Horizon Kenya

Exploring trends set to shape the future in Kenya

CHAPTER 4 OF 6:

FINANCE

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EAST AFRICA

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We synthesise global, regional and country-level data and research, and complement this with our own targeted intelligence-gathering from strong networks in East Africa.

This first Horizon East Africa report (compiled in 2019) looked at regional trends, while this second series provides more in-depth analysis into the key trends likely to shape the future of Kenya, considering the impact of COVID-19 on the country's prospects for economic transformation moving forward.

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Finance

A Pandemic Amidst An Imminent Debt Crunch

PART A: UNDERLYING TRENDS

Owing to unproductive spending and a growing dependence on commercial loans, Kenya is facing a potential debt crisis.

Kenya's debt has been rising since 2013 and growing interest costs are placing downward pressure on government spending.

Kenya's rising debt level has been caused by – among other things – unproductive spending.

Over the long-term, certain factors may help avert a debt crisis, such as the attraction of private sector investment, the discovery of oil and demands from youth for fiscal accountability.

PART B: IMPACT OF COVID-19 ON FINANCE IN KENYA

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What might a deeper deficit mean for economic transformation?

Narrowing fiscal space may put political pressure on reform efforts already underway.

Kenya will need investment to boost private sector growth, alleviate fiscal pressure, and put the country on a path to transformative growth.

Channeling appropriate finance requires a clear vision and prioritising strategic projects in the right sectors.

PART A:

UNDERLYING TRENDS

Owing to unproductive spending and a growing dependence on commercial loans, Kenya is facing a potential debt crisis.

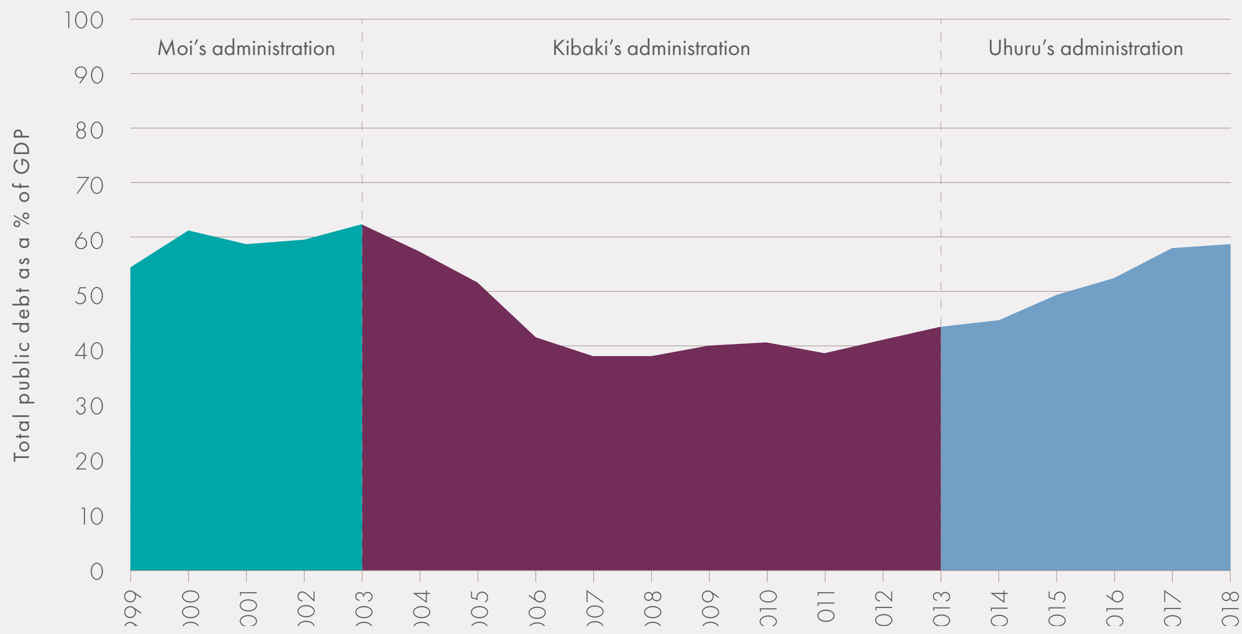
Kenya's debt has been rising since 2013 and growing interest costs are placing downward pressure on government spending

Kenya's debt has been a growing cause of international and local concern, rising from roughly 48% of GDP in 2013/14 to 65% in March 2021 (see Figure 1).[1] In October 2018, the IMF adjusted Kenya's debt risk from "low" to "moderate" and claimed the "higher level of debt, together with rising reliance on non-concessional borrowing, have raised fiscal vulnerabilities."[2] They have since adjusted this risk level from "moderate" to "high."

The composition of Kenya's external debt has changed significantly in recent years, with a growing share held by commercial banks (see Figure 2). In part, this trend has been triggered by Kenya's "lower middle-income" classification in 2014, which curtailed the country's access to concessionary finance. It has also involved a trend towards preference for syndicated loans, where the current administration accessing nine such loans, as compared to one under previous president Mwai Kibaki. These have been borrowed from Standard Bank, Standard Chartered Bank, Citi Bank, Trade Development Bank (former PTA Bank), Hong Kong & Shanghai Banking Corporation (HSBC), and Qatar National Bank.[3]

Figure 1

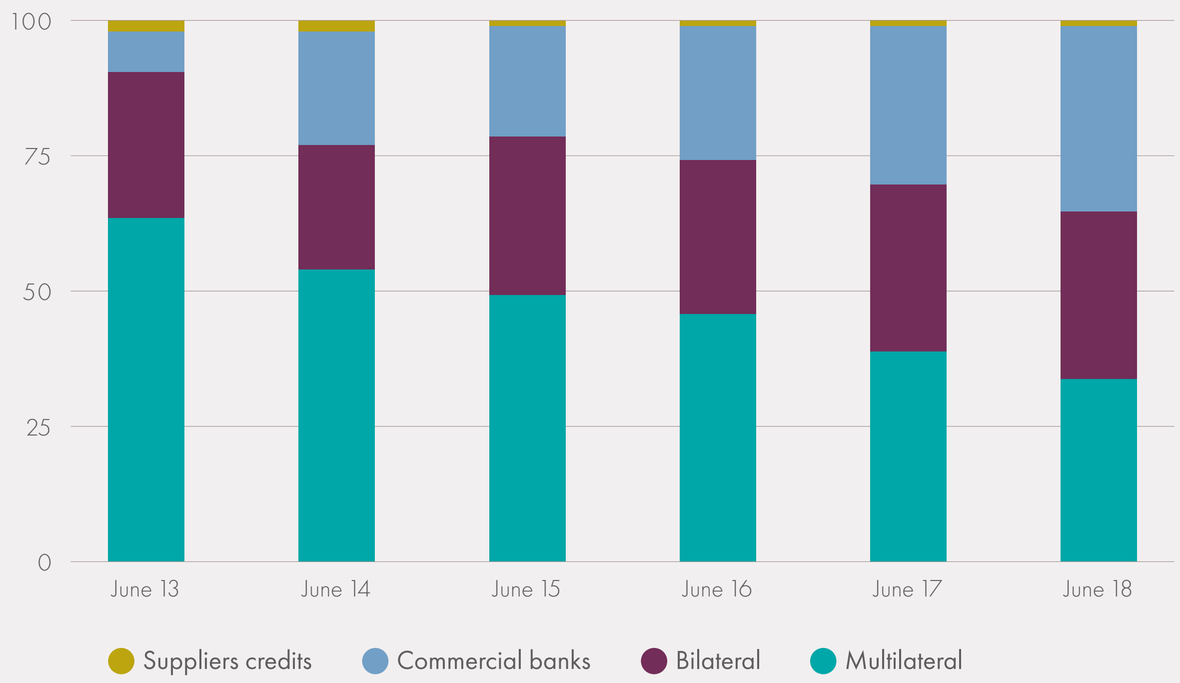
Long-Term Trend in The Share of Kenya's Total Public Debt to GDP (1999–2018)



Source: Institute of Economic Affairs (2019a)

Figure 2

Composition of Kenya's External Debt (2013–2018)



Source: World Bank (2019: 19)

According to the World Bank (2019), 46.4% of Kenya's deficit has been financed by external borrowing, with the current government turning to international capital markets and issuing three significant Eurobonds ($2 billion in 2014, $2 billion in 2018 and $2.1 billion in 2019). This has left Kenya vulnerable to shifts in international markets and exchange rates: as of December 2018, 71.3% of external public debt was denominated in US dollars.[4]

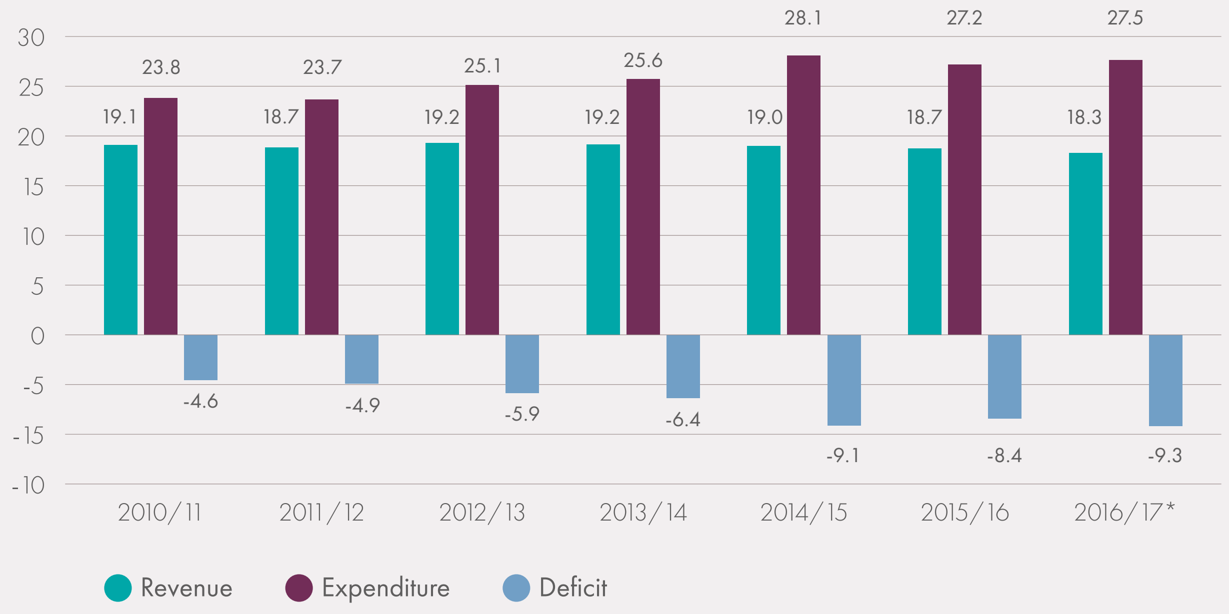
In addition, around 68% of Kenya's bilateral debt now originates from China, most of which has been extended on commercial – or near-commercial – terms.[5] The risks posed by these commercial loans became apparent in January 2020, following the end of a five-year grace period on the credit provided by China's Exim Bank for the Standard Gauge Railway (SGR). Debt service payments rose 130% in 2019/20, totalling KSH 71.5 billion (up from KSH 31 billion in 2018/2019).[6] Loan repayments for the project are expected to increase to KSH 84.3 billion in 2020/2021 and to KSH 111.4 billion in 2021/22.[7] Business Daily has reported that the original loan was offered at an interest rate of 5.6%, which is around 3.6% higher than the six-month average of the London Interbank Offered Rate (LIBOR).[8]

Prior to the COVID-19 crisis, Kenya was approaching a debt to GDP ratio of 60% and – according to economist David Ndii – the county's capacity to service this debt was "approaching distress thresholds."[9] Ndii outlines how the interest cost of Kenya's debt "has nearly doubled in five years." In addition, foreign debt service costs measured against export earnings have increased five-fold over the same period (rising from 4% to 20% of export earnings).[10]

The country's obligation to service its debts is affecting the government's ability to spend on development, which in turn is fuelling public concern. In February 2019, Joshua Musimi, a Director at the Office of the Controller of Budget, regarded the situation as "unsustainable" as the 2019/20 budget allocated KSH 1.1 trillion to servicing debt, an equivalent of 61% of total projected tax collection of Sh1.87 trillion, leaving just KSH 770 billion to recurrent and development expenditure.[11]

Figure 3

Expenditure, Revenue & Fiscal Deficit as % of GDP (2010–2017)



Source: Institute of Economic Affairs (2019b: 9)

Kenya's rising debt level has been caused by – among other things – unproductive spending

According to budgetary analysis conducted by the Institute of Economic Affairs (2019a), government expenditure has expanded from 22.3% of GDP in 2008/09 to 27% in 2017/18. In recent years, spending has significantly outstripped revenue collection (see Figure 3).

In Kenya, government expenditure is mostly dedicated to recurrent costs – such as the public sector wage bill – rather than development projects.[12] In an interview for this report, Ewart Salins, General Manager at Dry Associates Investment Bank, suggested a "bloated civil service (...) at central and country level" plus "fiscal leakages" are driving unproductive spending.

Analysis conducted by the World Bank (2019) supports this view and the report arrives at the following recommendation: "improving public wage bill management is imperative [in order] to create the needed fiscal space to fund public programmes." As a percentage of GDP, the country's public wage bill is higher than regional neighbours and every expenditure category – including basic salary, employment allowances and pension benefits – which have all risen between 2013/14 and 2017/18.[14] According to the report, this growth has been driven by a rise in the average wage per worker and an increase in overall headcount (especially at county level following devolution, an issue we explore in our chapter on politics). In a bid to control the wage bill, reforms were introduced in 2019, including the introduction of three-year renewable contracts for new civil servants.[15]

In large part, the government has justified the country's borrowing and spending on the basis that public investment in large-scale infrastructure will facilitate long-term economic growth, which will in turn finance debts.[16] While Kenya's GDP growth has maintained a strong trajectory in recent years, many large-scale public projects have been "politically-driven and of questionable economic viability", according to Mathias Muindi, a political risk analyst.[17] For example, as previously illustrated, the Standard Gauge Railway is often cited as an example of a large-scale public project with inflated costs and debatable economic returns. Financed by China, the first phase of the railway line from Mombasa to Nairobi was estimated to cost $3.6 billion. However, in April 2019 China refused to provide a further $3.7 billion to extend the line from Naivasha to the border with Uganda. According to John Mutua, an economist at the Institute of Economic Affairs in Kenya, "China shied away from the extension because they had questions about its commercial viability."[18] This indicates a shift in the nature of Chinese financing on large-scale infrastructure projects, from a flexible model to one that takes a closer look at the long-term financial viability of the projects it is funding.

The viaduct of the Nairobi railroad to Mombasa in the savannah of Nairobi Park in central Kenya

Over the long-term, certain factors may help avert a debt crisis, such as the attraction of private sector investment, the discovery of oil and the demand for fiscal accountability.

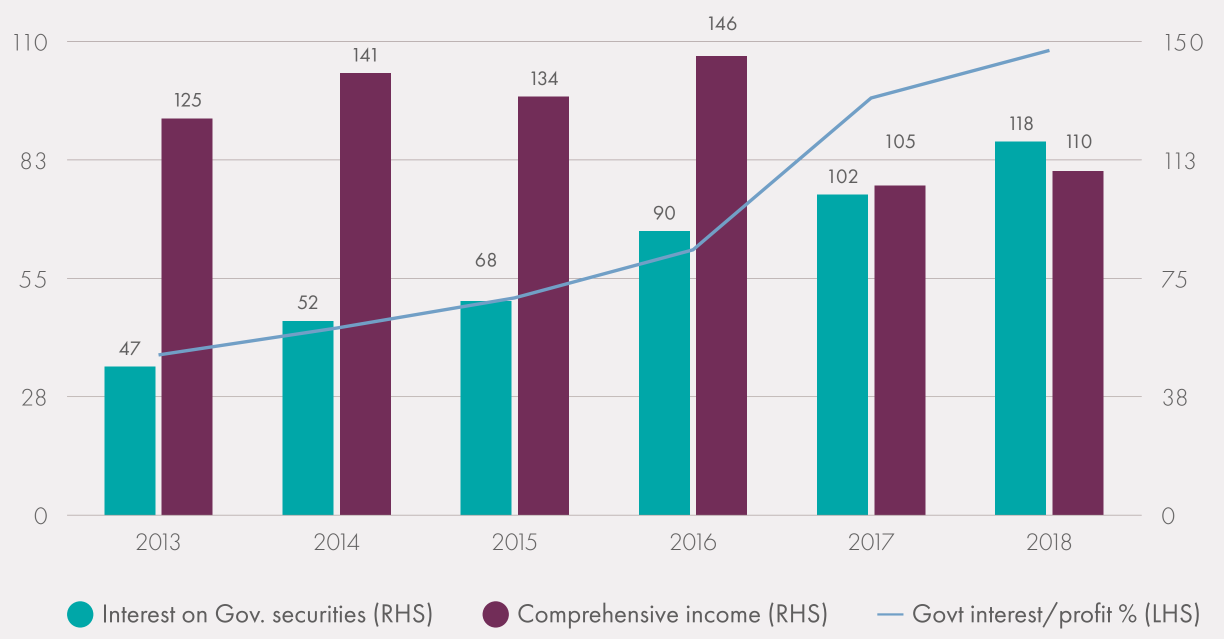
While Kenya's economy has been growing at a rate of 5%+ in recent years, the contribution of private sector investment remains small and in decline, falling from 1.3% of GDP in 2009-2013 to 0.3% in 2013–2017. There is evidence to suggest such investment has been crowded out by increases in public sector borrowing. In a recent opinion piece for The Elephant, David Ndii highlighted this clearly with analysis into Kenya's commercial banking sector. He noted that between 2013–2018, the contribution of government securities to bank profits increased from 37% to 108%, while in 2017 the sector saw a 40% drop in profits overall due to the imposition of an interest rate cap in late 2016 (see chart below).[19] Ndii summed up the situation nicely: "With so much money to spend liberally, trading with the government becomes the most profitable business, diverting other economic services away from, and inflating the costs for the private sector."

In an interview for this report, Kwame Owino, CEO of the Institute of Economic Affairs in Kenya, highlighted the vital role private sector investment must play in sustaining growth and ensuring fiscal stability: "Kenya cannot develop without foreign direct investment (FDI). [At the moment] firms in Kenya are too focused on being brokers to government to really enhance productivity. Ideally, Kenya [requires] $5 to $10 billion a year but this is not currently a realistic target." According to the World Bank (2020), FDI in Kenya amounted to $1.6 billion in 2018. However, recent developments suggest the government is making a concerted effort to support foreign investment in the private sector. For example, in early 2020 the Kenya Investment Agency proposed to fast track citizenship for credible foreign investors.[20]

Moreover, the repeal of the interest rate cap in November 2019 represents a positive signal for the country's domestic investors. Introduced in 2016, the cap set a ceiling on loan rates (4% above the Central Bank of Kenya's rate). As noted, the cap exacerbated a long-term trend of weak lending to the country's private sector. Smaller banks were hit hardest by the rule change and lending to SMEs effectively collapsed due to the cap. Indeed, the IMF indicated in 2018 that Kenya must substantially modify or remove the interest rate cap in order for a standby facility to be extended.[21] The recent repeal of the cap is expected to inject confidence into commercial banks, widen credit access for SMEs and boost private sector growth.[22] However, it is worth watching if interest rates rise rapidly as a result, putting a further squeeze on struggling SMEs.[23]

Figure 4

Kenya banking industry profits and government securities interest income trend, Ksh.b



Source: Ndii, David (2020) Of Tigers, Debt Merchants and 2020 Vision. The Elephant.

Workers walk past storage tanks at Tullow Oil's Ngamia 8 drilling site in Lokichar, Turkana County, Kenya

In support of a positive outlook, some commentators argue Kenya's recent discovery of 600 million barrels of oil in Turkana has the potential – over the long-term – to strengthen growth and ease the debt situation. Fuelling excitement over the sector's potential, Kenya completed its first export of oil in August 2019, a cargo of 240,000 barrels dispatched from the port of Mombasa under the Early Oil Pilot Scheme. While the delivery of meaningful export volumes will take time, oil exports are expected to improve Kenya's foreign currency and fiscal position in 10+ years – provided the government does not extensively borrow against future revenues.[24] However, the economic benefit will only serve a generation: while Kenya will earn roughly KSH 6.4 trillion from the oil in Turkana (c. KSH 280 billion p.a.), the reserves will be depleted in 23 years.[25] Benefits also need to be considered in conjunction with the government's efforts to mitigate against climate change and a growing emphasis on divestment from the sector, emerging trends we touch on in further detail in the environment chapter of this report.

In Kenya, the consistent mismatch between public spending and revenue collection indicates there is a structural issue with the budget process. According to Caesar Mwangi, a Director at ICEA Lion Group, a change in trajectory will require public pressure and the implementation of a longer-term political agenda: "we need a government with a long-term outlook. At present, policies and investments are made for five-year cycles."

Highlighting the positive political role the country's growing youth population may play, experts interviewed for this report expressed optimism regarding the fiscal situation. Indeed, greater public awareness and pressure is expected to result in fiscal policy decision-makers addressing the various drivers of debt over the long-term. Jared Kangwana, a former member of the East African Legislative Assembly, observed that "people will stand firm until the leaders come to their senses." In addition, Kennedy Odede, Co-Founder of Shining Hope for Communities, stated: "the debt position will be resolved in the next 10–15 years. The solution is the youth who demand accountability."

PART B:

IMPACT OF COVID-19 ON FINANCE IN KENYA

COVID-19 has placed further strain on Kenya's challenging financial situation.

The COVID-19 pandemic has significantly impacted economies in Africa: at the start of the crisis the IMF projected a 1.5% drop in the continent's GDP for 2020, as lockdowns, border closures and logistical bottlenecks stifled the exchange of goods and services.[26] The reduction in economic activity across Africa is set to have major implications for government budgets: over the course of 2020, the UN Conference on Trade and Development estimated public revenue on the continent would shrink by 5%.[27] Adopting a long-term perspective, the Institute for Security Studies (2020) believes the size of Africa's economy in a decade might be between $349–$643 billion smaller than what was forecast prior to the pandemic, with GDP per capita only recovering to pre-COVID-19 levels in 2024. While some economies have recovered faster than this initial projection, the long-term impacts of the pandemic on the continent going forward remains to be seen.

In Kenya, the crisis emerged at a time when – according to Oxfam, Christian Aid and Global Justice Now (2020) – the government was set to spend considerably more on servicing its debts in 2020 ($2.7 billion) than on public healthcare (c. $1.86 billion p.a. in recent years). Unsurprisingly, COVID-19 has placed further strain on the country's challenging financial situation: as of July 2020, Kenya's debt surpassed KSH 6.6 trillion (up from KSH 6 trillion in December 2019) and the Treasury believes annual debt repayments will exceed KSH 1 trillion in 2021/2022 (up from KSH 227.58 billion in 2013/14).[28] These developments and the likelihood of dampened growth over a prolonged period have prompted credit agencies like S&P Global Ratings and Moody's to downgrade Kenya's outlook from stable to negative.[29]

In the wake of the COVID-19 outbreak, the government is in this position owing to a combination of...

- ...increased public spending (e.g. as part of the 2020/21 budget, the government has instituted a wide-ranging stimulus package worth KSH 53.7 billion, which will support – inter alia – digital skills programmes, the health system, the tourism sector, manufacturers, climate initiatives, agribusiness and smallholders).[30]

- ...lost tax receipts (e.g. the Parliamentary Budget Office estimates that the government's COVID-19-related tax measures – such as the 2% reduction of VAT and the 5% cut of the top band rate - cost the public purse KSH 122.2 billion over the course of April – June 2020) while have a regressive impact on taxation overall.[31]

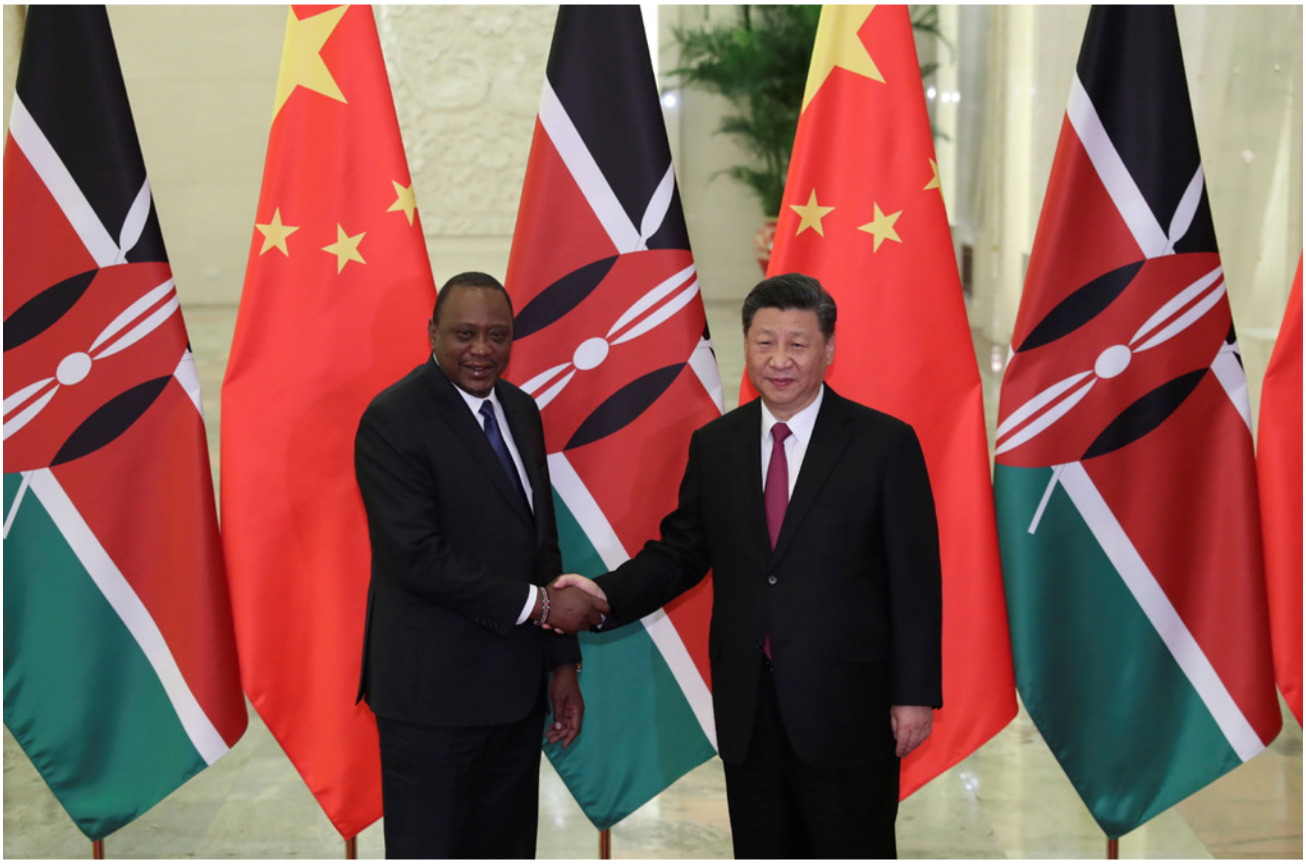
- ...and extensive borrowing (e.g. the IMF and World Bank have transferred loans of KSH 79.6 billion and KSH 107.7 billion respectively to bolster the budget and augment the health response).[32]

In a bid to alleviate the immediate financial pressure, Kenya has largely focused on securing debt relief from its largest creditor, China, rather than seeking multilateral support.[33] For example, Kenya has refused to sign up to the G20 initiative regarding the temporary suspension of payment obligations, citing concerns that the deal would negatively impact the country's credit rating and curtail its access to international capital markets.[34] China initially resisted the country's bilateral advances, claiming an agreement would dishonour G20 conditionalities on debt relief. However, in January 2021, Kenya received a $245 million debt referral from China, easing financial pressure on the country slightly.[35]

While COVID-19 has severely weakened Kenya's already strained public finances for the foreseeable future, aspects of the financial situation have been more positive. For example, the Central Bank of Kenya estimates that the current account deficit will remain stable this year at 5.8% of GDP.[36] According to the institution, the low cost of oil will "more than offset" the negative impact on exports and remittances (remittances – Kenya's leading foreign exchange earner – may fall by 12% this year as the diaspora struggle amid a global economic downturn).[37]

Moreover, while the profits of commercial banks dropped 7.7% in the first quarter of 2020/21 compared to the first quarter of 2019/20, the sector was able to rapidly restructure KSH 679.6 billion in personal and corporate loans as the pandemic took hold. According to Khusoko (2020), domestic banks have exhibited resilience in the face of COVID-19, owing to relatively strong liquidity buffers and effective monetary easing.

IN A BID TO ALLEVIATE THE IMMEDIATE FINANCIAL PRESSURE, KENYA HAS LARGELY FOCUSED ON SECURING DEBT RELIEF FROM ITS LARGEST CREDITOR, CHINA



Kenyan President Uhuru Kenyatta with Chinese President Xi Jinping

PART C:
CONCLUSION

What might a deeper deficit mean for economic transformation?

A farmer tends to his crops near Mount Elgon National Park, Kenya

Narrowing fiscal space may put political pressure on reform efforts already underway.

As this chapter will have made clear, the Government of Kenya's financial position is precarious and deteriorating, with an increasing proportion of government spending going to debt repayment and payroll over development spending on healthcare, infrastructure, and education. Indeed, Nation has recently reported that the country will need to lift its current KSH 9 trillion debt ceiling to KSH 12 trillion for FY 2021–2022.[39] As recently as September 2020, Business Daily had reported that it would take two years to hit this ceiling, indicating how quickly the situation is evolving.[40]

While the trend is undoubtedly a troubling one, narrowing fiscal space may also be seen as a force for increased political pressure on reform efforts in the short to medium term. For example, the World Bank was able to push through the use of an electronic voucher system to better target the country's agricultural inputs subsidy programme as a requirement for a $1 billion COVID-19 loan facility, greatly reducing the scope for rent capture in the system.[41] Related, the National Cereals and Production Board had its price-setting function for key commodities such as maize, revoked in a bid to reduce instances of corruption and cartel behaviour.[42] More recently, there has been a concerted reform drive in the coffee and tea sectors, with a new Tea Board being established, and the digitalisation of tea and coffee auctions.[43] These efforts all have clear and explicit presidential backing. Going forward, this trend is likely to continue as political pressure to block reform is overridden by the financial imperative to cut unproductive spending. However, an important countertrend to watch is the unfolding of the Building Bridges Initiative, which if successful, is likely to increase the size and cost of government.[44]

Kenya will need investment to boost private sector growth, alleviate fiscal pressure, and put the country on a path to transformative growth.

Dirk Willem te Velde, Head of the International Economic Development Group at the Overseas Development Institute (ODI), noted that, "If a government has the right vision and good projects, then finance will come."[45] To date, this has not always been the case, with the SGR as a prime example mentioned earlier in this paper. Antoinette Tesha, Textiles & Apparel Director at Msingi East Africa, noted: "We definitely need these large-scale infrastructure projects. However, the important thing is that we need to get the price right and ensure we are focusing on the right projects."

On the positive side, we can see some examples of investments going into previously underserved areas. For example, the World Bank recently announced $750 million to support the upgrade of 365 km of the Isiolo-Mandera Regional Road Corridor, a major transport route linking to the country's northeast to the rest of the country.[46] The government is also turning to alternative financing models to pay for large-scale projects, such as the Nairobi Expressway, which will connect Jomo Kenyatta International Airport to the Nairobi-Nakuru highway. This project is being financed by a private-public partnership involving the offer of a 27-year lease to the China Road and Bridge Corporation (CRBC), who will cover their investment by operating a toll service until the road is transferred into state ownership.[47]

Channeling appropriate finance requires a clear vision and prioritising strategic projects in the right sectors.

Dirk Willem te Velde emphasised the importance of sector targeting in Kenya's public financing agenda: "If you're thinking through current crisis, and better recovery, you need to think about diversification and getting into more complex value chains. More targeting is needed, and public financing has a role to play here." This means channelling scarce public financing to projects targeting key sectors with the potential to crowd in foreign investors and create spill-over benefits for the wider economy.

Unfortunately, foreign direct investment in particular is still being driven towards a smaller number of capital, rather than employment intensive sectors. According to the IFC this has been focused in ICT, real estate, banking, retailing, power generation, oil exploration, and mining in recent years.[48] The type of financing required to drive inclusive growth in Kenya, i.e. that which is channelled to businesses with high-growth potential in sectors that can generate mass employment like manufacturing and agricultural, is often unavailable due to a risk profile that is unappealing to commercial sources of finance.[49] Going forward, Kenya will need to unlock patient capital in these sectors to ignite employment-intensive growth.

A train at its platform on Nairobi Terminus just before departure to Mombasa.

Also in this series

The following chapters will be available on our website - www.horizon-ea.com - once released.

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Technology
The Unrealised Dream Of A 'Silicon Savannah'

Trade
In An Uncertain Time, Kenya Looks Closer To Home For Partners

Environment
A Changing Climate Moves Environment Up The National Agenda

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SOFALA | PARTNERS

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Chapter Notes

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Full interviewee list

Antoinette Tesha, Textiles & Apparel Director, Msingi East Africa

Caesar Mwangi, Visiting Fellow, Strathmore Business School & Director, ICEA Lion Group

David Ndii, Managing Director, Africa Economics

Dirk Willem te Velde, Head of the International Economic Development Group, Overseas Development Institute (ODI)

Ewart Salins, General Manager, Dry Associates Investment Bank

Jared Kangwana, (Former) Member, East Africa Legislative Assembly & Board Member and Senior Executive, Various (inc. Anglo-African Property Holdings Ltd, Maisha Microfinance Bank, The Monarch Insurance and Kenya Television Network)

Kennedy Odede, Co-Founder, Shining Hope for Communities (SHOFCO)

Kwame Owino, CEO, Institute of Economic Affairs (Kenya)

Mathias Muindi, Political Risk Analyst, Independent

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Kenya Markets Trust (KMT) is a Kenyan not-for-profit organisation that specialises in market transformation. KMT works to stimulate inclusive and resilient growth that will lead to a step-change in the livelihoods of millions of Kenyans. KMT takes a long-term approach, staying true to its mission while adapting to the forces – such as climate change and emerging technologies – that are shaping the markets it operates within. Since 2012, KMT has created 230,000 new jobs and £165m additional income for Kenyans. The current portfolio comprises work in agricultural inputs, water and livestock.

www.kenyamarkets.org | info@kenyamarkets.org

Gatsby Africa has worked to create jobs, raise incomes and build opportunities for people in Africa since 1985. Gatsby's mission is to accelerate inclusive and resilient economic growth in East Africa. Gatsby aims to achieve this by demonstrating how key sectors – such as commercial forestry in Tanzania – can be transformed. Gatsby funds and implements programmes that look to catalyse and influence large-scale and lasting change in priority sectors. Gatsby also builds and supports local organisations dedicated to sector transformation, while aiming to share learning with others – such as governments and donors – who are trying to catalyse economic growth.

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