THE ANNUAL ICPAK NATIONAL BUDGET REVIEW SEMINAR 2018

TOPIC: THE MACROECONOMIC FRAMEWORK UNDERPINNING THE BUDGET FOR THE FY 2018/2019 AND THE MEDIUM TERM

TUESDAY 19TH JUNE, 2018

VENUE: HILTON HOTEL, NAIROBI

6/27/2018

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THE CONTENT

- The presentation will focus on the following areas:

1. Background;
2. The Underpinning Macroeconomic Policy Framework For The FY 2018/2019 Budget;
3. Realism of the Macro Framework Growth Fundamentals;
4. Macroeconomic Stability and Recent Fiscal Developments; and
5. The Consolidated Fund Services and Debt

BACKGROUND

The FY 2018/19 budget has been prepared at a time when business activity is picking up due to improved political stability:

- **There is an improvement in the Purchasing Managers Index (PMI)to 56.4 in April 2018 from 55.7 in March 2018 and below 50 in the lower half of the previous year. This denotes expanding private sector activity. The Kenya PMI is a private sector led composite economic index produced by IHS Markit and Stanbic ;**
- **Inflation is low and stable at 3.78 percent in April 2018 from 4.18 percent in March 2018;**
- **The exchange rate has also been stable due to increased diaspora remittances (estimated at Ksh. 197 billion in 2017 and expected to be even higher in 2018);**
- **The food outlook seems promising due to enhanced rainfall performance over most of the country's food basket though there are risks from fall army worms (FAW);**
- **On the flipside, labour unrest in the education sector continues to adversely affect performance of the labour market; and**
- **Floods may also be counterproductive for food production and have made transportation challenging.**

MACROECONOMIC POLICY FRAMEWORK UNDERPINNING THE 2018/2019 BUDGET

- The budget estimates for the FY 2018/2019 and the medium has been prepared at a time when the country is just coming out of a prolonged electioneering period coupled with adverse weather conditions;
- The estimates are framed against a backdrop of improving economy globally, regionally and locally. The global economic growth momentum is expected to hit 3.9 percent in 2018 reflecting an improved domestic demand in advanced economies and China;
- The growth in Sub-Saharan Africa is projected to pick up to 3.4 percent in 2018 from 2.8 percent in 2017, albeit with variations across the region. The EAC economies continues to record a relatively robust and high growth supported by major infrastructural investments and strong private consumption across the member countries.
- The domestic economy has remained resilient despite the various challenges and uncertainties associated with the last general elections and unpredictable adverse weather conditions. The economy grew by 4.9 percent in 2017 compared with a revised growth of 5.9 percent in 2016, supported by performance in non-agriculture sector relative to the decline in agriculture sector. The economy is projected to recover to 5.8 percent in 2018.
- Inflation is expected to remain within a target range of 5% over the medium term; interest rates are expected to remain low and stable and exchange rate stability will be safeguarded in the medium term.

MACRO FRAMEWORK UNDERPINNING THE 2018/2019 BUDGET….cont

- The key drivers for this growth are improved **agricultural performance, manufacturing activities**, as well as ongoing **public infrastructural investments.** Stability in the macroeconomic environment is expected to strengthen this growth.
- To support the growth outlook, the government is planning to implement policies and programmes under the President's "Big Four Agenda".
- According to the National Treasury, the "Big Four Agenda" aims to build on the progress made under the Economic Transformation Agenda and address the remaining bottlenecks that continue to hold the economy from achieving its full potential. The "Big Four Agenda" targets are to:

1) **Support the value addition and raise the manufacturing sector's share to gross domestic product (GDP) to 15 percent by 2022;**
2) **Focus on initiatives that guarantee food security and nutrition to all Kenyans by 2022 through expansion of food production and supply, reduction of food prices to ensure affordability;**
3) **Provide universal health coverage (UHC) thereby guaranteeing quality and affordable healthcare to all Kenyans; and**
4) **Provide at least five hundred thousand (500,000) affordable new houses to Kenyans by 2022, and thereby improve the living conditions for Kenyans.**

REAL GDP GROWTH RATES FOR SELECTED SECTORS

Table 1: Real GDP Growth Rates For Selected Sectors (Percentage)

Sector	2013	2014	2015	2016	2017*
Agriculture	5.4	4.4	5.3	4.7	1.6
Mining	-4.2	14.9	12.3	9.5	6.1
Manufacturing	5.6	2.5	3.6	2.7	0.2
Electricity Supply	9.8	7.3	11.5	9.5	6.1
Water Supply	0.9	3.9	2.7	5.7	2.6
Construction	6.1	13.1	13.8	9.8	8.6
Wholesale and retail trade	8.4	6.9	5.9	3.4	5.7
Accommodation and food services	-4.6	-16.7	-1.3	13.3	14.7
Real Estate	4.1	5.6	7.2	8.8	6.1
Financial and insurance services	8.2	8.3	9.4	6.7	3.1
Overall Real GDP Growth	5.9	5.4	5.7	5.9	4.9

REALISM OF THE MACRO FRAMEWORK GROWTH FUNDAMENTALS

- Food security is one of the key focus areas of the budget in line with the Big Four Agenda. **Kenya's agriculture is largely rain-fed which has rendered the country vulnerable to adverse weather shocks.**
- The projected improved agricultural performance this financial year is not only due to enhanced rainfall but also as a result of initiatives to guarantee food security and nutrition to all Kenyans through expansion of food production and supply, reduction of food prices and value addition in the food processing chain.

Key Expenditure Allocation for Agricultural Sector in FY 2018/2019

Irrigation Projects		National Expanded Irrigation Programme Ksh. 2.4 Billion	Fertilizer Subsidy	Strategic Food Reserve (SFR)	Cereal Enhancement Programme	Fall Army Worm	Agriculture Mechanization	Small Scale Irrigation and Value Addition
Bura (Ksh. 1.3 billion)	Mwea (Ksh. 1.6 billion)	Ksh. 2.4 Billion	Ksh.4.3 billion	Ksh. 1.4 billion	Ksh. 1.8 Billion	Ksh. 300 Million	Ksh. 500 Million	Ksh. 1.4 billion

Realism of Fundamentals Driving Agriculture Sector Growth

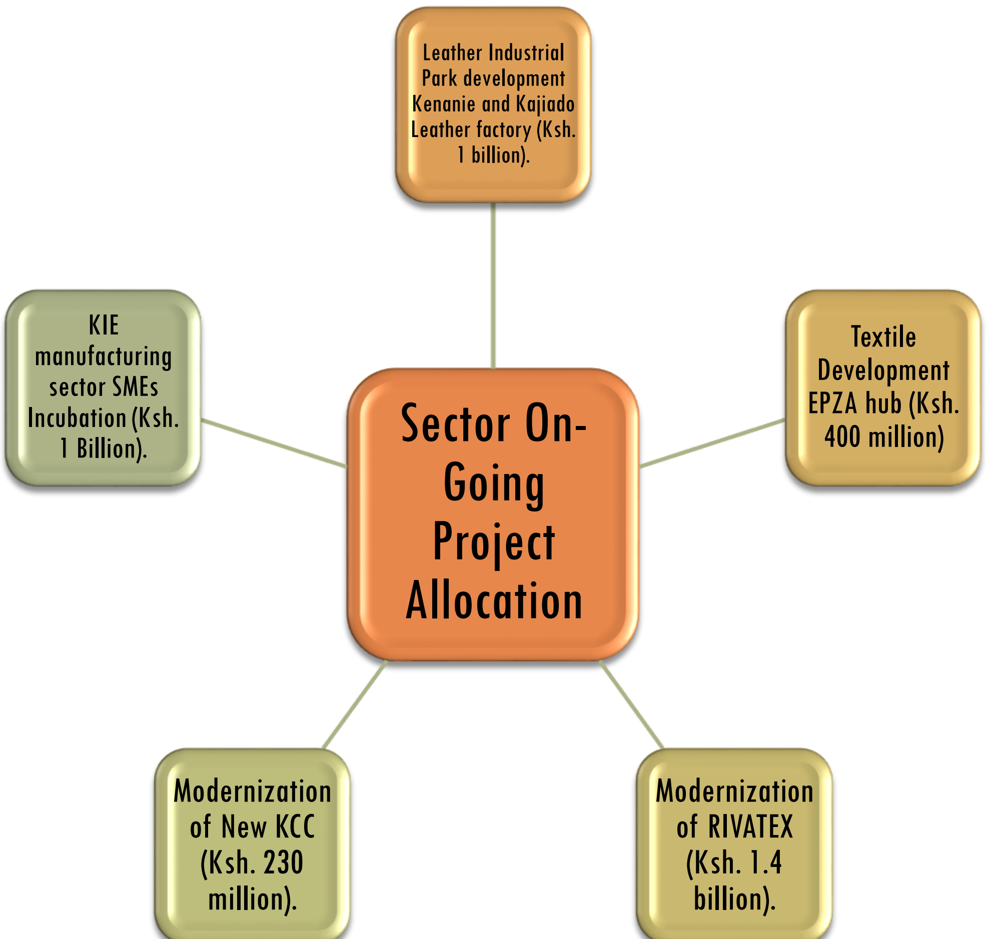
- Most of these agriculture related projects are scheduled for completion in 2020/21 even though a review of current status indicates that they are far from completion. Mwea irrigation project is to be completed in 2018. Galan-Kulalu is to be finalized in 2019 and Bura should be finalized in 2020. However, judging from the amount expended so far on the projects against the total cost, it seems unlikely that these projects will be finalized on time.

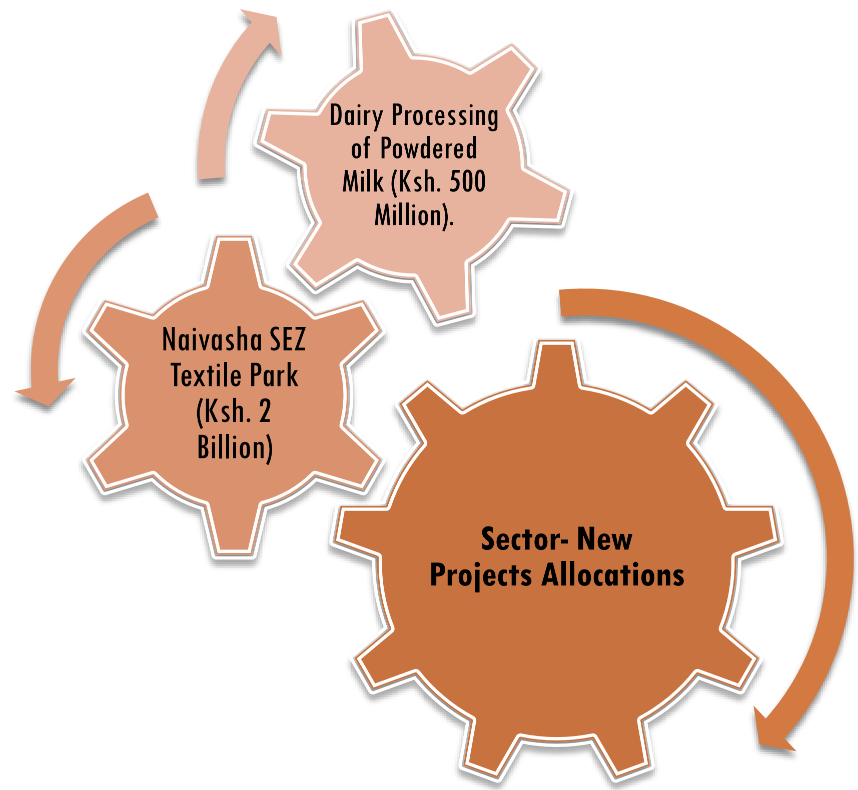
1. **The sector faces numerous challenges including: the invasion of fall army worms; floods across the country; high cost of key inputs; inadequate extension service; limited resources; and poor infrastructure is likely to negatively affect food production;**
2. **Late delivery and poor distribution of certified seeds and fertilizers has also been a challenge and many farmers have not benefited from this intervention. The government fertilizer subsidy programme covers only 30% of the country's needs yet the allocation for the programme has reduced to Ksh. 4.3 billion in 2018/19 from 5.6 billion in 2017/18;**
3. **Access to credit is a challenge for the sector. The share of private sector credit to agriculture declined to 2.5 percent in 2017 compared to 2.9 percent in 2016. Thus, though agricultural performance may improve in 2018, this improvement will not be remarkable enough to generate the much needed agricultural revolution.**

- The focus of the agriculture budget should therefore be:

1. **Adequate provisions for fertilizer subsidy, certified seeds, as well as address issues of storage (strategic food reserve), distribution (market linkages), use of modern technology and machinery;**
2. **Diversification especially from low to high value crops and Diversification of small holder Agriculture;**
3. **Increase value addition through stronger linkages with other sectors; and**
4. **Increased land under cultivation through Irrigation.**

Selected Manufacturing Sector Related Budget Allocations FY 2018/2019





Realism of Fundamentals Driving Manufacturing Sector Growth

- Performance in this sector is unlikely to be remarkable in the current year for several reasons including:

1) **The impact of these projects are likely to be felt more in the future when the project yields returns than in the implementation stage though activities such as construction, purchase of materials and hiring of labour may have a positive impact on GDP.**
2) **The perennial challenge in implementation of development budgets. Many of these projects should be nearing completion but are lagging due to poor budget implementation**
3) **The sector is also plagued by other challenges relating to lack of requisite skills by the labour force, high input costs and energy costs as well as poor quality of raw materials among others.**

- The following are some of the mitigating measures

1) **The 2018/19 budget should ensure that the key projects under manufacturing are finalized by ring-fencing resources for these projects. Any budgetary changes during the year should not affect projects related to manufacturing unless substantial reason is provided along with a plan on how this will be mitigated. In addition,**
2) **Expenditure should also be oriented towards addressing training and infrastructural needs such as industrial parks infrastructure, industrial sheds, fishing and aqua culture equipment, warehousing and cold chain sites among other investments along the value chain that will enhance productivity of manufacturing**

ON-GOING PUBLIC INFRASTRUCTURAL INVESTMENTS

Roads	• Ksh. 112.98 billion • Domestically and Foreign Financed
SGR	• Phase 2A Nairobi - Naivasha • Ksh. 74.4 billion
LAPSSET	• Ksh. 8.8 billion • Construction of 1st three berths commenced in August 2016 and far so at 48% completion rate
Airports	• Expansion of Malindi, Isiolo, Lokichoggio, Airports, Kabunde and Kakamega • Ksh. 1.4 billion
Mombasa Port Development	• (Ksh. 2.7 billion donor financed).
Energy	• Geothermal development (Ksh. 11.9 billion), rural electrification programme (Ksh. 5.1 billion), Last mile connectivity (Ksh. 3.19 billion

Realism of Fundamentals Driving Public Infrastructural Investments Projects

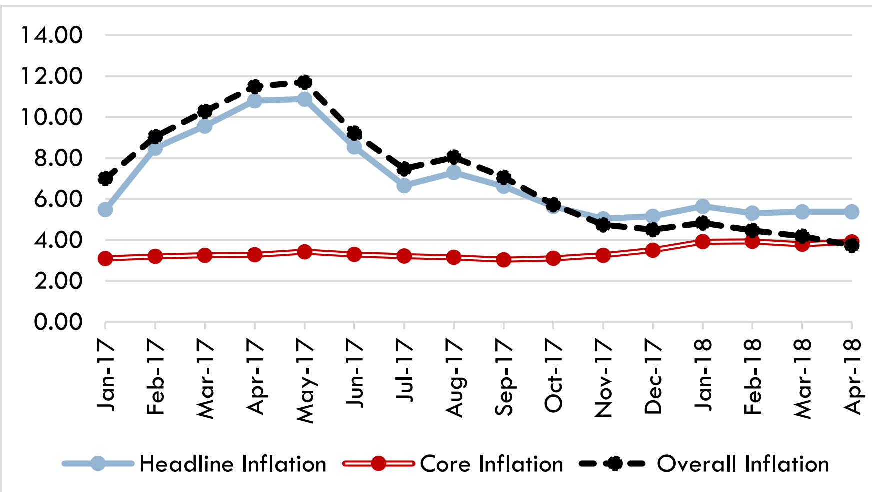
- These key concerns have been raised before and relate to the following:

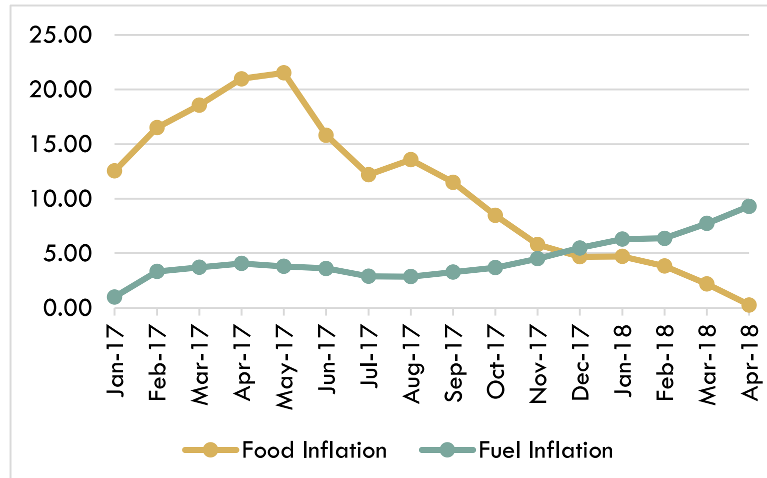
1) **Firstly, development projects in the country typically face a risk of delayed completion due to under-absorption of development funds. Some projects are usually allocated funds but then this is revised in the supplementary budget. Completion of these projects will therefore require budget discipline; and**
2) **Secondly, for some of these projects, the benefits are likely to be felt with a time lag. Are the timelines for the projects being adhered to? A review of the status of key projects indicates otherwise.**

- Similar to manufacturing, resources allocated for infrastructure investments should be ring-fenced to ensure that these projects are finalized within the stipulated time frame.

MACROECONOMIC STABILITY:- INFLATION

- Inflation has declined since September 2017 and has remained within the target range of 5± 2.5 percent. This is mainly attributed to a decline in food inflation due to seasonal reduction in food prices. Inflation stood at 3.73 percent in April 2018.
- The inflation trends from January 2017to April 2018 (KNBS) as shown in figure 1.0 and 2.0 below.





- Food and Non-alcoholic beverages category is no longer the largest contributor to inflation since March 2018 (Table 2). Currently, the key contributor to inflation is the housing, water, electricity, gas and other fuels category.
- The BPS 2018 and the budget estimates for 2018/19 project that inflation will remain within the target range in the medium term supported by prudent Monetary and Fiscal policies; favourable weather outlook; relatively lower international oil prices and stable exchange rate that is expected to dampen any risks of imported inflation.
- **To address energy costs, there are budgetary allocations for projects in the generation and transmission of electricity such as Menengai Geothermal Development Project (Ksh. 3.4 Billion), Loiyangalani - Suswa transmission line (Ksh. 9.6 Billion) and Electrification of Public Facilities(Ksh. 5.3 Billion).**

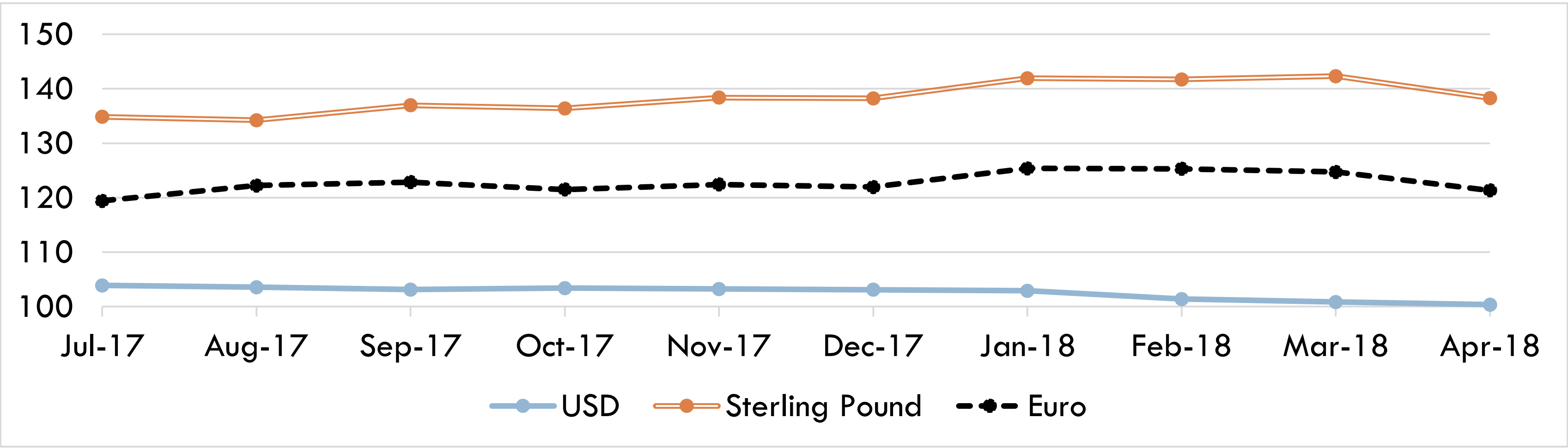
MACROECONOMIC STABILITY:- CONTRIBUTIONS TO OVERALL INFLATION

TABLE 2.0: SUMMARY OF CONTRIBUTORS TO INFLATION JULY 2017- APRIL 2018										
Category	Jul 2017	Aug2 2017	Sep 2017	Oct 2017	Nov 2017	Dec 2017	Jan 2018	Feb 2018	Mar 2018	Apr 2018
Food & Non-alcoholic Beverages	68.7	70.8	67.4	59.1	45.9	38.5	35.7	30.7	17.8	2.1
Alcoholic Beverages, Tobacco & Narcotics	1.0	0.9	1.0	1.2	1.4	1.4	1.3	1.4	1.2	1.3
Clothing & Footwear	4.7	4.1	4.2	4.2	4.8	5.0	5.6	6.3	6.4	7.9
Housing, Water, Electricity, Gas and other Fuels	8.7	9.3	9.7	12.7	21.2	21.4	22.1	23.4	37.0	49.5
Furnishings, Household Equipment and Routine Household Maintenance	3.3	2.9	3.0	3.8	4.1	4.6	4.7	5.9	5.9	6.5
Health	1.3	1.5	1.7	1.9	3.0	3.5	2.8	2.3	2.3	2.5
Transport	3.8	2.8	4.6	6.3	7.3	11.5	12.4	13.4	12.9	13.9
Communication	0.1	0.2	0.2	0.3	0.4	0.5	0.5	0.7	0.7	0.7
Recreation & Culture	0.5	0.4	0.4	0.5	0.5	0.8	0.8	0.8	0.7	0.7
Education	1.4	1.3	1.6	1.9	2.2	2.3	3.6	3.6	3.6	3.7
Restaurants & Hotels	3.9	3.6	3.8	5.2	5.8	6.8	6.6	6.9	6.7	6.2
Miscellaneous Goods & Services	2.7	2.3	2.5	2.9	3.6	3.7	3.9	4.6	4.7	4.9
TOTAL	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

- Risks to inflation outlook seem to have substantially shifted from volatility of food prices to increasing fuel prices domestically and internationally
- The short-term outlook to food inflation is likely to remain low due to good crop performance though there are risks associated with FAW as well as floods.
- Electricity prices may also remain low due to increased production of hydro power as well as continued enhancement of geothermal production (electricity tariff risks?).
- Globally, risks to inflation entail increase in oil prices emanating from robust oil demand growth forecasts, reduction in the US crude stocks and geopolitical tensions especially in the Middle East (OPEC Oil Market Report, April 2018)
- All factors considered, inflation seems likely to remain within the target range for the remainder of the year.

MACROECONOMIC STABILITY:- EXCHANGE RATE

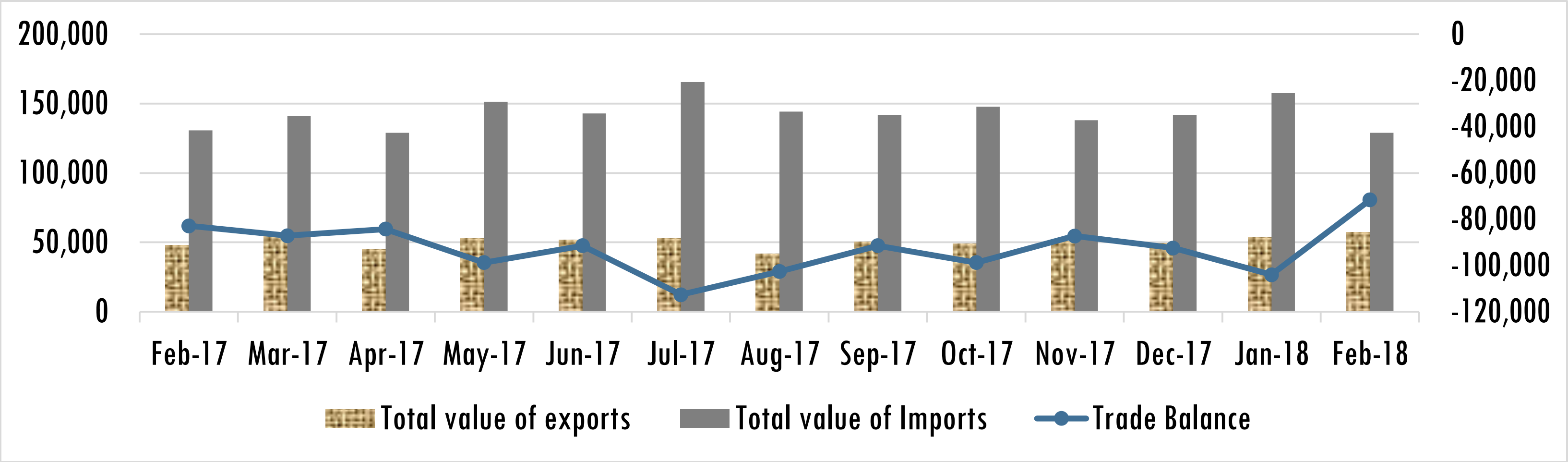
- The exchange rate has been relatively stable against major international currencies as shown in figure 3.0.



- The relative exchange rate stability is attributable to increased diaspora remittances at USD 222 Million by March 2018; a strong reserve position currently at 6.1 months of import cover compared to a threshold of 4 months of import cover; and increased international commodity prices which has been favourable to Kenyan exporters especially in horticulture.

MACROECONOMIC STABILITY:- EXTERNAL SECTOR

- The balance of trade deficit displayed an improvement on account of improved value of total exports and a decline in value of imports as shown in figure 4.0 on Kenya's Trade Balance in Ksh. Million.



- The value of imports declined partly because of a reduction in importation of food, beverage, machinery, equipment (KNBS), and strengthening of the Kenyan Shilling to the US Dollar. The increase in exports can be attributed to the seasonal increased demand for fresh horticultural produce especially cut flowers.
- The trade deficit also reflects the gap between savings and investment. **Therefore, an improvement in the trade deficit will not only require substantial improvement in the value of exports but also an improvement in the level of national savings, to boost investment and therefore growth levels in the country.**

MACROECONOMIC STABILITY:- RISKS TO STABLE EXTERNAL SECTOR OUTLOOK AND ECONOMIC GROWTH PROJECTION

- The risks to the stable outlook for the external sector is that the trade deficit may worsen on account of a substantial increase in imports, as the country begins to import goods related to implementation of infrastructural projects in FY 2018/19 budget, in particular Phase 2 of the SGR.
- There are significant challenges facing the Kenya's exports such as structural competitiveness and quality of exports. The country also faces a risk of withdrawal of the IMF precautionary facility if it does not fulfil the conditions imposed in the arrangement (such as the required level of fiscal deficit), which will adversely affect the foreign reserve position of the country.
- Based on these fundamentals, an economic growth target of 5.8 percent in 2018 may not be achieved. It seems more likely that the economy will grow at 5.5 percent in real terms.
- Lower growth implies lower revenue collection which may hamper implementation of the budget as has been envisaged.

RECENT FISCAL DEVELOPMENT

Between 1st July 2017 and 31st March 2018, the National Government paid a total of Ksh 1,049.29 million on account of guaranteed loans against the projected debt service of Ksh 1,140.85 million.

The cumulative overall fiscal balance, on a commitment basis (excluding grants), amounted to a deficit of Ksh 403.8 billion (equivalent to 4.7 per cent of GDP), as at 31st March 2018.

Between July 2017 and March 2018, external financing amounted to a net borrowing of Ksh 275.1 billion

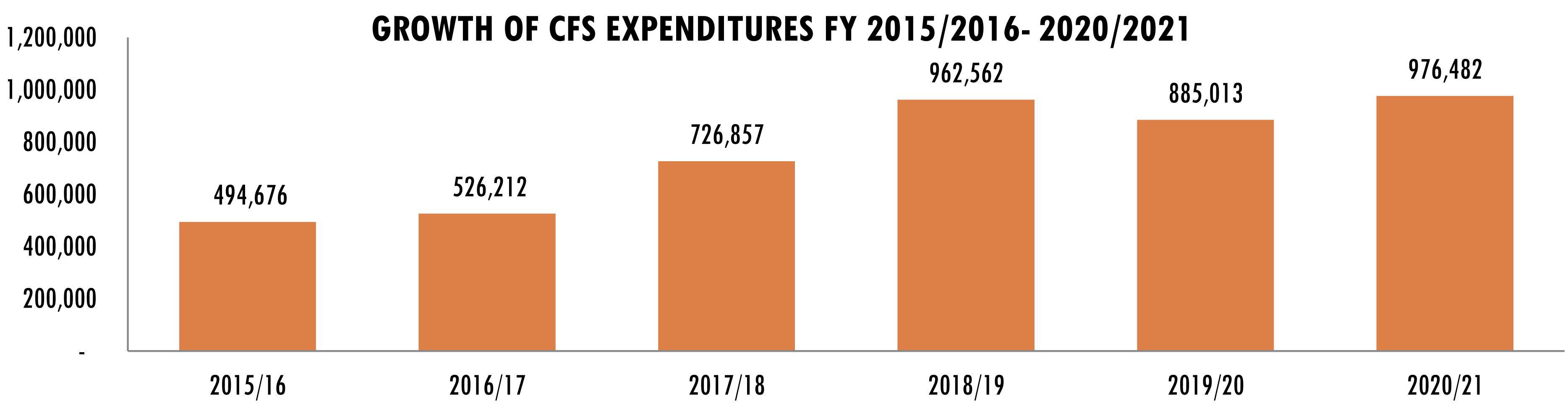
The net domestic financing amounted to a net borrowing of Ksh 125.6 billion (equivalent to 1.45 per cent of GDP) in the period ending 31st March 2018.

The total gross domestic debt stock increased by 21.9 per cent from Ksh 1,945.0 billion as at 31st March 2017 to Ksh 2,371.7 billion by the 31st March 2018.

The total external debt stock, including the International Sovereign Bond, stood at Ksh 2,512.4 billion for the period ending March 2018. The debt stock comprised of multilateral debt (33.3 per cent), bilateral debt (31.9 percent), Suppliers Credit debt (0.7 percent), and Commercial banks' debt (34.1 percent- including International Sovereign Bond)

CONSOLIDATED FUND SERVICES

TABLE 2.0A: CFS EXPENDITURE FY 2015/16 TO FY 2020/21 (KSH. MILLIONS)						
Financial Year	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**
Interest payables	215,507	244,178	305,062	399,981	424,457	449,927
Redemption	221,952	215,727	344,335	470,635	351,112	395,677
Public Debt Payables	437,459	459,905	649,397	870,616	775,569	845,604
Allowances & Others	57,217	66,307	77,461	91,946	109,444	130,878
Total CFS Expenditure	494,676	526,212	726,857	962,562	885,013	976,482
Change		31,535	200,646	235,705	- 77,550	91,470
Percentage Change		6%	38%	32%	-8%	10%



SELECTED CFS DEBT AND INTEREST PAYMENTS FOR FY 2018/2019

CREDITOR	DEBT REDEMPTIONS	INTEREST PAYMENTS
Standard Chartered Syndicated Loan	KSh. 78.7 Billion	-
Debut International Sovereign Bond (USD 2.75 BN)	KSh. 78.3 Billion	KSh.19. Billion
International Development Assistance	KSh. 14.6 Billion	KSh.6.3 Billion
Citi bank		KSh.7.9 Billion
TDB Syndicated Loan	KSh. 37.2 Billion	KSh.13.1 Billion
Exim Bank of China	KSh.8.4 Billion	KSh.22.7 Billion
China Development Bank	KSh.1.7 Billion	KSh.3.5 Billion
2018 international sovereign bond		KSh.15.6 Billion
New loans		KSh.17.9 Billion

- Total CFS expenditure will reach KSh. 962.5 billion in the FY 2018/19 having risen from KSh. 726.9 billion in FY 2017/18and will account for 50% of total national domestic revenue for FY 2018/19.
- Debt related payments will amount to KSh. 870.6 billion i.e. debt interest payable and debt redemption accruing to KSh. 400 billion and KSh. 470.6 billion, respectively.
- Debt related payments will grow by KSh. 221.2 billion, which explains the aggressive growth in CFS expenditures compared to growth in allowances and others payments (include pensions, gratuities, salary to constitutional commissions etc.)
- The FY 2018/19 CFS will be primarily influenced by the debt redemptions. However, other notable mandatory expenditures include: pensions which are expected to reach KSh. 86.3 billion on account increases to pensions to the military, civil servants, Members of Parliament rising from KSh.51.2 billion in FY 2014/15. In addition, gratuity have risen substantially, these primarily relate to civil servants gratuity following new wage demands and changes to terms of civil servant remuneration, and gratuity to the military due to better service terms.

THANK YOU – Q&A