeed, a review of total exchequer issues to MDAs indicate that Ksh. 240.75 Billion was not released by the end of the financial year in June. This translates to 19.8%, 13.2 % and 5.8 % for the CFS, development and recurrent expenditure estimates respectively that was not released which may be attributed to a slowdown in government activities at the beginning of the financial year due to the prolonged electioneering period. Going forward, the total expenditure is estimated at Ksh. 2.56 Trillion for FY 2018/19 while the target total revenue is Ksh. 1.99 Trillion.

[7] QEBR for the period ending 30th June, 2018

Key highlights of happenings in the Half Year of 2018

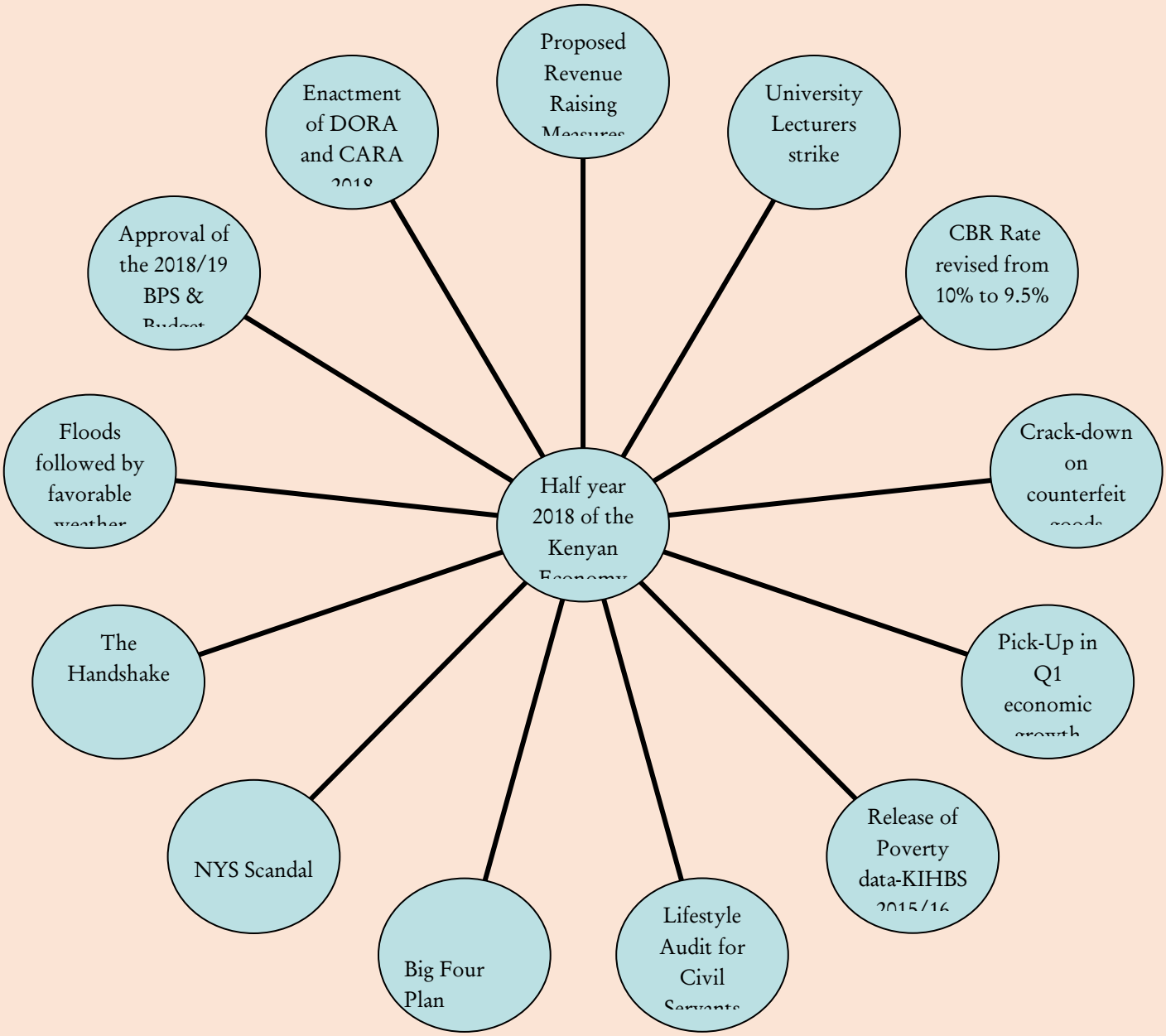


Table 3: Budget Out-Turn for the FY 2017/18 (Ksh. Billion)

	ITEM	FY 2017/18
A	**REVENUE**	**1,487.23**
	Ordinary Revenue	*1,365.06*
	AIA	*122.16*
B	**EXPENDITURE**	**2111.46**
	CFS	*388.99*
	Ministerial Recurrent	*930.60*
	Ministerial Development	483.14
	Net Lending	*2.53*
	County Allocation	*306.20*
	Equalization Fund	*0.00*
	Contingency Fund	*0.00*
C	**DEFICIT (Excluding Grants)**	**-624.23**
D	**FINANCING**	**624.23**
	Grants	*27.60*
	Project Loans	180.81
	Program Loans	*8.52*
	Commercial Financing	*283.84*
	Public Debt Repayment	*-141.53*
	Other Domestic Financing	*2.62*
	Net Domestic Borrowing	*273.71*
	Adjustment to cash basis	*-11.34*

Source: National Treasury