KENYA

A BRIEF RESPITE

In Kenya, further fiscal consolidation is proving increasingly difficult. The efforts required of the population were strongly protested over the summer of 2024, forcing the government to withdraw the finance bill it had drafted with the IMF. Now, for the current fiscal year, the deficit is to be reduced mainly through spending cuts, which are adversely affecting economic growth. While this alternative offers a brief respite, a sustained increase in public revenues remains essential to ensure debt sustainability and safeguard the IMF's financial support in the medium term. This could prove all the more necessary as Donald Trump's return to the White House could pose new risks for Kenya's public and external accounts.

SLOWDOWN IN ECONOMIC GROWTH

Economic growth has been slowing since the start of 2024. From 5.6% in Q4 2023, growth measured over 4 quarters fell to 4.7% year-on-year (y/y) in Q3 2024. Activity is unlikely to rebound sharply in Q4, and real GDP growth for the year as a whole will be lower than the Central Bank's initial forecast of 5.1%.

There are several reasons for this general slowdown in the main sectors of the economy. Firstly, activity between June and August was affected by the protests against the government's finance bill. In addition, the tightening of the monetary policy of the Central Bank of Kenya (CBK), pursued from May 2022 to early 2024, rapidly squeezed the flow of credit to the private sector (25% of GDP). In October 2024, nominal growth in credit to the private sector was null y/y, compared with 14% in December 2023. Despite a first cut in the policy rate in August 2024, commercial banks' lending rates continued to rise, hitting 17.1% in October, the highest level since 2016. Monetary tightening and the deterioration in the business climate since 2022 have severely penalised private investment. Finally, with the fiscal consolidation efforts undertaken by the Ruto administration, which came to power in 2022, public development spending, which includes public investment, contracted by 8.5% in nominal terms during the 2023/2024 fiscal year (FY).

As a result, by 2023, the total investment rate had already fallen to 16% of GDP, compared with 19% in 2022 and 20% on average over 2015-2021. This decline is damaging the country's medium-term economic outlook. The Kenyan Treasury's target of taking economic growth above 7% by 2028 seems ambitious, as does the goal of doubling the share of the manufacturing sector in GDP by then. The manufacturing sector currently accounts for just 7.3% of GDP, and this share has declined slightly since 2019. Nevertheless, this sector is the second largest provider of formal employment after the agricultural sector. Therefore, its development remains crucial to reduce the size of the informal sector (estimated at around 80% of total employment), which would help increase fiscal revenues.

INFLATION UNDER CONTROL AND MONETARY EASING UNDERWAY

In 2022, rising oil prices (26% of imports) and global monetary tightening contributed to a sharp depreciation of the local currency and a significant rise in inflation. The Kenyan shilling depreciated by 27% against the US dollar between the end of 2021 and the end of 2023, while inflation averaged 7.7% over 2022 and 2023. The CBK raised its policy rate by 600 basis points (bps) between May 2022 and February 2024, taking it to 13%. The subsequent improvement in the external accounts, thanks in particular to the government's return to international capital markets in February, enabled the Kenyan shilling to appreciate again (by 23% against the dollar between February and April) and then stabilise. Since May 2024, inflation has fallen back below the Central Bank's 5% target, hitting 3% in December. These two factors enabled the CBK to cut its policy rate by 175 bps between August and December.

FORECASTS

	2022	2023	2024e	2025e	2026e
Real GDP growth (%)	4.9	5.6	4.6	5.0	4.8
Inflation, CPI, year average, %	7.6	7.7	4.5	5.0	5.0
Cent. Gov. balance / GDP (%) (1)	-5.3	-5.2	-4.8	-4.4	-4.0
Cent. Gov. debt / GDP (%)	67.8	73.1	68.2	70.7	70.5
Current account balance / GDP (%)	-5.0	-4.0	-4.1	-4.3	-4.8
External debt / GDP (%)	34.6	39.4	34.9	37.0	37.4
Forex reserves (USD bn)	7.4	6.6	9.2	8.9	8.6
Forex reserves, in months of imports	4.2	3.5	4.7	4.4	4.2

(1) Fiscal year from July 1st of year N to June 30th of year N+1

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

KENYA: CONSUMER PRICES AND MONETARY POLICY

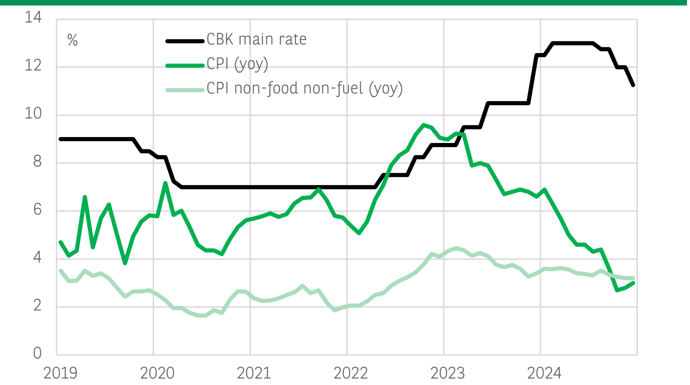

CHART 1 SOURCE: CBK, BNP PARIBAS

The monetary easing cycle is expected to continue at the next committee meeting in February 2025, given the sharp slowdown in growth of credit to the private sector and the margin between the current inflation rate and its target. However, the CBK's room for manoeuvre has narrowed since Donald Trump's return to the White House and the risk of a status quo in US monetary policy in 2025.

FISCAL CONSOLIDATION AT RISK

Since 2022, the government has been undertaking a process of fiscal consolidation. It is aiming to correct years of substantial deficits (7.2% of GDP on average over 2015-2022), which pushed the public debt ratio to 73% of GDP in Q4 2023 (compared with 45% in 2015). The interest burden on public debt, which has systematically absorbed more than 25% of government revenues over the last five years, is a major obstacle to debt sustainability.

In FY 2023/24, unpopular measures, such as doubling VAT on fuel and creating new taxes, enabled government revenues to grow by 14%, compared with nominal GDP growth of 9%. However, at 17% of GDP, revenues remained low, while interest payments on debt amounted to 5.3% of GDP, or 31% of government revenues. Therefore, despite a slightly positive primary fiscal balance, the fiscal deficit remained at 5.2% of GDP.

The Treasury has attempted to redouble its efforts for the current fiscal year (July 2024-June 2025). However, the initial finance bill, which planned to drastically reduce the deficit to 3.3% of GDP by increasing tax revenues, was fiercely protested. The protests, which culminated in the storming of Parliament at the end of June, forced the government to withdraw its finance bill, which had been drawn up in collaboration with the IMF. Instead, the finance bill that was finally adopted stipulates a fiscal deficit of 4.4% of GDP. Fiscal consolidation is no longer being achieved through increasing revenues, but through reducing spending instead. More specifically, development spending has once again been revised downwards (-14% compared with the initial finance bill), while total revenues are expected to stagnate at 17% of GDP, compared with 18.5% in the initial finance bill.

The planned budget cuts do not tackle the government's recurrent expenditure. This includes the public sector wage bill, the size of which is a major challenge. In FY 2022/23, it absorbed 42% of fiscal revenues. The government's plan to reduce this to 35% by 2028 seems ambitious in light of the strong pressures to increase wages. Besides, in order to ensure public debt sustainability, government revenues still need to be increased. This will need to be accompanied by measures to restore taxpayer confidence, such as improving the transparency of public spending, increasing public accountability and fighting corruption. Implementing these measures will be essential if the government wants to renew the IMF's financial support in the medium term, as its programme expires in April 2025.

TEMPORARY IMPROVEMENT IN THE BALANCE OF PAYMENTS

The external accounts are fragile. The current account's structural deficit is large (-5.5% of GDP on average over 2015-2022). Since 2023, due to the fall in public investment and the recovery in agricultural exports after two years of drought, the current account deficit has contracted to 4% of GDP in Q3 2024. However, the same vulnerabilities persist and the trade deficit remains high (8% of GDP). On the one hand, the country's export base is limited to low value-added agricultural production that is vulnerable to climate shocks. On the other hand, a large proportion of imports cannot be reduced, as Kenya is a net importer of energy and food products.

To finance the current account deficit, Kenya relies mainly on issuing public debt in foreign currency, with debt accounting for 86% of gross foreign capital inflows on average over 2015-2023. With the global monetary tightening of 2022-2023, the government lost its access to international capital markets. Despite increased financial support from multilateral donors over the period, Kenya had to draw on its foreign exchange reserves to cover its external financing needs. They fell by USD 1.1 bn between February 2022 and mid-February 2024. Since a Eurobond issuance in February, the confidence of private external creditors has risen and net portfolio flows have returned to slightly positive territory (USD 700 mn cumulatively over 12 months). Foreign exchange reserves have gradually increased by USD 2.1 bn between February and January 2025, hitting USD 9.2 bn. At this level, they cover 4.7 months of imports, a relatively comfortable level. However, without financial support from the IMF, foreign exchange reserves are expected to fall again in 2025 and 2026.

KENYA: DIFFICULT FISCAL CONSOLIDATION

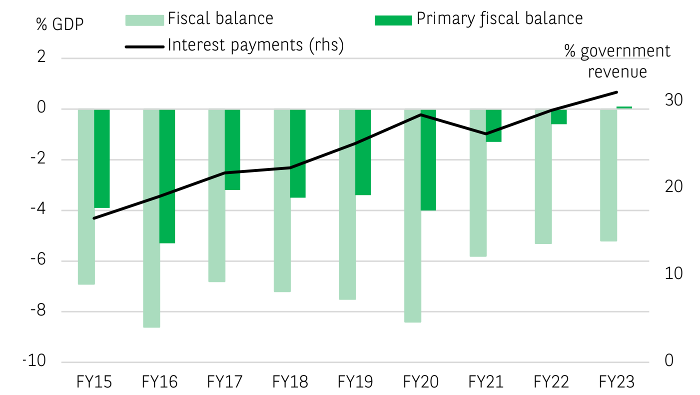

CHART 2

SOURCE: CBK, BNP PARIBAS

TRUMP 2.0 AND THE RISKS TO PUBLIC AND EXTERNAL ACCOUNTS

Given the vulnerability of external accounts, Donald Trump's return to the White House is a risk factor for Kenya. His programme is likely to delay monetary easing by the Fed, which could contribute to a tightening of international financing conditions. This could disrupt the Kenyan government's external financing plans ahead of the many debt repayments that it faces in the medium term. Between 2025 and 2031, the country will have to repay a total of USD 4.2 bn in Eurobonds that are due to mature, including an amortisation of USD 1 bn in 2028. In addition, if the CBK eases its monetary policy less than expected, this could adversely affect the interest burden on domestic public debt (80% of total interest payments) and on fiscal consolidation. For the time being, the USD/KES exchange rate has been stable since the election of D. Trump (-0.3% between the first week of November 2024 and mid-January). However, pressure on the external accounts and the exchange rate could increase from April 2025 with the end of the IMF programme.

Kenya's exports to the United States, and the African continent's exports to the United States as a whole, could also suffer as a result of Trump's protectionism. Kenya and 31 other African countries currently enjoy duty-free access to the US market for many goods thanks to the African Growth and Opportunity Act (AGOA). As a result, in 2023, the average tariff on Kenya's exports to the United States was just 0.3%. However, the AGOA expires in September 2025, and its terms will have to be reviewed by the US Congress. On a positive note, with the United States accounting for just 6% of Kenya's exports (mostly textiles), the impact should be limited. In addition, Kenya could succeed in redirecting its textile exports to the European Union, with which it has signed a free trade agreement in force since July 2024.

Finally, the amount of official development assistance (ODA) paid by the United States could be revised downwards. On average over 2019-2023, ODA flows from the United States totalled USD 0.8 bn per year, i.e. almost a quarter of total ODA flows and 0.8% of GDP. Of this amount, 40% is earmarked for emergency food programmes which, in theory, should not be suspended. However, the HIV programme (29% of the United States' ODA), as well as other health and education programmes, face the risk of budget cuts.

Lucas Plé
lucas.ple@bnpparibas.com