Country Note | Kenya – Drought & rate cap to weigh on growth

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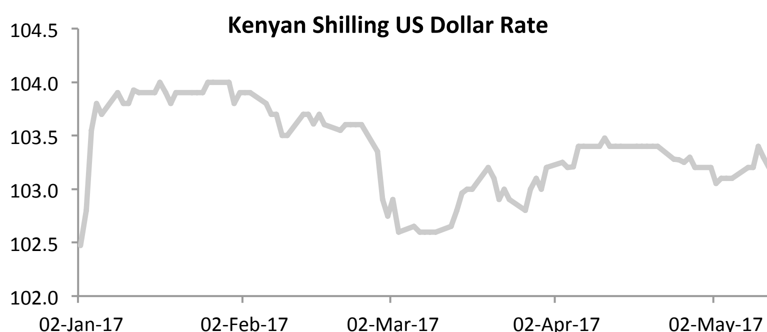
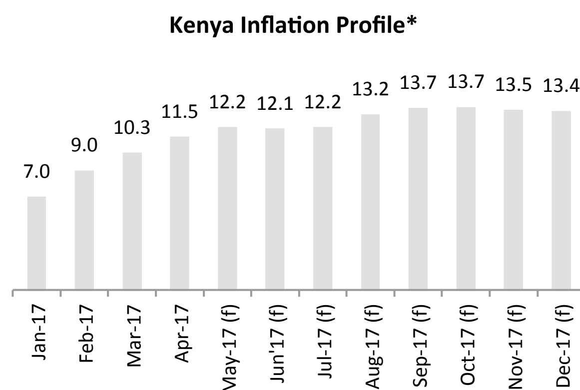
We cut our 2017 growth forecast to 5.1 percent (from 6 percent). Drought troubles re-emerged in Q1-2017, with an almost immediate impact on inflation. (Food inflation was 21 percent in April.) Rains have fell short by more than a quarter of the average this year, weighing significantly on agricultural output (24 percent of GDP, 50 percent of export earnings and 60 percent of employment). Food and cash crops have been affected. An imminent maize shortage would only be averted with ramped-up imports. The authorities' maize reserves have been almost totally depleted, and thus would need re-stocking. The late and meagre rains are also delaying the flowering of coffee bushes. Sugar and tea production are envisaged to decline quite significantly (more so for sugar) this year as well. Considering it is election season (polls on 8 August), nerves are a little frayed; with the opposition and indeed millers blaming the government for not heeding earlier shortage warnings. It is estimated the maize harvest this year could fall short of the 4.3 million tonnes needed by more than 1 million tonnes. Together with slower private sector credit extension on the back of the authorities' interest rate cap (put in place in September 2016), growth is set to be constrained consequently. A counter-argument is that the interest rate cap is not primarily responsible for lower credit to key sectors of the economy. That is, just because it is slower does not mean growth would be significantly impacted. The Central Bank of Kenya did a study on this, governor Patrick Njoroge says in a recent interview with CNBC Africa. It found for instance that retailers in the trading sector, due to

Kenya Macro Forecasts	2017	2018	2019
Real GDP, % change	5.1	5.5	6.0
Inflation, % change	11.8	8.4	5.8
Current Account Balance (% GDP)	-6.0	-5.5	-5.1
Fiscal Balance (% GDP)*	-7.1	-5.7	-4.5
USD:KES**	103.5	103.0	101.0

*Source: Macroafricaintel Research, *fiscal year begins July 1, **year-end*





*Source: CBK, KNBS, Macroafricaintel Research; *% year-on-year & updated monthly*

their own unfavourable circumstances, have now come to depend more on supplier credit. And that even as agriculture is a dominant sector of the economy, bank credit constitutes just 4 percent of its financing. Still, there has been an opportunity cost to the government's interest rate cap, with banks prefering to divert the relevant portion of their risk buckets to risk-free government securities. Private sector credit extension is currently about 4-4.5 percent, a far cry from 21 percent in August 2015. Add to that the earlier highlighted looming drought-induced food crisis. Unsurprisingly and with elections only months away, the Kenyatta government has been forced into action. Authorities announced in mid-May that about KES6 billion would be used to subsidize food imports. A supplementary budget is in the works in this regard. The Central Bank of Kenya (CBK) would almost certainly not be able to ease policy this year. Good thing it took the chance when it did in September 2016. Lower interest rates was a factor behind our higher growth forecasts in September.

Violent and chaotic party primaries raise concerns about August elections

Party primaries in April were marred by violence and rigging. Both the ruling Jubilee party and newly formed opposition coalition National Super Alliance (NASA) party had one form of disruption or the other. However, the fracas at that of the Jubilee party was more serious. 62 people were charged to court in early May for either bribing voters or inciting violence during the primaries. Incidentally, as quite a few intending candidates were not able to secure party nominations before the 10 May Independent Electoral and Boundaries Commission (IEBC) deadline, the August elections are set to have the highest number of independent candidates on record. Preparations for the polls by the IEBC itself have ran into some holdups. For instance, the IEBC cancelled the contract for the electronic voting system in March, raising opposition fears that a forced manual voting amendment of the electoral law by the ruling Jubilee party may become the main voting mechanism, instead of the backup it is supposed to be. Although the IEBC says it is considering other options, indications suggest the election may be significantly contentious should voting be done manually. Thus, fears about violence during the elections are not misplaced. But would it likely be as intense as the 2007 elections? We do not think so.

Rising debt profile worrying

Key concern is that the authorities are increasingly relying on relatively expensive syndicated loans. As at end-2016, Kenya's external debt was US$17.7 billion (26 percent of GDP). Since then, the authorities have taken on at least US$2.55 billion in syndicated loans. In March, authorities took US$1.55 billion in syndicated loans: $800 million from Standard Chartered, Standard Bank, Citi, and Rand Merchant Bank; $500 million from Afrexim and TDB; and $250 million from TDB. And in May, the authorities took another US$1 billion syndicated loan split between commercial banks and development financial institutions. These alone add 3.7 percent of GDP to the debt stock. It is doubtful the authorities' 6.0 percent of GDP fiscal deficit target for 2017/18 FY (starts 1 July), from 9.0 percent of GDP in 2016/17, would be met. We have raised our fiscal deficit forecasts consequently. President Uhuru Kenyatta tried to be reassuring on the rising debt profile in his state of the nation address in mid-March. But the government's actions have not been in tune with its rhetoric: On 1 May, Mr Kenyatta raised the minimum wage by 18 percent. It is not all too surprising though. (We highlighted in our last note how upcoming elections might spur disproportionate public spending.)

CBK to pause expansionary stance

Drought conditions in Kenya have caused a spike in food prices, with inflation in toe. Annual consumer inflation was 11.5 percent in April. (compare that to 7 percent in January.) Our current forecasts put inflation higher subsequently; and definitely outside of the Central Bank of Kenya's (CBK) 2.5-7.5 percent target band for the remainder of 2017. In March, the price of a 90kg bag of maize rose by 5 percent, and is set to spike even more as sellers hoard their stock. Army worms were also reported to have ravaged over 140,000 hectares of maize crops in western and southern Kenya in May, potentially adding to food price pressures down the line. With elections due in August, the government can ill-afford a food shortage crisis. So after depleting its maize reserves to less than a

day's worth (4,500 tonnes) in mid-May, following a release of about 36,000 tonnes to ease the supply shortage, the Kenyan government plans to subsidise wholesale food imports to stabilize prices. But for the drought-induced food crisis, the bank would have remained in a good position to cut rates further this year, after a 50 basis point cut to 10 percent in September 2016. Now, that is totally out of the question. And it would not make sense for it to hike rates either.

Kenya	Q2 2017	Q3 2017	Q4 2017	Q1 2018
Policy Rate, %	10.0	10.0	10.0	10.0

Source: Macroafricaintel Research

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