Parliamentary Budget Office

Enhancing the Legislative and Oversight Role of the Kenyan Parliament

ECONOMIC AND FISCAL UPDATE JULY 2015

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.

Though Kenya's economy has proved resilient, a lot needs to be done to address the ever increasing challenges that continue to impede growth in the economy in order to achieve higher growth

Roses and Thorns

Kenya's economy is poised for progress in the 2015/16 financial year. Hopeful prospects for the economy stem from the continued significant investments in infrastructure such as the standard gauge railway as well as the commuter rail project which are expected to ease transportation and reduce cost of doing business, including attracting investment and boosting trade in the region. Despite monumental challenges within the past financial year, resilience of the Kenyan economy in the past has enabled it to weather the storm. However, in the face of ever increasing internal and external challenges, it remains to be seen whether this resilience will wear thin.

Kenya continued to face significant challenges, notably insecurity, that pose a significant threat to economic progress

Domestically, challenges to the economy stem primarily from the ongoing insecurity concerns which are a threat to businesses and have also led to a significant decline in tourist arrivals in the country. Though the economy has shown great resilience, insecurity remains the single biggest impediment to growth that could have a significant drag on the economy. Spending more on internal security including reorganization of police groups can help alleviate the security situation. There is need also to streamline the process of starting a business in order to make the country more attractive to investors.

State of the global economy has also adversely affected Kenya's economy

Globally, challenges emanate from the state of the global economy notably the burst of the Chinese stock bubble. The value of Chinese stocks has continued to plummet over time after a speculative bubble burst caused by too many speculative buyers venturing into the market without a proper long term investment strategy. As a result, China's economy is slowing and there are concerns as to how this is likely to impact the Kenyan economy. Firstly, a slowdown in the Chinese economy could reduce the amount of Foreign Direct Investment from China currently being injected to African economies. Furthermore, a shaken faith in the stock market especially among foreign investors can lead to risk aversion and investment in perceived safer zone such as the in the dollar which will continue to strengthen it thereby worsening the state of the Kenyan currency. Countries with close ties to China such as Taiwan, Korea, the US and the European Union are likely to be adversely affected with trickle down effects to third part trading partners of these countries/ regions.

The China stock bubble burst will have trickle down effects in closely associated countries with far-reaching ramifications

Economic Growth

GDP growth is expected to be upwards of 6.0 percent in 2015. To reach this growth momentum, there is need for solid contribution from key sectors such as Agriculture, Manufacturing, Transport and Communication as well as Tourism among others.

Agriculture is considered the backbone of the economy but has not developed much, causing a slowdown in economic activity

The Agricultural sector is still touted as the backbone of the country's economy though it remains rainfall dependent and has not grown significantly over the last decade. The key agricultural exports crops remain to be coffee, tea and horticulture which are exported in their raw form. This has made the country very vulnerable to fluctuations in international prices which lead to reduced earnings. Rainfall dependency is also a significant impediment to agricultural performance as erratic rainfall patterns continue to adversely affect output. Enhancing performance of the agricultural sector will entail embracing value addition agriculture by increasing economic value of a commodity through the production process as well as value chain management.

The manufacturing sector is facing challenges from infrastructure deficiencies, high cost of doing business and high energy and labour costs which have stifled growth in this sector

Manufacturing is also a key sector in the Kenyan economy and a significant Vision 2030 goal. Data from the KNBS denotes that from 2008, the contribution of the Manufacturing sector to GDP has been declining from 10.8 percent in 2008 to 9.2 Percent in 2012. Some of the challenges facing the manufacturing industry in Kenya include infrastructure deficiencies which increase cost of doing business and high energy costs as well as high labour costs. Improving the sectors contribution to economic growth will entail infrastructure development as well as macroeconomic stability particularly with regard to inflation and the exchange rate.

The services sector is another key contributor to GDP growth with the tourism sector as a key component. Due to rising insecurity, performance of the tourism sector has declined significantly with a noted drop in tourist arrivals in the country. This has also contributed to the decline in performance of the hotels and restaurants subsector. Improving performance of the tourism sector will therefore entail, firstly, addressing the issue of insecurity. There is need also to focus on marketing and branding including giving incentives to tour firms to invest in tourism.

The services sector, especially tourism, has suffered greatly from the insecurity challenge. A lot will have to be addressed to revive this sector

Revenue performance

In year 2014/15, tax revenue performed exceptionally well with the KRA collecting Ksh. 1.001 trillion; a 3.86 percent increase from the revenue collected in financial year 2013/14. The increased revenue collection in the just concluded financial year has been attributed to the sealing of loopholes such as transfer pricing as well as increased electronic tax surveillance which enhanced compliance.

Tax revenue performed exceptionally well in the last financial year. However, the ever increasing government expenditures have annulled this gain and the country appears to rely on borrowing to meet its budget deficit

According to the latest exchequer issues, 1.4 trillion had been spent as at May 2015 against a budget of 1.52 trillion denoting a balance of Ksh. 79 billion. It should be noted however that the first and second supplementary budgets which were both passed in June increased the total expenditure by close of the financial year increased the 2014/15 budget by Ksh. 244 billion. It is however not clear how the Government intended to fund this additional budget and coming so close to the end of the financial year, it remains to be seen whether these supplementary budgets were actually implemented.

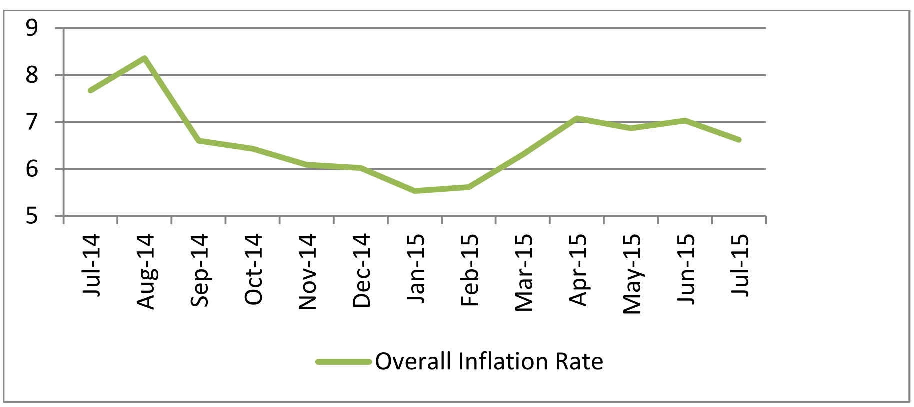
In 2015/16, fiscal policy will target revenue collection of Ksh. 1, 3580.0 billion (20.8 percent of GDP). This comprises of Ksh. 1,254.9 billion in ordinary revenue and Ksh. 103.2 billion Appropriations-in-Aid. Enhanced revenue measures will comprise reforming of tax and revenue systems, electronic single window system for use by all importers and exporters; digitizing inbound payment service transactions as well as deepening tax administration reforms to ease compliance. It is important however, to ensure that government expenditure remains within reasonable limits to ensure proper planning

Macroeconomic Stability

Inflation levels have remained within reasonable levels for the better part of the year but are likely to face significant pressures ahead particular from fuel as well as a weak exchange rate

Inflation levels have remained within reasonable levels for the better part of the 2014/15 financial year; a trend that appears set to continue through the 2015/16 financial year with the July 2015 inflation levels recording a decline from 7.03 percent in June 2015 to 6.62 percent in July 2015. This reduction has been attributed to lower food prices. The challenge will be to maintain inflation at the single digit level throughout financial year 2015/16 given the significant inflationary pressures likely to be encountered ahead. Notably, the increasing cost of fuel remains a concern as is the weakening Kenya shilling.

Figure 1: Trends in Inflation over the period of June 2014-July 2015

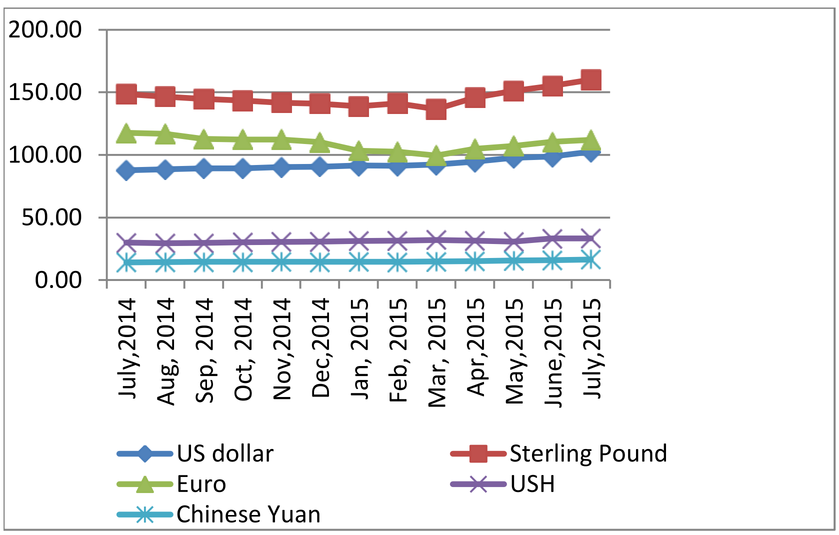


Source: KNBS, 2015

The Exchange Rate continues to present a worrying trend despite specific interventions by the Central Bank to shore it up against the dollar. In the past two months, the Central Bank tightened monetary policy by raising the CBR by three percentage points - a move that has led to a sharp increase in interest rates and reduced availability of credit. However, the Shilling has remained stubbornly around the 100 mark.

It is worth noting that the challenge of shoring up the Shilling may be much more complicated than simply adjusting the CBR by a few basis points. For far too long, the country has operated on a high current account deficit with a significant import bill against moderate export earnings. This structural inefficiency has rendered the country vulnerable to shocks that adversely affect the exchange rate. The slump in the tourism industry as well as the strengthening of the dollar has further complicated matters.

Figure 3: Trends in Exchange Rate over the period July 2014 - July 2015



Source: CBK, 2015

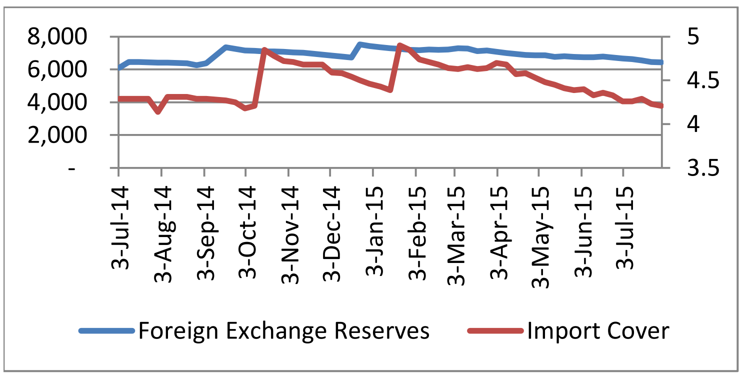
The exchange rate continues to weaken against the dollar despite measures to shore it up. Structural deficiencies in the Kenyan economy are likely to be the reason for the shilling's persistent slide

A weakened shilling is not necessarily a bad thing as it makes our exports more competitive in the global market. However, care should be taken to address the structural deficiencies in our economy to protect us from external shocks that are likely to adversely affect the economy.

Interest rates have increased sharply following the upward revision of the CBR and are likely to remain high in the coming months as the Central Bank targets to put a stop to the steady decline of the shilling.

Interest rates are likely to remain high in the coming months thereby stifling growth in the private sector

Figure 3: Trends in Foreign Exchange vs. Import Cover over the period July 2014 - July 2015



Source: CBK, 2015

Domestic borrowing

The average yield rate for the 91-day Treasury bill rose sharply to approximately 11.5 percent for the month of August; from an average rate of 8.4 for the months of March through July. The high interest rates are likely to stifle credit access by the private sector by making it more costly for them. High interest rates also denote the government's increased appetite for borrowing.

Domestic borrowing appears to be increasing notably through the overdraft facility, denoting increased government appetite and revenue shortfalls

Notably, the Treasury has been borrowing large amounts through the overdraft facility which typically facilitates the government to meet urgent recurrent type expenditure. Huge sums of money were borrowed in the overdraft facility with the highest amount at 39.3 billion in the week ending on 10th July 2015.

The observed increased government appetite implies that the government is struggling to meet its expenditure needs.