Kenya's Political & Economic situation: Unforeseen political stalemate - Austerity measures to kick in? Can we bet on it?

In the last one week, Kenya has been marred with youth-led protests, triggered by the Finance Bill 2024. The protests escalated into the unprecedented invasion of the Parliament premises, the Supreme Court and the Nairobi County Council offices**. In response, the President of Kenya declined to assent to the Finance Bill 2024, and referred it back to the National Assembly with reservations, recommending the deletion of all 69 clauses of the bill. Therefore, the President's Memorandum constituted a rejection of the bill in its entirety. In effect, the rejection implies a financial gap of about KES 346bn between the expenditure approved by the National Assembly through the Appropriation Bill 2024, and the projected revenues that may be raised from the existing tax measures - that's through the existing Income Tax Act, the Excise Duty Act and the VAT Act.**

To restore law and order, the military was called in to support the police – the civil society has however condemned the move as unnecessary and unconstitutional. **With increased vigilance though, we foresee more peaceful demonstrations going forward**. While the Finance Bill 2024 will be withdrawn, the protesting youth have promised to continue with the demonstrations during the week starting 1st July, to mourn the protestors who were killed. In addition, the youth have also issued a memorandum to the President with their demands. The demands include:

- Reconstitution of the Independent Electoral & Boundaries Commission (IEBC) and increased voter registration. Currently, the IEBC is not properly constituted to conduct elections
- Reconstitution of the cabinet and a thorough audit of the appointees in Ministries, Departments and Agencies of the government
- Dismissal of corrupt government officials, and the scrapping of the Chief Administrative Secretaries positions – assistants to the Cabinet Secretaries
- Cutting down on the government's non-essential expenditure such as hospitality, unnecessary offices, travel, perks etc.
- A full audit of the National debt, with full disclosure of how much has been paid and how much is still outstanding
- Termination of the Housing Levy and an audit of the funds
- The Public Service Commission (PSC) to provide a framework to increase opportunities for qualified youth
- Release of everyone arrested and detained during the protests

In an attempt to explain the government's position, the President of Kenya held a televised interview with the journalists on Sunday 30th June. He noted that the tax proposals within the Finance Bill 2024 were targeted at addressing Kenya's fiscal deficit, in particular:

- Debt servicing (KES 1.0tn in interest payments in 2024/25 – 35% and 26% of budgeted ordinary revenue and expenditure, respectively;
- Public wage bill (wage bill as a % of revenue stands at about 46% against the recommended 35% levels – about KES 0.6tn in 2024/25);
- Mandatory county government allocations (a minimum of 15% of the audited revenues – about KES 0.4tn in 2024/25).

Without the expected additional KES 346bn (c.10% of budgeted 2024/25 revenue) from the Finance Bill 2024, the President hinted that the country will be forced to borrow about KES 1.0tn in the fiscal year 2024/25. In the 2024/25 budget estimates, the fiscal deficit is estimated at approximately KES 0.6tn (excluding grants). **In our view, we find the statement contradictory since the President had earlier indicated that the revenue shortfall will be made up for by cutting expenditure. He had asked the reduction of about KES 346bn in expenditure across the National and County governments. From history though, we have not seen the government successfully achieve austerity measures. It's our belief that the President seems to understand this difficulty – we wait to see if he will champion the required political goodwill. Given the National Assembly passed the Appropriation Bill 2024, the reduction of approved expenditure can only be achieved through enacting a Supplementary Appropriation Bill 2024.**

In the last few days, the President has met with multiple religious groups to forge the way forward. The religious groups have requested the youth to end the protests and engage the government. The President has mentioned that the government will set up a National Multi Sectoral Forum to engage all stakeholders to address the concerns raised by the youth. Key matters to be discussed will include:

- Jobs and other opportunities
- The Nation's tax policy
- The National debt burden
- Expanded representation and accountability
- Anti-corruption measures

KENYA'S FISCAL PERFORMANCE

Below is a table showing the fiscal performance of the government against its targets. We highlight that, over the five-year period;

- The government has underperformed its revenue targets
- The government has performed below targets on expenditure– lower absorption rates
- The fiscal deficits have been below target
- The borrowing targets have not been met

The government's past budgetary performance, especially with respect to the fiscal deficit and total borrowing, does offer some relief following the rejection of the revenue measures proposed within the Finance Bill 2024.

BUDGET: ACTUAL VERSUS TARGETS

Amounts in KES bn	2019/20		2020/21		2021/22		2022/23		2023/24*	
	Actual	**Target**	**Actual**	**Target**	**Actual**	**Target**	**Actual**	**Target**	**Actual**	**Target**
Total revenue	1,753	1,900	1,815	1,911	2,231	2,255	2,384	2,520	2,886	2,986
Expenditure & net lending	2,565	2,818	2,750	2,887	3,028	3,286	3,221	3,367	3,878	3,747
Fiscal Deficit (incl. grants)	**- 812**	**- 918**	**- 934**	**- 976**	**- 797**	**- 1,031**	**- 837**	**- 846**	**- 908**	**-719**
Fiscal deficit to GDP	*8.0%*	*9.0%*	*8.3%*	*8.7%*	*6.3%*	*8.2%*	*5.9%*	*5.8%*	*5.6%*	*4.4%*
Net foreign financing	340	324	323	418	143	343	311	363	502	132
Net domestic financing	450	594	627	559	605	688	460	484	407	587
Total financing	**791**	**918**	**950**	**976**	**748**	**1,031**	**770**	**846**	**908**	**719**
Total debt to GDP	*60.7%*	*60.7%*	*63.2%*	*64.2%*	*64.1%*	*64.6%*	*68.4%*	*62.3%*	*68.8%*	*62.2%*
Interest expense to ord. revenue	*27.8%*	*26.9%*	*31.7%*	*29.2%*	*30.1%*	*32.7%*	*33.7%*	*31.8%*	*34.8%*	*30.2%*
Interest expense to expenditure	*17.0%*	*15.4%*	*18.0%*	*16.0%*	*19.1%*	*18.4%*	*21.3%*	*20.2%*	*22.2%*	*20.7%*

*Source: National Treasury, Parliament; Amounts in KES bn, * Budges Estimates 24/25*

2024/25 BUDGET

Amounts in KES bn	2024/25		
	Target	**Target (excluding additional revenue from Finance Bill 2024)**	**Target (austerity measures following rejection of Finance Bill 2024)**
Total Revenue	3,354	3,008	3,008
Expenditure & net lending	3,921	3,921	3,575
Fiscal Deficit (incl. Grants)	**-515**	**-913**	**-567**
Fiscal deficit to GDP	*2.9%*	*5.1%*	*3.2%*
Net foreign financing	259	365	227
Net domestic financing	258	548	340
Total financing	**515**	**913**	**567**
Total debt to GDP	*64.5%*	*66.7%*	*64.7%*

Source: National Treasury, Kestrel Estimates

We observe from the table above that the rationalisation of expenditure draws the government closer to its initial fiscal deficit to GDP target. Looking ahead, owing to the demands for budget cuts, we expect the cuts to largely focus on the operations and maintenance expenses for Ministries, Departments and Agencies. In our view, the reduction in the public wage bill will be quite difficult owing to the push back from labour unions. Alternatively, the government could review downwards its development expenditure – though this will deliver minimal fiscal deficit gains since large projects are financed via project funding and not from revenue.

WHAT NEXT FOR THE IMF FUNDING PROGRAM?

In the last 5 years, as part of the IMF Funding and Budgetary Support program, the government was to reinforce fiscal consolidation, through tax mobilisation (pegged on cutting on tax expenditures & broadening the tax bracket), public wage bill reforms, restructuring of State-owned Enterprises (SOEs), rationalization of unproductive spending and more recently scaling back on subsidies. The measures have been targeted at making Kenya's debt level sustainable. While the government has made some progress, mostly keeping the fiscal deficit contained, the risk of Kenya's debt being unsustainable remains.

Given that one of the IMF's key pillars of increased tax mobilization is off the table, in our view, we expect the IMF to review its recommended policies and reforms outlined in the 11th June 2024 Staff- Level Agreement. Even if the Staff-Level Agreement is not reviewed, we expect the IMF's Executive Board approval of the Seventh Review of the EFF/ECF Agreements to be delayed. A delay in the approval will deny Kenya USD 976m under the expanded IMF program.

ECONOMIC OUTLOOK:

2024 Expectation (Jan 2024)	**Rating**	**Basis (Jan 2024)**	**Basis (Post Finance Bill 2024 rejection)**
GDP: 4.8% - 5.2%	**Neutral**	○ Subdued private sector consumption amidst inflationary pressure & higher taxes. ○ Modest government consumption growth in line with targeted fiscal consolidation & growing debt servicing obligation. ○ Tight bank lending standards and high lending rates to limit private sector	**Impact: Negative** 1Q24 GDP performance was resilient supported by improved agricultural output & services sector performance, improved trade balance and steady inflation. We expect GDP to slow down in 2H due to; tight monetary & fiscal policies, reduced

2024 Expectation (Jan 2024)	Rating	Basis (Jan 2024)	Basis (Post Finance Bill 2024 rejection)
		credit growth – negatively impacting both consumption & capital formation. ○ Stable agricultural output and services sector performance to positively impact growth.	private sector activity and continued contraction in private sector credit. We expected 2024 growth to be closer to the lower end of our 2024 range.
Interest rates: CBR: 11.5% - 14.0%; 10-year government yield: 15% - 17%	**Negative**	○ Hawkish monetary policy to persist amidst weak KES and inflation resurgence risk. ○ Refinancing pressure & increased domestic borrowing to sustain elevated yields, but investor risk-off sentiment will moderate the increase. ○ Peer countries' yields remain above 15-year average, amidst continued tight policy.	**Impact: Neutral** **CBR:** In February the benchmark rate was increased by 50bps to 13.0%. **10-year yield**: 17.60% in Jan, peaked at 18.6% in March and currently at 17.69%. We expect CBR to ease to 12.0% in 2H24 as the Central Bank tries to stimulate economic activity, but remains defensive on the FX front. We expect the 10-year yield to remain above the 17% mark driven by increased borrowing to cover for an expanded fiscal deficit. An increase above the 19% mark will be dependent on whether the Central Bank continues to support market liquidity through Reverse-REPOS (in 1H24, liquidity injection hit a historic high, c. 50.0% of the banking industry's total assets).
Currency: 10% - 12% depreciation against USD;	**Negative**	○ Supply-demand imbalance to persist on increased foreign debt servicing and modest narrowing of the trade account. ○ Low FX reserves to add to supply-demand imbalance and hoarding of hard currencies. ○ Policy led widening of real interest rates to offer some relief, but investor risk appetite must also turn.	**Impact: Negative** 1H24, the KES has appreciated 20.8% against the USD, beating our expectations by far. In 2H24, our base case is for the KES to depreciate by 10.0% as structural GDP weakness becomes more pronounced, the boost from new lumpy FX loans ebbs and demand for the USD increases on weak economic sentiment.
Inflation: Headline 6.0%-8.0%; Core 3.0%-3.5%	**Neutral**	○ FX weakness, scaling back of subsidies & excise tax increases on goods & services to sustain elevated headline inflation. ○ Core inflation to flatten amidst easing consumer demand & tight bank lending standards.	**Impact: Neutral** Jan to June, on improved food production and stronger KES, inflation eased from 6.9% to 4.6%. We expect inflation to remain within the 5.5% to 6.0% range, amidst reduced economic activity, but a weaker KES.

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