KENYA

RELATIVELY SPARED FROM THE CRISIS BUT WEAKENED

Although Kenya was spared a recession in 2020, the Covid-19 shock exacerbated the country's economic vulnerabilities. The risk of excessive public debt is especially high, and despite financial support provided by multilateral and bilateral creditors, budget management will remain a big challenge in the short and medium terms. The level and structure of the debt expose the government to solvency risk. Fortunately, reforms are expected to reduce this risk, and the IMF financing programme recently granted to the Kenyan authorities should support these efforts and help reassure non-resident investors.

A DYNAMIC BUT UNCERTAIN RECOVERY

Although Kenya was spared a recession in 2020, the pandemic had a significant impact on the economy, which is largely driven by the services sector. At the height of the crisis in Q2 2020, GDP contracted nearly 6% year-on-year. The Central Bank of Kenya (CBK) cut its key rate on two occasions, lowering it by a total of 125 basis points to 7%. In addition to fiscal support measures (estimated at 0.5% of GDP), other measures were taken to inject liquidity, including a 100bp reduction in the reserve requirement ratio to minimise the impact of the shock and allow the exchange rate to act as an adjustment variable. All in all, full-year 2020 GDP growth is estimated to near zero.

The rebound in GDP growth is expected to continue in 2021 with a full-year growth of nearly 5%. Yet the current environment is still marred by a high level of uncertainty. This is mainly due to the high risk of a new wave of contaminations and further restrictions on business. In early March, the Kenyan authorities implemented new preventive measures and restrictions to combat a surge in new Covid-19 cases. The prospects of recovery will continue to hinge on the spread of the pandemic and the rollout of a vaccination campaign. To date, the country has received nearly a million doses of the AstraZeneca vaccine as part of the Covax initiative[1]. The authorities' goal is to vaccinate half of the population by mid-2023.

In January, the IMF granted Kenya a financing programme to help support the recovery phase, with funding of USD 2.4 bn over three years. The programme will support fiscal consolidation efforts in particular, to help the Kenyan government contain the growing risk of excessive debt.

THE FISCAL DEFICIT AND PUBLIC DEBT ARE MORE VULNERABLE

Already hit structurally by budget mismanagement, the fiscal deficit swelled last year in the midst of the crisis (to 8.5% of GDP in 2020, compared to a 2015-2019 average of 7.9% of GDP). The accumulation of deficits has driven up the public debt, which increased even more as the fiscal pressure intensified due to crisis management: the revenue collected in fiscal year 2019/20 fell far short of forecasts, while expenditures were much higher than expected. The public debt has now swelled to nearly 70% of GDP (+15% in nominal value compared to 2019), the critical threshold defined by the IMF to indicate a high risk of excessive debt.

Already present before the crisis, this excessive debt risk is now a major source of vulnerability. Attesting to this situation, S&P downgraded the country's sovereign rating from B+ to B in early March 2021. Moreover, with more than a third of the debt comprised of commercial loans, its very structure implies a considerable cost. Interest on the external debt has doubled since 2015 due to the reduction in the share of concessional loans (they now account for less than a quarter of Kenya's debt). The government has had to face up to the sharp drop in fiscal and export revenue over the past year, which has sharply undermined its debt servicing capacity. The government is also exposed to currency risk because half of debt outstanding is denominated in foreign currency (67% in USD). In 2020, the Kenyan shilling depreciated by 10% against the US dollar.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	5.4	-0.1	7.6	5.7
Inflation (CPI, year average, %)	5.2	5.3	5.0	5.0
Cent. Gov. balance / GDP (%)	-7.7	-8.4	-8.1	-6.7
Cent. Gov. debt / GDP (%)	62.1	68.7	71.5	72.9
Current account balance / GDP (%)	-5.8	-4.8	-5.3	-5.4
External debt / GDP (%)	46.8	47.2	45.9	45.0
Forex reserves (USD bn)	9.5	8.9	7.2	7.9
Forex reserves, in months of imports	6.1	4.9	4.2	4.6

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

UNPRECENTED CONTRACTION OF THE ECONOMIC ACTIVITY

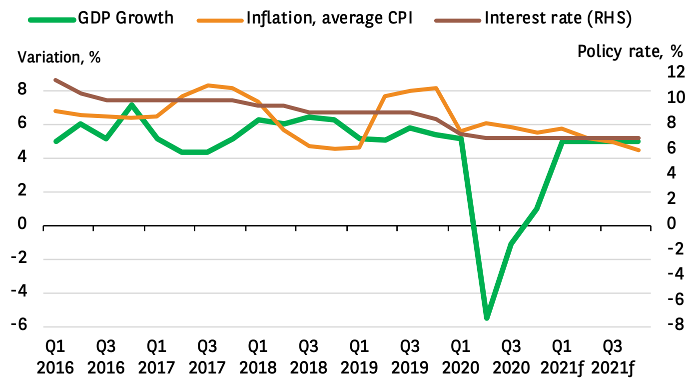

CHART 1 SOURCE: CENTRAL BANK, BNP PARIBAS

1 This initiative of the UN and its partner countries aims to guarantee that all countries have equitable access to safe and effective vaccines.

TEMPORARY SUPPORT MEASURES

To address this situation, the country has benefited from a debt servicing moratorium with the Paris Club of international creditors. Initially reluctant to join the Debt Service Suspension Initiative (DSSI), fearing it would send a negative signal to bond investors and reduce its access to the market, Kenya was finally granted a 6-month holiday on debt payments by the Paris Club between January and June 2021, saving the country about USD 300 million. Debt payments to Chinese creditors were also suspended over this same period, representing savings of about USD 345 million. These amounts will have to be paid back over a 5-year period starting in 2023. The Kenyan government has pledged to continue honouring the amounts due to its multilateral creditors.

All in all, the financial relief is both limited and temporary. It will ease the liquidity squeeze and will enable the funds to be reallocated to support the recovery, but it does not resolve the structural problem of debt sustainability. The amount saved (USD 545 million) accounts for only 20% of overall servicing of its external public debt in 2021. Moreover, the amounts at stake are rather small compared to the country's overall external financing needs, which are equivalent to about 6% of GDP in 2021 (USD 6.7 bn). Debt servicing will still account for about 27% of exports, exceeding the IMF's indicative prudential threshold of 23%.

Alongside these measures, Kenya reached an agreement with the IMF for a 38-month, USD 2.4 bn financing programme subject to a quarterly review. The funding should be used in principle to support recovery efforts, streamline expenditures, and broaden the tax base. These reforms are necessary to ensure debt sustainability in the medium term and to contain the related risks, which are straining the local bank system. Already strapped with a high doubtful debt ratio (14.14% in December 2020, 2.1 percentage points higher than in December 2019), the banking system is largely exposed to sovereign risk, and to the solvency risk of parastatal or state-owned companies: nearly a third of all banking sector loans are comprised of public debt. This also creates a crowding out effect for private sector lending.

THE POLITICAL CALENDAR COULD DELAY FISCAL CONSOLIDATION

Measures to improve public finance management will remain the focus of attention in the months ahead. The government has said it is determined to favour borrowing from multilateral and bilateral creditors, which allows it to lock in more favourable interest rates.

Depending on the amounts obtained through official creditors, the Treasury of Kenya also intends to raise funds in the international bond market this year. The bond issue will be used to pre-finance future debt payments at a time when interest rates are still relatively attractive, but susceptible to deteriorate[2]. At mid-March, the Kenyan 10-year government bonds yield was 12.8%, up from 12.7% in mid-March 2019.

The political calendar suggests that these fiscal consolidation efforts could be postponed and limited in scope. With a constitutional referendum scheduled for June 2021 and general elections to be held in 2022, there is reason to doubt that the government will be able to concentrate on measures to clean up public finances in the months ahead.

RISING PUBLIC DEBT LEVEL AND BURDEN

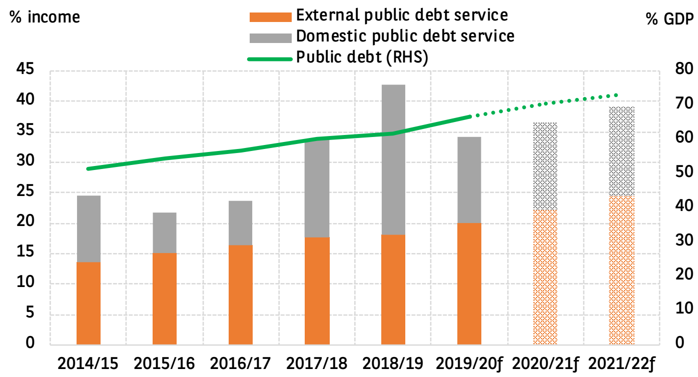

CHART 2 SOURCE: NATIONAL TREASURY, CENTRAL BANK, BNP PARIBAS

The Building Bridge Initiative (BBI) has major implications for the next elections because it aims to redefine the government's structure. The initiative is still being debated in Parliament, because both its content and form are controversial at a time when gatherings are banned and the organisation of the referendum will be very costly.

Non-resident investors have managed to look beyond the political risks in recent years, and Kenya's attractiveness could be preserved under these circumstances. Foreign investors are still necessary as a source of financing and new source of growth. The private bond market's resilience in recent months relative to the regional market illustrates the persistent attractiveness of Kenya's economy. The sovereign bond issue expected later this year will set the tone. Seen in this light, the new IMF financing programme is a positive factor.

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Perrine GUÉRIN
perrine.guerin@bnpparibas.com

2 Expectations of rising inflation and higher interest rates in the advanced countries (notably the US) have a negative impact on the attractiveness of emerging market bonds for investors: it reverses the yield/risk ratio.