KPMG

Economic Snapshot H2, 2016

Kenya

Inflation – After a five-month long disinflationary trend, which pushed consumer price inflation to three-year lows in May (5% y-o-y), inflationary pressures have increased in recent months. The consumer price index (CPI) rose by 6.4% y-o-y in July following a 5.8% y-o-y increase in June. The food and non-alcoholic beverages sub-index remains the primary driver behind rising consumer price inflation, with the latter increasing by 10.8% y-o-y in July. Furthermore, the CPI rose by 0.6% on a m-o-m basis after increasing by 1.1% m-o-m in June.

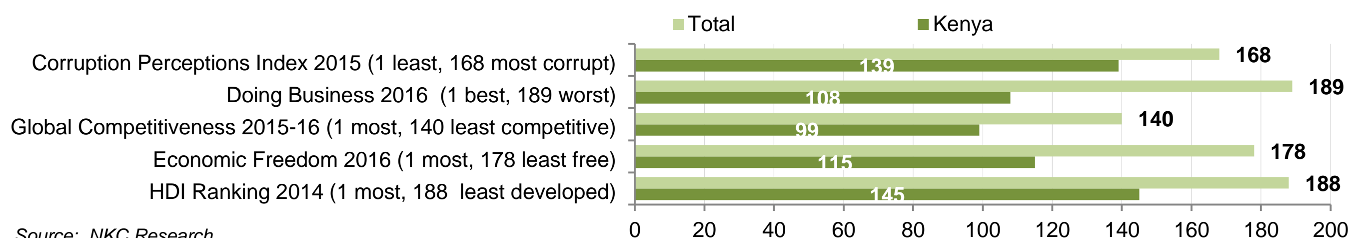
Growth – The most recent figures show that Kenya maintained strong economic growth momentum into the first quarter of this year. The East African nation recorded a 5.9% y-o-y real GDP growth rate in Q1 2016, which is somewhat higher than the 5% y-o-y expansion recorded in Q1 2015. Economic growth was also relatively broad-based, with strong performances in agriculture (+4.8% y-o-y), industry (+5.9% y-o-y) and services (+7% y-o-y).

National Development Plan – Kenya's overall economic policy seeks to address persistent security challenges and infrastructure bottlenecks, while preserving macroeconomic stability. From the fiscal side, this entails substantial infrastructure investment, while the country collaborates with the International Monetary Fund (IMF) in policy development. A key element of this investment strategy involves considerable investment in transport infrastructure in an attempt to consolidate Kenya's position as a regional transportation and services hub.

OPPORTUNITIES	STRENGTHS
The East African Community (EAC) trade bloc has a combined population of over 150 million and a combined nominal GDP of over $100bn.	Kenya plays a central role in East Africa as the largest economy and as a gateway to the region. The economy is diversified and the financial sector is strong, with deep and developed domestic debt markets.
The tourism sector is expected to recover, albeit gradually.	The government has increased efforts to improve the country's security environment, but the risk of terrorist attacks will persist and weigh on security perceptions.
Potentially lucrative opportunities for investment in the services sector (especially tourism, banking, telecommunications, wholesale & retail trade, and business process outsourcing).	A large, highly skilled and educated workforce that ranks among the best in Africa.
Investment opportunities in renewable energy, particularly solar, wind, and geothermal power.	The country is planning to add up to nine solar power plants over the next few years via public-private partnerships (PPPs). Kenya is looking to triple its generating capacity to 5,000 MW by 2030.

VULNERABILITIES	WHAT IS BEING DONE?
Terrorism is the most serious impediment to foreign investment and tourism.	The government has taken drastic steps to address the terrorism issue, which could prove to be counterproductive in the long term.
The economy remains dependent on rain-fed agriculture.	Irrigation infrastructure is expanding, which should reduce volatility in agricultural output over time.
Dependency on hydroelectricity; oil-importing region.	New power plants using a combination of geothermal energy, co-generation, coal, and liquefied natural gas will become operational over the next few years, thereby reducing Kenya's reliance on hydropower.
The country's fiscal position remains a concern, with public infrastructure investment and devolution holding further downside risk.	The government has explicitly committed towards fiscal consolidation. These efforts should produce results over the medium term.

MEGA TRENDS	
Population	45,925,301 (July 2015 est.); Age 15 - 64: 55.6%
Population growth rate (%)	1.9% (2015 est.)
Life expectancy at birth	Total population: 63.8 years; male: 62.3 years; female: 65.3 years (2015 est.)
HIV/AIDS	Adult prevalence rate: 5.9%; People living with HIV/AIDS: 1.5 million (2015 est.)
Adult literacy rate (age 15 and over, can read and write)	Total population: 78%; male: 81.1%; female: 74.9% (2015 est.)
Urbanisation	Urban population: 25.6% of total population (2015); Urban population growth: 4.3% (2015)
Population below national poverty line	43.4% (2012 est.)
Unemployment rate	40% (2011 est.)
Employment (% of total)	Agriculture: 14%; Industry: 20%; Services: 66% (Formal Employment, 2014 est.)
Labour participation rate (% of total population ages 15+)	67.4% (2014)
Business languages	English (official), Kiswahili (official)
Telephone & Internet users	Main lines in use: 85,496; Mobile cellular: 37.7 million; Internet users: 21 million (2015)
Sources: CIA World Factbook, World Bank, Trading Economics, ITU, UNAIDS & NKC Research	



Source: NKC Research

Risk environment / Risk outlook

S&P Global Ratings	Fitch	Moody's
B+/Negative	B+/Negative	B1/Stable

S&P Global Ratings (S&P) affirmed Kenya's sovereign credit rating at "B+" in April this year, while the outlook was maintained at negative – the outlook was adjusted from stable to negative in October last year. According to S&P, Kenya's credit rating is constrained by the country's history of ethnic tensions, low GDP per capita, high government debt, and susceptibility to balance-of-payments pressures. The primary driver behind the negative rating action in October was Kenya's fiscal position, which, according to S&P, is weakening structurally and this will feed through into a mounting debt stock. The agency maintains this view, most recently noting that Kenya's public finances remain weak, with government debt projected to continue on an upward trajectory. That being said, the agency also noted that Kenya's rating is supported by the country's diversified economy with a solid growth track-record, a strong private sector and growing middle class, as well as a large and deepening domestic debt market that benefits from a flexible monetary arrangement.

Fitch Ratings revised the outlook on Kenya's "B+" credit rating from stable to negative in July last year. In mid-July this year, the ratings agency affirmed the "B+" credit rating and maintained the negative outlook. As to be expected, Fitch's statement had a particular focus on fiscal policy, with government finances identified as a key driver behind the negative outlook. The agency noted that public debt is expected to increase, while the government's reliance on expensive domestic borrowing continues to push up financing costs. Other factors constraining Kenya's credit rating include low GDP per capita and poor performances in social and governance indicators. In turn, the country's credit rating is supported by positive growth prospects, with high levels of infrastructure spending and private consumption buoyed by strong credit growth.

Moody's Investors Service affirmed Kenya's credit rating at "B1" with a stable outlook in February this year. According to the agency, the key driver behind the affirmation is the expectation of a solid economic growth performance; while Kenya's sizeable fiscal and current account deficits are projected to commence a narrowing trend during the next fiscal year. With regard to the former, Moody's noted that Kenya is well-positioned to benefit from greater economic integration in East Africa in coming years, further cementing its economic position within the region. In addition, growth drivers will remain broad-based and include continued, albeit declining, public investment spending and productivity gains from the completion of key infrastructure projects.

Infrastruc-ture	Diversity of the Economy	Banking Sector	Continuity of Economic Policy	GDP Growth	Key Balances	Foreign Investment	Socio-economic Develop-ment	Forex Reserves
Weak	Relatively diverse	Relatively well-developed	Good	Strong	Twin deficits	Below potential	Low	Sufficient

Stock Market	Listed Companies	Liquidity	Market Cap	Dominant Sector	Daily Trading Volume
Nairobi Stock Exchange (NSE)	65 (primary listings only)	Liquid in African context	$20.4bn (NSE, August 2016)	Banks; food & beverages	9.9 million shares daily (mid-August 2016)
Capital Market	**Development**	**Liquidity**	**Maturity Range**	**Municipal Bonds**	**Corporate Bonds**
Yes	Advanced in African context	Very liquid in African context	91-day to 30-year	No	Yes

Macro-economic overview

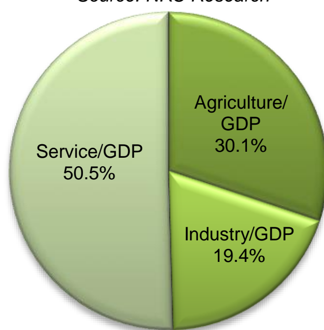
Macroeconomic indicators have generally improved in recent quarters, with the shilling finding some stability, price inflation peaking, and economic growth coming in higher than anticipated. The East Africa region, and Kenya in particular, remains a relatively bright spot in terms of economic growth on the continent, with most other African economies under pressure from structurally-lower commodity prices. Kenya continues to boast a healthy level of foreign currency reserves, debt metrics remain at sustainable levels, and shilling volatility remains limited.

That being said, Kenya's fiscal position remains a cause for concern. Last year saw a marked rise in government borrowing costs (due to tightening monetary conditions) and a rapid depreciation of the shilling exchange rate (significantly increasing the servicing cost of external debt) in the context of an expansionary fiscal policy. The largely expansionary budget for the 2016/17 fiscal year (FY) is somewhat perplexing given the Kenyan government's repeated commitment towards fiscal consolidation and debt restraint. The country's precarious fiscal situation was the primary reason why two of the three international ratings agencies downgraded the country's outlook last year. Progress with regard to fiscal consolidation will be critical to reclaiming government financial management credibility and in easing investors' concerns regarding macroeconomic fundamentals.

The realisation of fiscal consolidation in the context of continued economic growth and the maintenance of other macroeconomic fundamentals will steadily improve Kenya's economic outlook. This will require efficient and prudent financial management by the Kenyan government, which is far from assured given the country's struggle against corruption and poor governance scores. The country's strong manufacturing base and relatively developed services sector will allow the country to take advantage of economic growth in neighbouring countries, thus cementing Kenya's position as the region's dominant economy. Greater

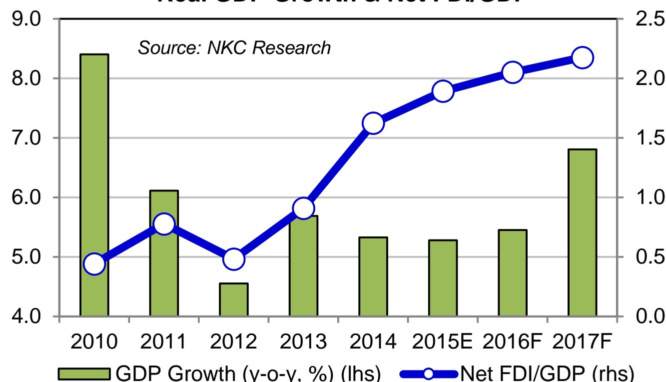
economic integration within the East African Community EAC holds considerable upside growth potential, while the successful development of the domestic hydrocarbons sector could catapult the East African nation onto a higher growth trajectory.

Economic Structure as % of GDP
2015 Estimate
Source: NKC Research

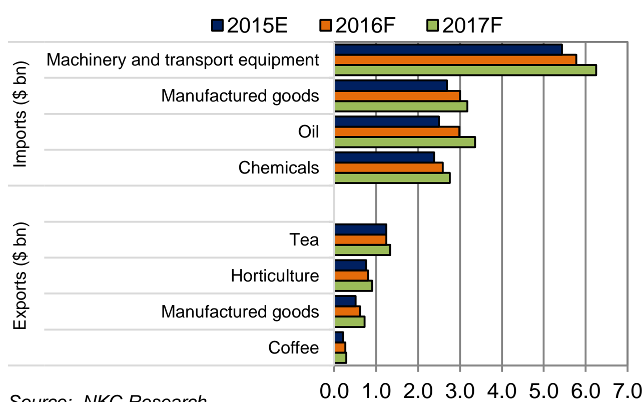


The country boasts the largest and most sophisticated economy in the East Africa region, with Kenyan companies present throughout the region, while Kenya itself has developed into a regional transportation and services hub. However, the country remains highly dependent on the agricultural sector. Agriculture remains a cornerstone of the Kenyan economy, fulfilling a salient role as an employer and as provider of livelihoods through subsistence farming. The sector contributes around 30.1% to GDP and is the primary generator of foreign currency in the economy. Formal economic production is dominated by the services sector, with a well-developed retail sector, relatively sophisticated and growing telecommunications and financial services sectors, and a developed tourism sector. In turn, the industrial sector is driven by strong public investment in infrastructure, and the country also has one of the strongest manufacturing sectors in sub-Saharan Africa (SSA). The manufacturing sector is currently dominated by food and consumer goods processing, and manufactured goods have played a salient role in diversifying exports away from the agricultural sector.

Real GDP Growth & Net FDI/GDP



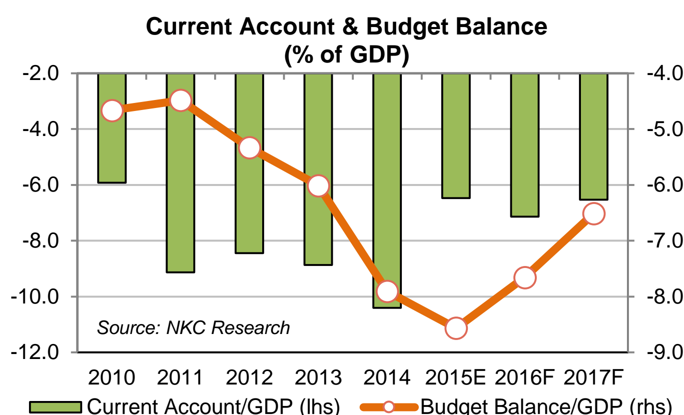
The 5.9% y-o-y real GDP growth rate in Q1 2016 was driven by strong growth in numerous sub-sectors, reflecting the economy's relative diversity. Sub-sectors that continue to show strong growth include construction (+9.9% y-o-y), information & communication (+9.7% y-o-y), transport & storage (+8.4% y-o-y), financial services (+8% y-o-y), and wholesale & retail trade (+7.3% y-o-y). In addition, the struggling tourism sector recorded a remarkable recovery during the first quarter of the year. The accommodation & restaurants sub-sector grew by 12.1% y-o-y during Q1 2016, compared with an 11.4% y-o-y contraction during the same period in 2015. In turn, the manufacturing sector recorded another quarter of lacklustre growth, expanding by 3.6% y-o-y during Q1 2016. Turning to foreign direct investment (FDI), Kenya attracted 96 different foreign investment projects in 2015, according to fDi Intelligence, reflecting a 55% increase on 2014 and representing the highest rate of investment since the investment monitor began recording data in 2003. During 2015, 71 foreign companies invested in Kenya – the highest number to date. The United Kingdom (UK) and US were the primary sources of FDI in 2015, each contributing 16 FDI projects, followed by India (10 projects) and South Africa (seven). Investment was largely focused in Nairobi, with the capital accounting for 54% of all FDI projects in 2015, followed by Mombasa with 6%.



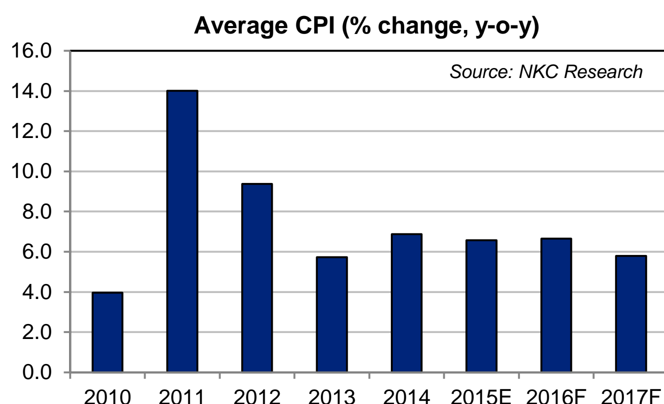
Main Imports: % share of total	2015E	2016F	2017F
Machinery and transport equipment	33.74	34.23	35.36
Manufactured goods	16.71	17.79	17.95
Oil	15.53	17.69	19.00
Chemicals	14.80	15.33	15.59
Main Exports: % share of total	**2015E**	**2016F**	**2017F**
Tea	21.10	20.02	20.20
Horticulture	12.85	12.98	13.71
Manufactured goods	8.64	9.89	10.88
Coffee	3.59	4.32	4.38

Total exports amounted to around KSh292bn during the first half of this year, reflecting a 10.1% y-o-y increase. This strong performance was primarily driven by agricultural exports, with commendable performances in numerous agricultural export categories. More specifically, tea exports increased by 25.4% y-o-y during H1 2016, amounting to KSh66bn; while horticulture exports rose by 25.7% y-o-y during the period, reaching KSh48bn. In addition, coffee exports

increased by 11.8% y-o-y during H1, amounting to just over KSh12bn. In turn, total imports amounted to KSh690bn during H1 2016, reflecting an 8.9% y-o-y reduction. Although recording an 11.1% y-o-y drop during the period, machinery and equipment remained the largest imports category during the period, accounting for 31% of total imports during H1 2016. Overall, this resulted in a merchandise trade deficit of KSh398bn during the period under analysis, which is a remarkable 19.2% y-o-y narrower than the previous year's deficit.



Kenyan authorities put forward a surprisingly expansionary fiscal budget for the 2016/17 FY. Expenditure is budgeted to increase by nearly 23%, reaching around $22.4bn. Official projections expect a fiscal deficit equivalent to 9.3% of GDP. However, the most recent medium-term fiscal framework puts forward an alternative scenario, which adjusts committed financing from development partners to reflect lower absorption. In the latter scenario, the budget deficit amounts to 6.9% of GDP in the current fiscal year. Our projection is more in line with this scenario, with the fiscal deficit expected to reach just over 6% of GDP in the current fiscal year. The expansionary nature of the budget is somewhat perplexing given recent commitments towards fiscal consolidation. Progress with regard to fiscal consolidation will be critical in reclaiming government financial management credibility. Turning to external balances, Kenya's current account deficit is expected to widen this year, driven by higher imports of capital equipment related to major infrastructure projects. The expansionary nature of the recent fiscal budget will reinvigorate infrastructure investment efforts, which will be reflected in higher capital goods imports. In turn, export growth is expected to remain largely subdued this year, with a relatively strong domestic currency putting pressure on manufactured goods exports, while potentially adverse weather conditions during Q4 related to the La Niña weather phenomenon hold downside risk for salient cash crop exports.



The Monetary Policy Committee (MPC) decided to reduce the Central Bank Rate (CBR) by 100 bps to 10.5% in May – the first reduction in the policy rate since May 2013. The Central Bank of Kenya (CBK) loosened its monetary policy stance to support economic growth, with the central bank not expecting excessive demand-driven inflationary pressures over the short term. The MPC noted that the inflation environment was improving; that the foreign exchange market has remained stable due to improving fundamentals; and that foreign currency reserves were providing adequate buffers against short-term shocks. More recently, the CBK adhered to market expectations by maintaining the CBR at its MPC meeting held on July 25. However, the central bank did decide to ease monetary conditions by reducing the Kenya Banks' Reference Rate (KBRR) from 9.87% to 8.9%. According to the MPC statement, the central bank expects price inflation to remain within the targeted range of 2.5% - 7.5% over the short term, while the banking sector continues to stabilise with improving liquidity conditions and stable levels of non-performing loans. Inflationary pressure over the short term will stem from exogenous sources, notably depreciatory pressure on the shilling and developments affecting food prices.

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