Parliamentary Budget Office

Enhancing the Legislative and Oversight Role of the Kenyan Parliament

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This brief provides a summary of key recent economic and budget developments and is intended to keep stakeholders especially the legislators updated on the latest trends in the economy.

The months of September/October 2015

The months of September/October marked a difficult period for the economy owing to high fiscal pressures as bonds matured at a time when there was low uptake of treasury bills and bonds as well as revenue shortfall. This occasioned a cash crunch in the entire government operations. This has adversely affected budget implementation due to low exchequer releases, especially for development expenditure. Indeed, the flow of resources to counties has also been affected. The completion of capital projects is critical for the envisaged economic growth target of 6.5 percent in 2015. It is therefore apparent that unless urgent measures are taken, the slow pace of budget execution may adversely affect the economy. One of the ways to unlock the current problem is to urgently undertake expenditure rationalisation and focus more energies towards weeding ouit non-core expenditure and implementing development projects that yield high returns. In addition, there is urgent need to comprehensively undertake a cost benefit analysis of all development projects with the view of prioritizing those that will yield high returns.

It is also worth noting that if the much talked about El-Niño rains become catastrophic, the government may be forced to reprioritize its budget to mitigate any associated risks. This may further exacerbate the situation leading to economic slowdown.

Economic Growth

Latest data from the Kenya National Bureau of Statistics (KNBS) indicates that the economy grew by 5.5 percent in the second quarter of 2015, an increase from the 4.9 percent growth experienced in the first quarter of 2015. On average, this implies that the economy grew by 5.2 percent in the first half of 2015. Therefore, for the envisaged target of 6.5 percent to be met in 2015, the economy should grow at an average of 7.8 percent for the second half of the year.

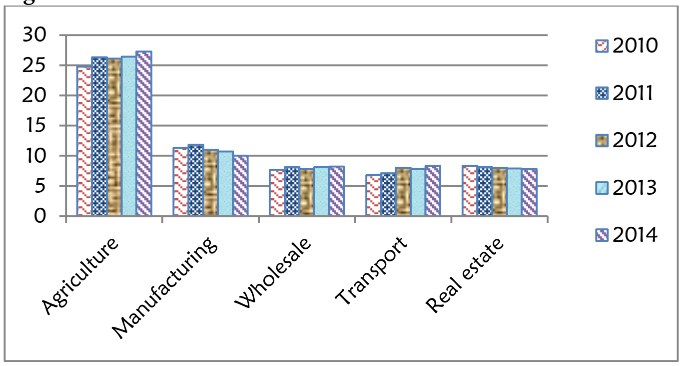
This is an unlikely to occur, hence the urgent need to re-adjust the forecast and as necessary institute monetary and fiscal measures that will mitigate further slow down of the economy.

The cost of repayment for external debt is set to rise by at Kshs 3.88 billion[1]on account of a weaker shilling thus depleting the country's revenue even further. Additionally, if not checked, the effects of a full blown El-Niño episode are likely to be felt in the agriculture and infrastructure sectors with adverse effects on the economy.

As illustrated in Figure 1, over the past five years, the Agriculture sector and the Transport sector have been among the highest contributors to GDP growth. Poor performance of these sectors will therefore affect growth negatively.

[1] Based on approx. 20% exchange rate depreciation; assuming interest payments of USD denominated external debt for FY 2015/16 will increase by a similar proportion

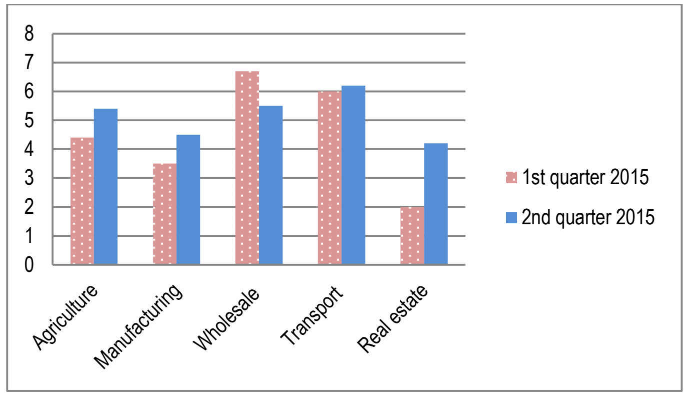
Figure 1: Contribution to GDP



Data Source: Economic Survey 2015

Other crucial sectors for the economy are Manufacturing, Wholesale and retail trade as well as the real estate sectors. During the second quarter of 2015, most of these sectors recorded improved performance from the first quarter as a result of improved weather conditions which led to higher yields in the Agriculture Sector as well as improved production of hydro-electricity. The construction sector received a boost from the ongoing mega infrastructure projects and the real estate sector. However, growth in the wholesale and retail trade sector declined from 6.7 percent in the first quarter to stand at 5.5 percent in the second quarter probably due to challenges facing the business environment as insecurity and a weak shilling which limits the importation of tradeable goods in the sector as well as a challenging regulatory environment. Going forward, the stabilization of the shilling and the mitigation of the various sectoral challenges will promote growth for the remainder of the year. The economy is thus likely to expand by no more than 5.5 percent in 2015.

Figure 2: Performance of Key sectors in the first and second Quarters of 2015



Data Source: KNBS

Inflation

The overall inflation rate in September stood at 5.97 percent in; in October it increased to 6.7 percent. This increment was attributed to increase in prices of several food items as well as the transport index. However, the current inflation rate is still within the medium term inflation target of 5 ±2 percent.

Going forward, should the anticipated El-Nino rains bring about floods and destruction of infrastructure, inflation may go up as the food supply chain is disrupted due to destruction of crops as well as inhibited transportation leading to high food and transport costs in the short term. However, the inflation rate will most likely remain within the single digits for the remainder of calendar year.

Figure 3: Trends in Month on Month Contribution to Inflation over the period Sep 2011-Sep 2015

Item	Sep-13	Oct-13	Sep-14	Oct-14	Sep-15	Oct-15
Food & Nonalcoholic Beverages	56.96	58.04	46.56	47.36	63.85	65.19
Alcoholic Beverages, Tobacco & Narcotics	2.10	2.26	0.71	0.63	1.17	1.11
Clothing & Footwear	4.80	4.94	5.11	5.24	6.55	5.66
Housing, Water, Electricity, Gas and other Fuels	11.82	10.76	15.48	15.16	9.95	11.63
Furnishings, Household Equipment and Routine Household Maintenance	3.75	4.16	4.20	3.99	4.92	4.82
Health	2.09	2.23	2.49	2.54	2.79	2.52
Transport	7.59	6.34	13.83	13.40	-2.16	-2.02
Communication	-1.63	-1.72	0.29	0.25	0.79	0.70
Recreation & Culture	2.97	3.17	2.02	1.92	1.25	1.09
Education	1.92	2.04	2.60	2.59	2.26	2.02
Restaurants & Hotels	4.61	4.61	4.01	4.22	4.44	3.53
Miscellaneous Goods & Services	3.02	3.18	2.68	2.71	4.18	3.73

Source: PBOs Computation, KNBS

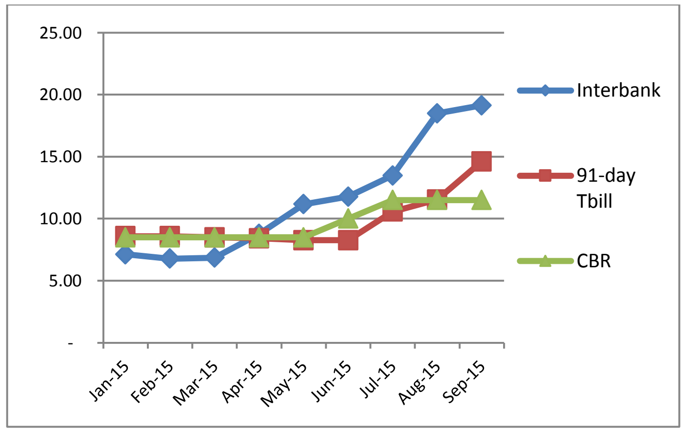
Interest Rates

The Central Bank of Kenya (CBK) has maintained the Central Bank Rate (CBR) at 11.5 percent for the third month since July 2015. This was attributed to maintenance of liquidity in the market to rein in inflationary pressures. This tight monetary stance has signaled other interest rates to rise.

In addition to the high CBR, increased government borrowing in the domestic market due to low performance of revenue has also contributed to a significant surge in the lending rates as well as the T-bill rates. The average yield rate of the 91-day Treasury bill rate has increased significantly in the recent past. The high T-bills and T-bond rates will prove costly to the government in terms of increased domestic debt which has to be paid on short term basis. However, albeit short-lived, the high yield of the T-bill rates may trigger capital inflows from foreign investors thereby improving the country's foreign exchange position.

Also, the high lending rates are likely to slow down economic activity in the private sector due to reduced availability of credit thereby dampening private sector led economic growth.

Figure 4: Trends in T-bill rates and interbank rates over the period Jan 2015- September 2015



Source: Central Bank of Kenya

Exchange Rate

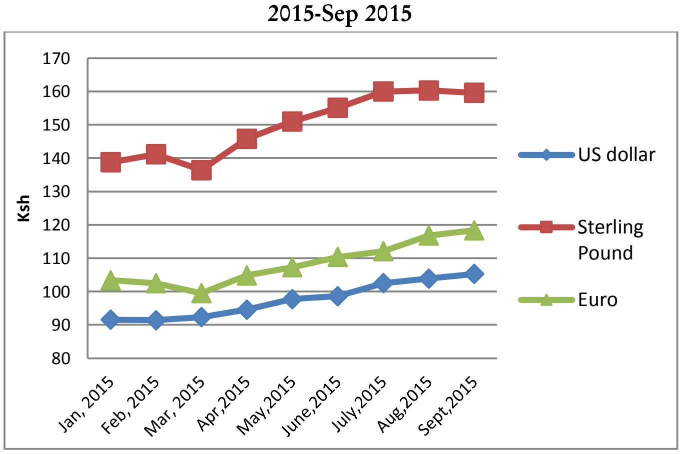
The Kenya shilling has continued to depreciate against the major world currencies but appreciated against other East African currencies. The shilling has shed of 15% of its value against the dollar and the sterling pound, and 14% against the Euro, since January 2015. In the month of September, the Kenyan Shilling exchanged at an average of Kshs. 105.29, Kshs. 159.58 and Kshs. 118.38 with the US Dollar, Sterling Pound and Euro respectively. In the EAC region, the Kenya shilling exchanged at an average of Kshs. 35.28 and Kshs. 20.63 against the Ugandan Shilling and Tanzanian Shilling respectively.

The depreciation of the exchange rate to the dollar is attributed to the strong dollar against other currencies, reduced forex inflows due decreased tourism earnings and under-performance of the export sector particularly the production of tea, coffee and horticulture. Indeed, the gains of higher export earnings on account of a weaker shilling have been offset by low production volumes. In August, the value of exports was Kshs. 4,370 million less compared to the previous month.

As earlier indicated, a weak shilling against the dollar has negatively affected the debt portfolio of the country, raising the debt owed in foreign amount.

The CBK has tried to stabilize the shilling by raising both the CBR rate and KBRR rate besides selling of forex reserves in the market. This has helped easen the rate of depreciation of the shilling and stabilized the exchange rate to the dollar at about 103. Given the current fundamentals we project that the shilling will remain relatively stable above the 100 mark in the coming months.

Figure 5: Trends in Exchange Rate over the period January 2015-Sep 2015



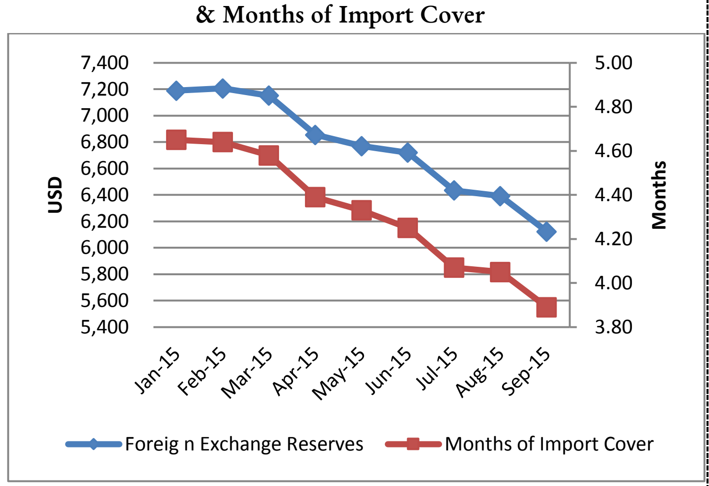
Data Source: KNBS

Foreign Exchange Reserves

The CBK has been selling forex reserves in the market as an intervention measure to prevent further depreciation of the shilling. This has gradually reduced the foreign reserves to slightly below the statutory 4 month threshold. The official foreign reserves stood at USD 6.2 billion equivalent to 3.9 months of import cover at the end of September 2015 compared to USD 6392 million equivalent to 4.05 months of import cover in August 2015.

Going forward, increased capital inflows on account of attractive T-bill yields may improve the forex reserves in the short term. However, as this debt matures in the future, debt obligations are likely to return the import cover below the threshold, unless the challenges facing the export sector are addressed. A low import cover renders the country vulnerable to macroeconomic shocks and can have adverse consequences on the economy.

Figure 6: Month-month September Foreign Exchange Reserve & Months of Import Cover



Data Source: Central Bank of Kenya

Domestic Debt

Kenya's domestic debt stood at Kshs. 1,386 billion as at the end of September; a slight decrease compared to the previous month where it stood at Kshs. 1,398 billion. The decrease was attributed to the decrease of successful treasury bills bids that the government received in the money market. According to government composition by instrument of domestic debt, the composition of treasury bills decreased from 20.7 percent to 19.7

percent in the month of August and September respectively.

However, increased domestic borrowing to meet the fiscal pressures amidst revenue shortfalls hassled to a dramatic increase in interest rates on government paper (Treasury bills and bonds), currently at 20 percent. This is the highest ever seen in the market since 2012.

Going forward, domestic debt is likely to increase thereby constraining fiscal space. It is thus important that the government tightens its belt and as necessary instill fiscal measures that can-adjust non-core expenditures so as to release some of the pressure on the exchequer.

Memorandum Items[2]

Category	Estimate for 2015/2016	Current Actual/Provisional
GDP Growth rate	6.0%	5.3% in 2014
Revenue	Kshs. 1,627 billion	Kshs.181,213 million(Sep 2015)
Debt	2.916 trillion	
Of which: Domestic		Kshs. 1,413 billion(23rd Oct, 2015)
External		Kshs. 1,530 Billion(August 2015)
CBK Overdraft		Kshs. 46.37Billion (23rd Oct, 2015)
Exchequer releases		Kshs. 173,618million (September 2015)
Of which: CFS		Kshs. 75,777 Million (August, 2015)
Transfers to Counties	Kshs.264.28	Kshs. 11,834 million(September 2015)

[1] Source: National Treasury, Central Bank