Parliamentary Budget Office

Enhancing the Legislative and Oversight Role of the Kenyan Parliament

Half Year Economic & Fiscal Update, August 2020

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.

A plague of Locusts and a Virus…

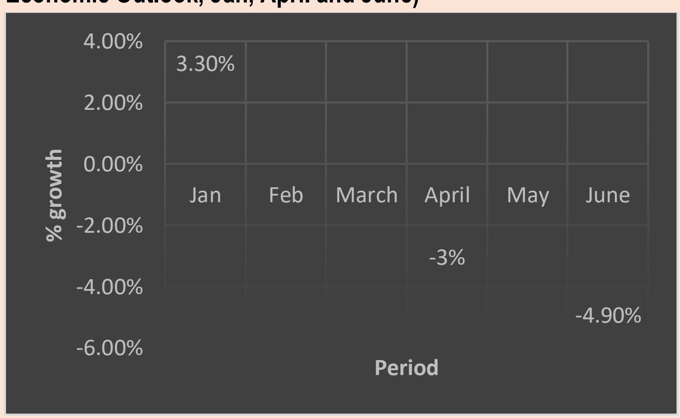
The year 2020 began with general optimism for the Kenyan economy except for a locust invasion in the Horn of Africa that was soon declared by the Food and Agriculture Organization to be *"the worst desert locust crisis in over 25 years, and the most serious in 70 years for Kenya"*. The invasion quickly spread to 25 counties particularly in the arid and semi-arid region, invading farms and vegetation and posing a significant threat to the performance of the agricultural sector. In July, it was reported that the invading swarm of locusts had declined due to control operations by the Kenyan government. However, some counties such as Turkana[1] are still in the throes of the invasion.

In March 2020, the COVID-19 pandemic took hold of the economy, crippling major sectors notably in tourism, hospitality, manufacturing and industry. The economic burden of the health pandemic is mainly an outcome of the containment measures put in place by the government to curb the spread of the virus. These include dusk to dawn curfew, ban on public gatherings, work from home directive and cessation of movement in counties most affected by the virus. These measures led to a significant decline in economic activity resulting in reduced incomes and mass layoffs which adversely affected consumer spending thereby reducing aggregate demand. Furthermore, industries that rely on imported raw materials and intermediate goods experienced a disruption in their supply chains leading to significant scale-down of operations. Above-average rainfall in the March-May rainfall season also triggered flooding and landslides and a number of Kenyans were displaced from their homes.

The Global Economy

Global economic performance weakened significantly in the first half of 2020 on account of the disruptions brought about by the Covid-19 pandemic. Lockdowns, travel restrictions and other measures aimed at containing the pandemic have adversely affected supply and demand of goods and services. As a result, the global economic growth projection has been downgraded significantly by the IMF from a previous forecast of 3.3% in January 2020 to -4.9 percent in June 2020[2]; denoting a global recession. The world bank on the other hand projects a global GDP contraction of -5.2% in 2020.[3]

Figure 1: Global Economic Growth projections 2020 (World Economic Outlook, Jan, April and June)



Data Source: IMF, World Economic Outlook (Jan, April and June 2020)

[1] FAO, Desert Locust Situation Update, 21 July 2020

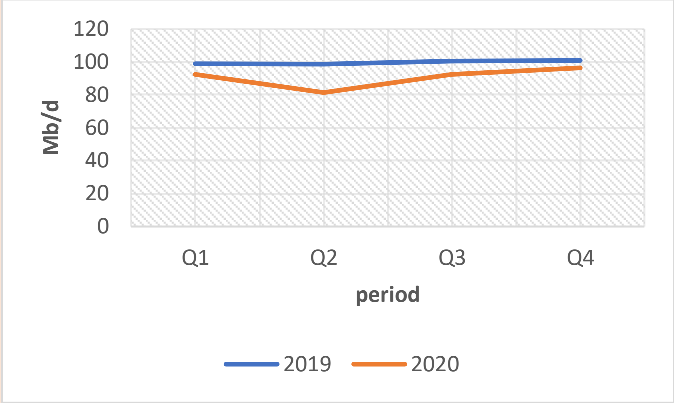
[2] IMF, World Economic Outlook, 2020

[3] World Bank, Global Economic prospects, June 2020

According to the IMF, first quarter economic performance was generally worse than expected in emerging markets with the exception of Chile, China, India, Malaysia and Thailand. In the advanced economies, apart from Australia, Germany and Japan, all the other economies faced lower than expected GDP growth. The IMF further argues that it is very likely that most economies experienced more severe contractions in the second quarter of 2020 since more strict containment measures were implemented in this quarter with the exception of China where most restrictions were lifted in early April 2020.

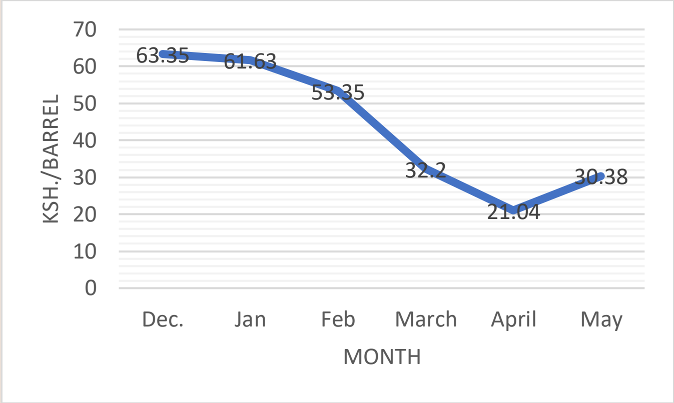
Oil producing countries faced a double challenge in the first half of the year. The global reduction in economic activities adversely affected demand for Oil leading to a significant decline in oil prices as shown in figure 2. Notably, the declining prices happened amidst a global crude oil price war. The demand by the Organization of Petroleum Exporting Countries (OPEC) to further restrict production from April was rejected by Russia, leading to the scrapping of production restrictions that existed at the time which led to increased oil production. Increasing production at a time when demand was low negatively affected the economies of oil-exporting countries. Going forward, Oil demand is projected to increase driven by the phased reopening of most economies and resumption of air travel across the globe.

Figure 2: World oil demand in 2019 and 2020



[4]Data Source: OPEC

Figure 3; Crude oil prices from December 2019 to May 2020



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Data Source: OPEC

The second half of the year is expected to experience better economic performance compared to the first half. The factors that may contribute to the improved outlook include the general easing of Covid 19 restrictions across the globe leading to increased economic activities. Most countries have now developed new systems and knowledge to contain the Virus as opposed to lockdowns and restrictions. However, the optimistic outlook in the second half is only possible with an assumption that the pandemic does not worsen going forward such that it

[4] Mb/d-Millions barrel per day

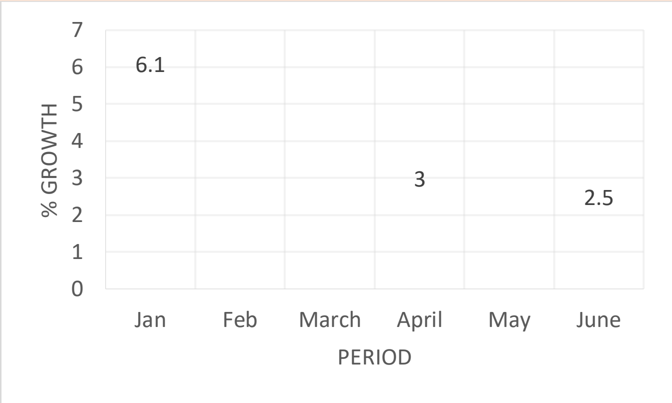
[5] OPEC Monthly Oil Market Report (Jan-June 2020)

necessitates the imposition of stiffer containment measures. However, the performance of the second half of 2020 is expected to be lower than the performance in the same period of 2019.

The Domestic Economy

The National Treasury downgraded the economic growth projection from a previous forecast of 6.1% in February 2020 to 3% in April and further downwards to 2.5% in June 2020 on account of the economic uncertainty brought about by the health pandemic.

Figure 4: Changing growth projections by the National Treasury

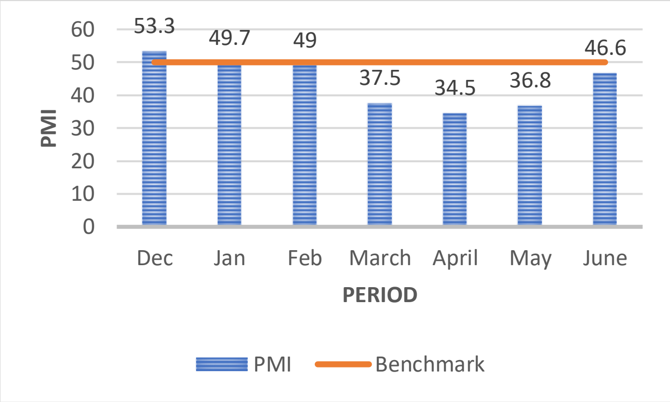


The revised growth projections are as a result of challenges in both the supply and demand side of the economy. Since the emergence of COVID-19, there has been a gradual slowdown in production globally and this, along with the ban on air travel, has adversely affected the supply of goods to Kenya. In particular, the complete shutdown of China in February 2020 adversely affected production in Kenya due to the country's heavy reliance on production inputs from China. Kenya imports approximately twenty one percent of its total imports, especially production inputs, from China. Between January and March, imports from china had fallen by 36.6%, with 82% of businesses in the wholesale and retail sector that depend on imports from China reporting a disruption in their business operations.[6]

The imposition of COVID containment measures in March led to a significant reduction in economic activity. This is illustrated by the Markit Stanbic PMI Index which shows a PMI that has maintained below the threshold of 50 from January to June with a lowest of 34.5 in April. A PMI Index below 50 denotes deterioration of business activity. The situation is expected to improve in the second half of the year as a result of reduced Covid 19 restrictions.

The Nielsens Consumer Confidence Index for Q2 indicates a drop in consumer confidence index by 11 points.

Figure 5; The trend in the Markit Stanbic PMI between December, 2019 and June 2020



Source; Stanbic Bank Kenya and IHS Markit.

On the demand side, the effects have been profound. The Covid-19 containment measures adversely affected the transport sector, recreation, tourism, hospitality and accommodation. According to the Kenya Integrated Household Survey (2015/16), expenditure on these sectors accounts for approximately 50% of total expenditure. These sectors contribute significantly to employment by hiring directly and indirectly through supply

[6]KEPSA; Business perspectives? on the impact of Covid 19 on Kenya's Economy, March 2020

contracts and account for 60% of the country's working population. Reduction in economic activity resulted in mass layoffs, cancellation of supply tenders and consequently loss of tax revenue for the government. A KNBS survey shows that over 3 million Kenyans have been directly and indirectly affected by job cuts due to the pandemic.

In the first quarter of 2020, KNBS indicates slowed growth in some sectors of the economy. Manufacturing contracted by -1% compared to a growth of 3.5% in 2019, Wholesale & retail grew by 7.2% compared to 11.6% in 2019, Accommodation & restaurant experienced a contraction of -5.6% compared to a growth of 10.2% in 2019. Transport and Agriculture were less affected in the first quarter. Agriculture was supported by adequate rainfall during the October – December short rains season in 2019 while restrictions in the transport sector had not been initiated in the first quarter. The growths are shown in table 1.

Growth in GDP by Activity (Quarterly)

Year	qtr	Agric	Manuf acturing	Wholesale & retail	Accom & restaurant	Transport & storage
2016	1	7%	9.1%	2.9%	-4.1%	-3.7%
	2	26.9%	15.1%	2.9%	1.7%	17.1%
	3	19.9%	13%	9.4%	11%	15.4%
	4	4.5%	7.1%	12.6%	10%	13.2%
2017	1	44%	4%	16.9%	20.1%	7.4%
	2	25.2%	0.1%	20.9%	3.3%	6.2%
	3	29%	13%	21%	5.3%	2.5%
	4	20.9%	-0.4%	16%	8.2%	9.1%
2018	1	5.7%	6.8%	10.9%	12.4%	21.5%
	2	3.7%	5.2%	11%	9.8%	14.7%
	3	4.4%	6%	11%	20.5%	18%
	4	16.2%	0.8%	11.1%	28.3%	26.5%
2019	1	16.8%	3.5%	11.6%	10.2%	14%
	2	6.9%	3.9%	11.5%	20.16%	13.6%
	3	5.1%	4.1%	8.2%	10.1%	16.9%
	4	9.1%	15.4%	11.8%	-5.2%	14.7%
2020	1	15.6%	-1%	7.2%	-5.6%	14.4%
	2	15.6%	-3%	4%	-10%	2%
	3	15.6%	1%	6%	-2%	5%

It is estimated that the performance of these sectors worsened between April and June except Agriculture whose performance is likely to have been buoyed by above-average rainfall in most parts of the country during the March-May long rains season. Stiffer restrictions announced in late March adversely affected Accommodation & restaurant and the transport sectors. The Accommodation and restaurant sector depends almost entirely on the tourism sector which is estimated to have incurred a loss of about Ksh.85 billion due to the pandemic and is projected to recover by only 30% between July and December[7] 2020.

Going forward, the outlook for food production is generally favourable though there are risks emanating from the likelihood of desert locust upsurge as well as projected below-average rainfall for the October to December short rains season. In particular, food security outcome in urban areas may worsen due to declining incomes particularly among urban poor households on account of reduced economic activity.

The phased reopening of the economy from early July could improve the performance of some sectors albeit slowly., The slight improvement in business activity as illustrated by the PMI index is largely on account of change in curfew hours, easing of movement restrictions, and the increased economic activity in trading partner countries especially in Europe which has led to increased export orders and a resumption of cargo flights. The sectors expected to benefit from the easing of restrictions include; Wholesale & retail trade, Accommodation & restaurant as well as Transportation and storage. Accommodation and restaurant will, however, continue operating at a lower capacity particularly for the large hotels that depend on international tourists. This is because International tourism may not pick in the second

[7] Ministry of Tourism& Wildlife, media briefing, June 29,2020.

half of the year. The wholesale and retail sector may still experience setbacks due to the reduction in consumer spending that is likely to persist to the end of the year. It should be noted that this economic outcome is largely dependent on the status of the pandemic. A drastic worsening of COVID-19 statistics could result in re-introduction of restrictions. Taking all these factors into account, GDP growth is, therefore, likely to average **1% to 2%** in 2020.

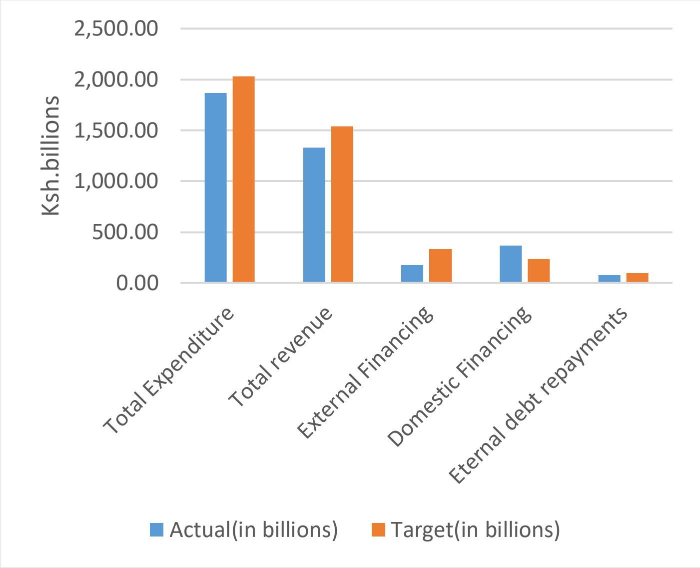
Fiscal Sector

By the end of March 2020, revenue collection was below target by Ksh.204.8 billion with a total collection of Ksh.1,332.2 billion against a target of Ksh.1, 537 billion. Total expenditure stood at Ksh.1,868.2 billion against a target of Ksh.2,028.5 billion. The low expenditure was mainly due to lower absorption of the national government recurrent expenditure. Expenditures such as foreign and domestic travel, trainings and operations reduced significantly in the final quarter. This Expenditure could pick up? in the 2020/2021 financial year with the phased reopening of the economy announced by the President in July 2020.

Going forward, reduced economic activity along with the reduced tax rates and tax reliefs introduced by the government to cushion Kenyans against the adverse effects of the Covid 19 pandemic is expected to significantly reduce revenue collection in the final quarter of 2019/20 and for the rest of the year.

External financing amounted to a net borrowing of Ksh.98.4 billion by 31st March 2020. Total disbursements amounted to Ksh.173.7 billion against a target of Ksh.331.2 billion. External repayments of principal debt amounted to Ksh.75.3 billion against a target of 98.371 billion. The net domestic borrowing amounted to Ksh.367.4 billion against a target of Ksh.233.4 billion.

Figure 7: Performance of selected fiscal indicators by March 2020.



Source; National Treasury

By the end of June, the government surpassed its domestic borrowing target [8], possibly taking advantage of the increased liquidity by the commercial banks. Given increased caution in lending by commercial banks and the increased borrowing by the government, the private sector credit will be negatively affected hampering private sector growth. Commercial banks are expected to increase lending to the private sector towards the end of the year as the level of optimism rises. The government should adhere to its target domestic borrowing to avoid crowding out the private sector in the second half of the year.

Inflation

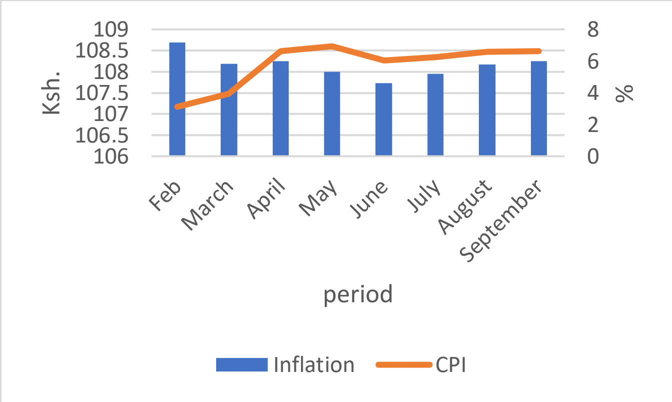
The Kenya National Bureau of Statistics rebased the Consumer Price Index and the Producer Price Index with an objective of enhancing the quality of statistics. The CPI

[8] Kestrel Capital,6th july,2020

increased the size of the basket from 234 items to 330 items. It introduced more relevant items in the basket and dropped items that have become obsolete. The weights on the CPI have been updated and the expenditure groups have been recalculated in line with the Kenya Integrated Household Budget Survey of 2015/16. The rebased PPI was to reflect the changing production patterns and a new industrial structure and is derived from the census of Industrial Production of 2018. The consumer price index on the other had increased significantly in February before stabilizing between April and May. Inflation declined from 7.17 in February 2020 to 4.59 in June 2020. This is attributed to decreased demand and less money in circulation in the economy after a decline in economic activity due to Covid 19 restrictions.

Going forward, Inflation is expected to increase on account of increased fuel prices. The Energy Regulatory Authority announced new fuel prices as from July 14, 2020, citing the recovery of crude oil prices and the increase in the petrol levy from Ksh.0.4 to Ksh.5.40 as the reasons for the major increase in fuel prices. Fuel is a major component in production and transportation and thus will drive up the price of goods due to increased costs.

Figure 8. The trend in Inflation and CPI February to June 2020, with projections for July to September 2020.



Data source; KNBS

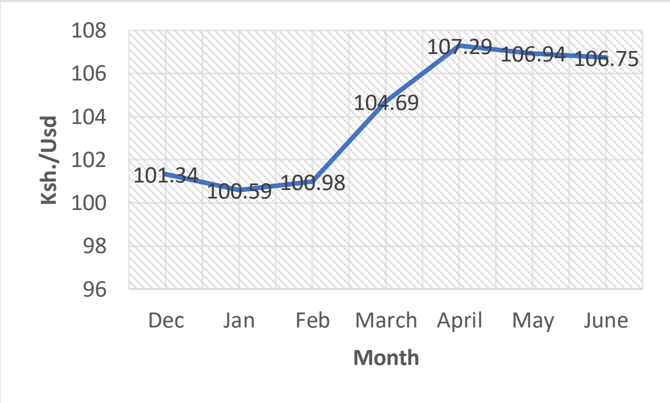
Projections; PBO

Exchange Rate

The value of the Kenya shilling was stable between December and February averaging Ksh.100 to the dollar. However, by April 2020 the shilling had deteriorated to Ksh.107.29 to the dollar. This was likely a result of increased dollar demand with less supply. The demand was been driven by two forces; the first one being the Central Bank Communication of the intention to buy USD 300 Million from commercial banks for three months (March, April and May); the second one was, the possible buying and hoarding of dollars as a result of panic in the market caused by uncertainty due to the Covid-19 pandemic. The shilling gained slightly in May to Ksh.106.94 to the dollar and appears to have stabilized at that level as indicated by the Ksh.106.75 to the dollar in June.

Going forward, the value of the Kenya shilling is expected to decline further as importation picks up pushing the dollar demand upwards. The tourism sector which is expected to alleviate the pressure by earning foreign revenue for the country, may not earn much in the second half of the year due to reduced international travel on account of Covid 19.

Figure 9. Trend in the exchange rate between Dec,2019 to June,2020 (Ksh vs USD)



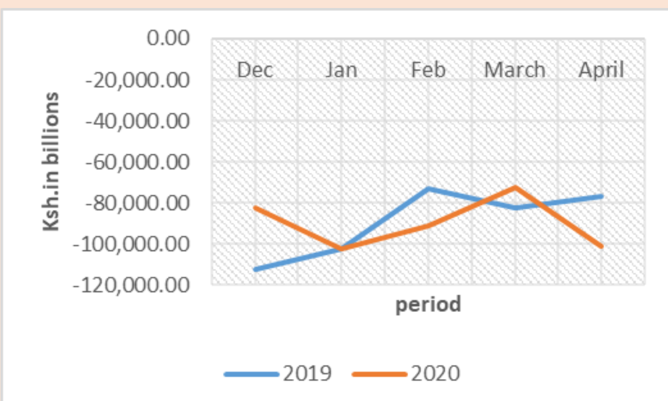
Data source; Central Bank of Kenya

External Sector

The trade balance improved from -102,629.88 billion in January to -72,590 billion in March before deteriorating -101,339 billion in April. The performance of the trade balance was a bit stable in the same period in 2019 compared to the same period of 2020 reflecting the negative impact of the Covid 19 pandemic to international trade.

The deterioration in the trade balance is as a result of the Covid 19 pandemic. The grounding of International flights negatively affected the Kenyan export Market a case in point is the horticulture exports which is estimated to have lost EU $ 3million per day during the lockdown period[9].

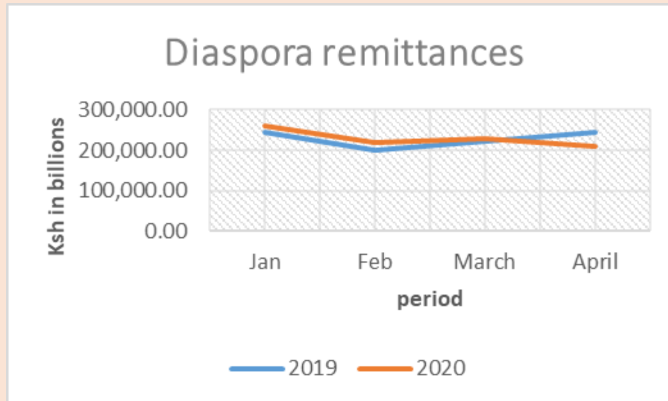
Figure 10.A comparison between the trade balance in 2019 and 2020(same period)



Data source; Central Bank of Kenya

Diaspora remittances had generally increased in early 2020 before taking a dip from mid-March. The remittances declined from Ksh.259, 392.10 million in January to Ksh.208, 217.73 million in April indicating the Covid 19 effects on the Kenyan diaspora community. Going forward, Diaspora remittances will entirely depend on how the Covid 19 situation resolves globally.

Figure 11.A comparison between the performance of diaspora remittances in 2019 and 2020(Jan-April)



Data Source; Central Bank of Kenya

Interest Rates

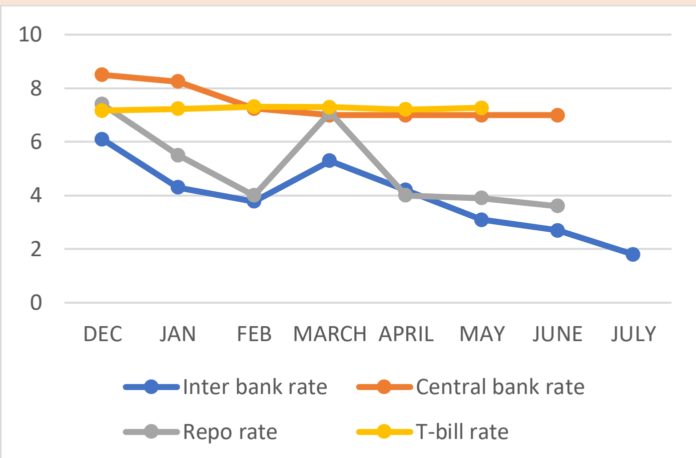
The Monetary Policy Committee has maintained a downward trend of the Central Bank Rate since December 2019. The rate was reduced from 8.5 in December 2019 to 7 in March 2020. The objective of the lowered rate is to reduce the lending and deposit rates by commercial banks. To augment this, and in response to the Covid 19 pandemic, the Central Bank lowered the Cash reserve Ratio to 4.25 per cent in order to avail Ksh. 35.2 billion to commercial banks. This liquidity availed by CBK to banks is based on their demonstrated requirement to directly support borrowers who are distressed as a result of COVID-19.

A look at the interbank rate shows a decline from 5.3% in March 2020 to 1.8% in July 2020. The decline in the interbank rate indicates low demand for cash by banks from other banks signifying adequate liquidity in the commercial banks. The objective of the Central bank lowering its ratios was for banks to lend more due to reduced cost of funds. However, the continued increase in liquidity in the banking sector between March and July shows that the CBK objective was not achieved. This could

[9] Eco Watch, June 08,2020

be explained by low demand for credit and/or increased caution in the banking sector due to uncertainty caused by the health pandemic. Going forward, the phased reopening of the economy may boost confidence for commercial banks to release the additional liquidity to borrowers and may also revive some businesses thereby enabling them to seek credit from banks.

Figure 12.the trend in the various monetary rates between Dec 2019 to June 2020

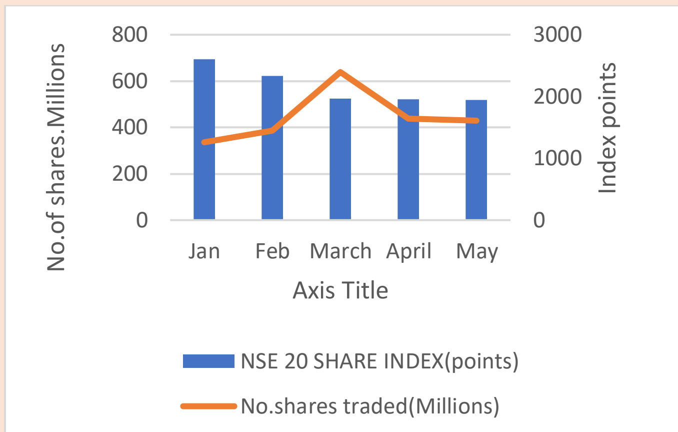


Data source; Central Bank of Kenya

Figure 13, shows the performance of the Nairobi Stock exchange between January 2020 and May 2020. The bourse lost 652 points in this period, dropping from 2600 points in January to 1,948 points by May. During this period, the number of shares increased from Ksh.336 million in January to Ksh.639 million in March before dropping to Ksh.430 million in May.

As a result of the drop in the stock market index, investors lost billions of investments. It is noted that the market lost a market cap of Ksh.345 billion in a week (16th -20th March) indicating a panic by investors due to the uncertainty as a result of the Covid 19 pandemic. The NSE 20 share index, one of the stock market indices was pushed to the lowest level in a decade representing huge capital loses by blue-chip companies. This signalled capital flight due to uncertainty on the potential effects of Covid 19 to the economy. As a result, the bourse suspended trading for 12 minutes as per the NSE rules. This phenomenon has been experienced across the world with the Dow and S&P also experiencing the steepest daily falls since 1987 leading to the suspension of trading by 15 minutes at the New York stock exchange.

Figure 13. The performance of the Nairobi Stock Exchange between January to May 2020.



Data source; KNBS

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