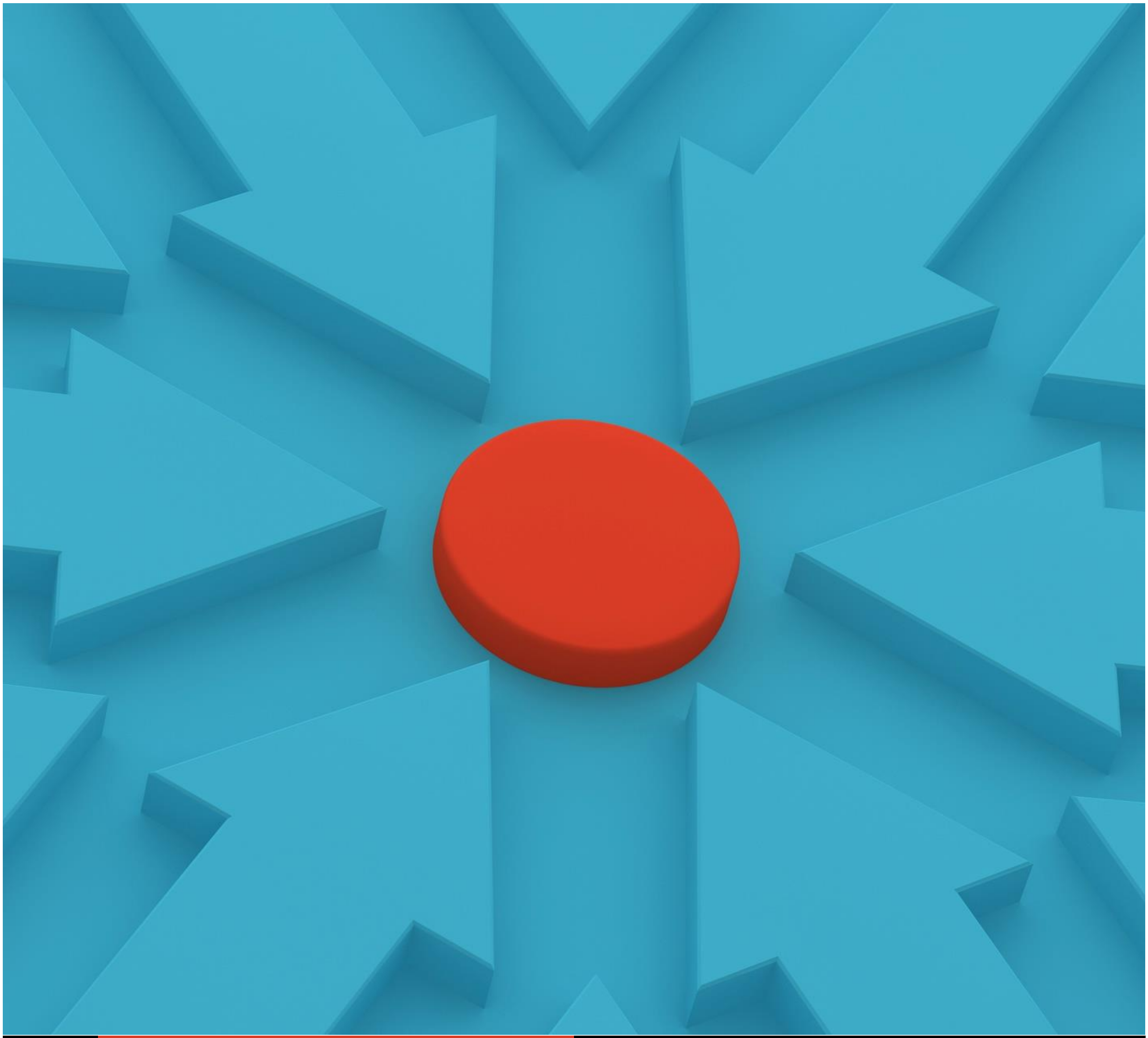

ECONOMIC OUTLOOK

2024

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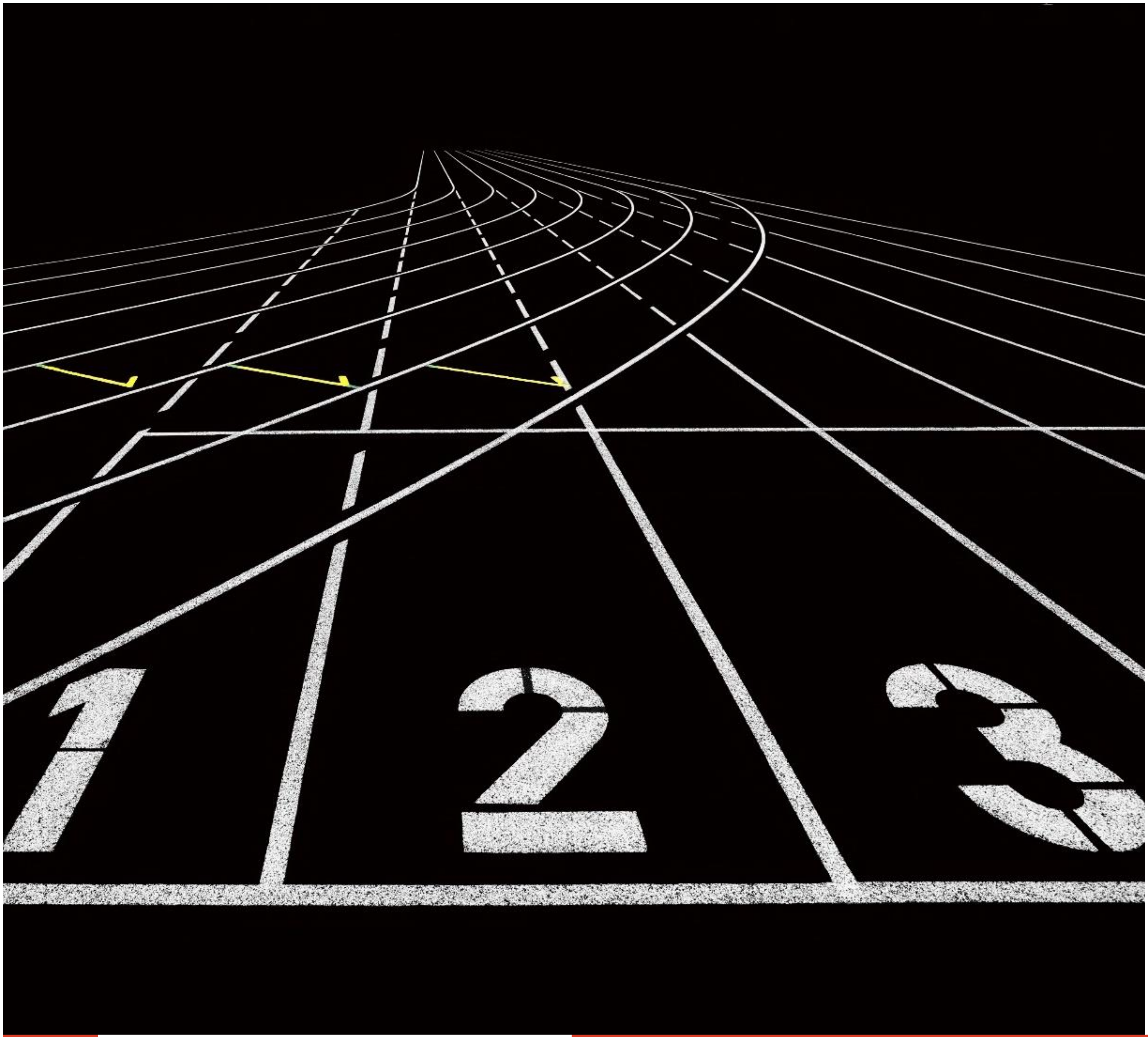


ECONOMIC OUTLOOK

This report will review the economic performance and events of the year 2023 and give an outlook of what to expect in 2024. Instead of using lagging indicators like GDP to understand economic performance, we have chosen to analyse forward indicators from three key economic branches: Monetary policy performance, fiscal policy performance and business environment performance.

In our view, any action taken under these three branches is a leading indicator that contains valuable foresight. We believe that understanding the events and performances of these three areas will give investors and business owners actionable intelligence to support there strategies.

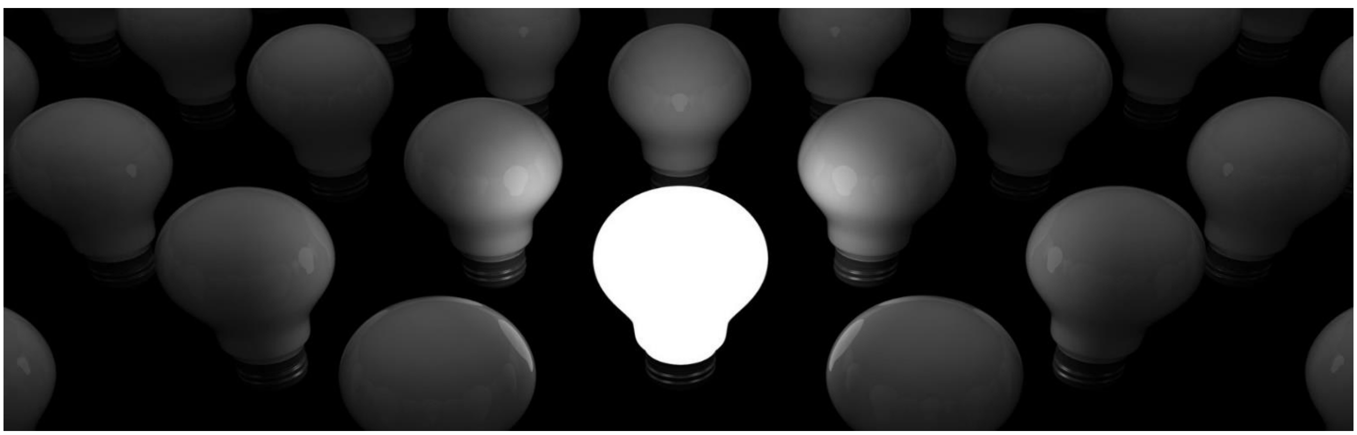
EXCECUTIVE SUMMARY

1. Fiscal performance

The year 2023 was arguably one of the most eventful years in recent times as far as fiscal policy is concerned. With the Kenya Kwanza regime firmly on the decision seats, no time was wasted in making policy changes that set the tone for what to expect in the coming years. With the realities of a struggling & vulnerable economy, coupled with a government that had little to no fiscal space to operate, it meant that policy makers had to make some radical policy changes. The policy goal was to boost revenue collection while re-organise expenditure to prioritize on liability management and investments in primary sectors. We discuss these policy changes and analyse the effect they've had so far. Since most are still early stage, we give our views on potential impacts.

2. Monetary performance

The Central Bank of Kenya also went through its own regime change following the end of Dr. Patrick Njoroge's 8-year term. The new Governor Dr. Kimani Thugge did not also waste any time in making policy changes. He believed at the time of his appointment that further monetary tightening was necessary to manage price levels. Since his first Monetary Policy Committee (MPC) meeting in June, CBR rate has increased by 300 Bps in four sittings. He has also chaired other MPC meetings where the committee made changes to Monetary policy operational targets while also reducing the barriers for banks to access liquidity from Central Bank. We discuss these policy changes and give our views on their potential impacts.



3. **Business performance**

We have attempted to measure and give an opinion on the health of Kenya's business environment in 2023. We have used Indicators/signals that show us the production and consumption of 3 key intermediate goods (goods consumed by both producers and consumers): energy, cement, and food. Observing trends in the production and consumption of these products helps us understand the business environment better.

4. **An economy in transition**

The authorities were not the only ones going through a transition in 2023. By observing and analysing the policy changes introduced at the fiscal & monetary level, coupled with some changes we see in the global economy, we are convinced that our economy is transitioning from government driven to private sector driven growth. The new order will come with new opportunities while closing some of the old ones. We discuss our justification for this observation under this topic. Lastly, we give an outlook on how we see the business environment performing in 2024. We also share some opportunities that we expect to see during this transition and how businesses and households can take advantage.

FISCAL POLICY PERFORMANCE

In 2023, the government embarked on major fiscal policy changes with an objective of boosting revenue collection, managing liabilities, and investing in primary sectors. At the same time, they are seeking to revive an economy that has suffered effects of negative global shocks, climate crisis, rising cost of living and low employment. Fiscal consolidation goals and economic stimuli goals are objectives that will more likely clash with each other given that they both fight for the same scarce resources. Below we look at some of the major fiscal policy changes undertaken in 2023, and how they could potentially impact the economy.

1. Increased tax rates & enhanced tax collection measures

Faced with increasing debt service obligations, the government introduced a raft of new tax measures in the 2023/24 fiscal year aimed at increasing revenues. In varying degrees, the government introduced and/or increased taxes on wages, small business's revenues, petroleum products, digital services, digital assets, imported goods among others. Government also enhanced revenue collection measures by changing tax administration laws. Requirements such as: reduced tax remittance & reporting deadlines, use of KRA electronic invoice systems, enhanced border inspections and physical inspections of business were introduced by the new law. By implementing the new tax measures, the government targets to raise Kshs. 2.6 trillion in ordinary revenue in the current fiscal year which will be a 26% growth from the Kshs. 2 trillion collected in FY2022/23.

So far, revenue collection has faced headwinds as National Treasury data indicates below target performance for the first 5 months. As at end of November 2023 Treasury had collected Kshs 847bn in ordinary revenues is a growth of 11.7% compared to a similar period in the previous period. When prorated to an annual figure, the collections represent 79% of the budgeted figure (88% prior year).

In our view, the revenue targets are unrealistically ambitious with low chances of realization. The high tax burden will likely force businesses & households to change behaviour, which may lead to lower collections. Indeed, KNBS has reported a decline in consumption of petroleum products in the first 9 months of 2023 compared to 2022. This means that businesses & households are changing their behaviour either by reducing economic activities or by seeking alternatives. Increasing taxes amid a cost-of-living crisis may also cause civil unrest among citizens which may lead to heightened political tensions, dampening economic activity even further.

Policy Objective

Boost revenue collection, manage liabilities & invest in primary economic sectors

Performance review

Review performance against objectives

Adjust for growth.

Make the necessary changes to position for growth

2. Push for Increased National Savings

In 2023, the government started the process of changing and implementing new laws and regulations that govern retirement savings and healthcare insurance. They also started government sponsored programs that incentivise citizens to save and borrow using mobile money. The new policy's goal is to mobilise more resources for investments (capital accumulation). KNBS data shows that capital accumulation as a national income category has stagnated in growth for the last 5 years declining twice over the period.

Increasing the country's saving rate is a positive move by the government as it will stimulate future investments, which will drive up production and ultimately grow employment and incomes. This leads to sustainable economic growth.

3. Elimination of consumer subsidies and tax exemptions

2023 saw the government eliminate consumer subsidies and tax exemptions introduced after the Covid crisis. The subsidies were meant to cushion low-income households from rising cost of living. Subsidy elimination resulted in a sharp increase of consumer prices in 2023 especially in the energy sector, where the cost of electricity and fuel have skyrocketed to unprecedented levels. Electricity prices for instance went up by 40% as at end of 2023 (KNBS) while Kerosine and diesel went up by 36% and 24% respectively.

Given the government's liquidity position, it was prudent to eliminate unsustainable consumer subsidies to free up funds for debt servicing and investments in real productive sectors. Policy makers should have however used other non-monetary measures to cushion consumers from high consumer prices. For instance, by eliminating certain restrictions in the energy sector, government can encourage use of alternative energy solutions like solar, electronic vehicles, etc. which are cheaper, sustainable, and more efficient.

4. Privatization of State-owned enterprises

The government has embarked on a process that will see it privatise some state-owned enterprises. Companies identified are in sectors such as energy, agriculture, logistics, hospitality, publishing, manufacturing among other. It should be noted that this was one of IMF's terms and conditions for the loans it gave Kenya. The period between 2006 to 2008, the government privatised a total of four companies by way of Initial public offerings at the Nairobi securities exchange and one through a strategic sale. It has not privatised any entity since then.

In our view, privatising commercial state-owned enterprises is a positive move for the economy since it releases underutilized capital resources to the private sector. Government will also improve its cashflow position through sale proceeds and reduced budgetary support for loss making entities.

It is also a positive signal to investors who would want to invest in a market with minimal government interference. Should the government privatise some of the companies through the stock market, it will be a good market trigger that could drive asset price discovery at the stock market.

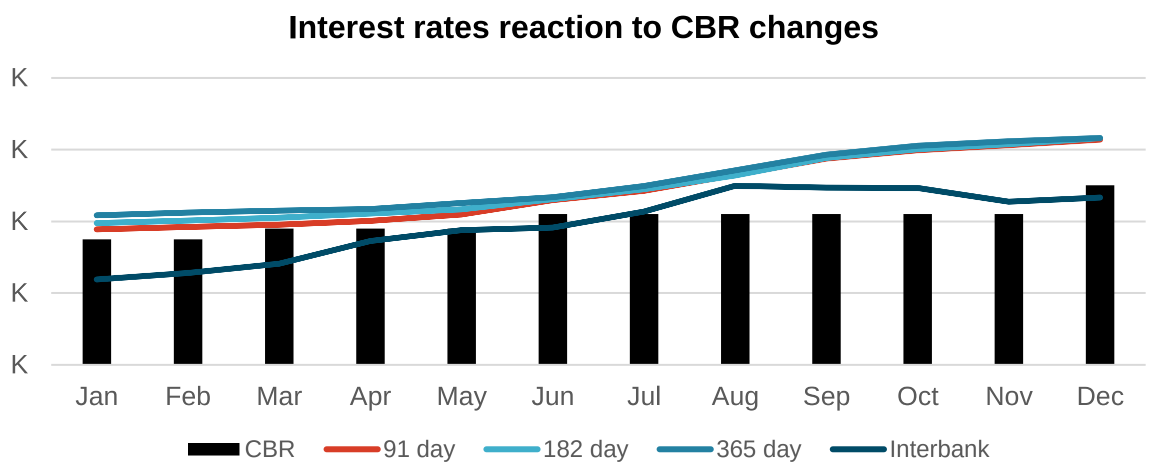
Government should however limit privatization to entities that engage purely in commercial activities. Entities that provide public goods are better of run by government since the economic benefits go beyond profit maximization. The government should also be careful not create private monopolies by giving up economies of scale that may create barriers of entry for other competitors. Economic theory indicates that monopolies of key goods & services will cause all market participants to be worse off in the long run.

MONETARY POLICY PERFORMANCE

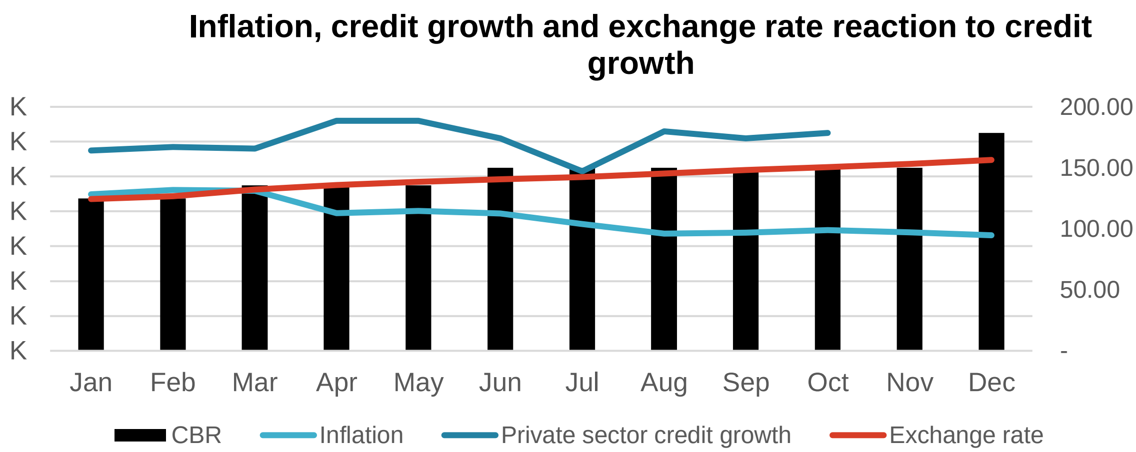
Following the change in leadership at the Central Bank, a couple of policy changes have happened that may signal a change in philosophy and ideology. The pace of monetary tightening was increased with CBR being raised by 300 Bps within for meetings. New monetary policy operational targets have also been set with more measures aimed at improving the transmission of monetary policy to the financial markets. Below we review the actions taken in 2023.

1. Central Bank Rate moves from 8.75% to 12.5% in 12 months.

The Monetary Policy committee maintained a relatively tight monetary policy stance throughout 2023 in response to rising inflation, global uncertainties, and a persistently depreciating Kenya shilling. The committee met a total of 7 times in 2023 (6 times in 2022), raising the Central Bank Rate (CBR) 3 times. CBR stood at 8.75% in January 2023 and closed the year at 12.5% in December 2023. This was the highest 12 month increase in 12 years (since 2011). Short term debt markets reacted accordingly, with interest rates consistently trending upwards across different instruments & tenures as shown in the diagram below.



As shown in the diagram below, different metrics changed differently as the tight policy transmitted into the market. Inflation trended downwards; Kenya shilling depreciated further while private sector credit remained stable at low double-digit figures.



Headline Inflation trended downwards from 9% in January to 6.63% in December. The downward trend in inflation was driven largely by a decline in food inflation which started the year at 12.8% and gradually declined to close the year at 7.7%. Fuel Inflation remained sticky & elevated throughout the year, starting the year at 13.8% and closing the year at 13.7%. Non-food Non-fuel (Core Inflation) declined from 4.3% in January to 3.4% in December. As far as price stabilisation is concerned, the MPC seems to have effectively brought stability in consumer prices.

Unfortunately, the same cannot be said about the Kenya shilling, which continued to depreciate throughout the year despite the tight policy stance. The Kenya shilling depreciated by 27% against the US dollar, to close the year at Kshs. 156.56. The shilling's immunity to monetary policy action vindicates many economic experts (Including this publication), that the Central bank was artificially supporting the shilling when balance of payment pressures intensified. Indeed, the new Central Bank Governor Kimani Thugge, admitted to a parliament committee in October that the shilling was overvalued by 20-25%, suggesting that this was done by using CBK reserves. By December 2023, as the MPC was raising CBR from 10.5% to 12.5%, the Governor told a press briefing that he now believes that the shilling had found its true value.

Private sector credit growth averaged at 12.1% in the first 10 months of 2023 compared to 11.7% in a similar period in 2022. Ratio of non-performing loans to issued loans increased from 13.8% in October 2022 to 15.3% in October 2023. The increase in private sector lending despite a tight monetary stance may be an indicator that businesses and households view the current situation as temporary and transitional. Banks also slowed down on purchasing government securities in 2023 in response to concerns about government's public debt sustainability.

2. Improving Monetary policy transmission

In August 2023, the Monetary Policy Committee (MPC) met and approved measures aimed at improving transmission of monetary policy across the financial markets. First, MPC introduced an interbank interest rate corridor of +/- 2.5% around the CBR. This effectively means that monetary policy operations will be aimed at ensuring the Interbank closely tracks the CBR movements as opposed to tracking money supply targets. Second, the MPC reduced the price of the CBK discount window from CBR + 600bps to CBR + 400bps. The discount window is a borrowing facility available to banks from the Central bank in case they face short term liquidity pressures. MPC also removed administrative encumbrances that were previously attached to the facility. The committee's aim is to improve liquidity distribution across the banking sector, thereby improving monetary policy transmission.

The immediate reaction by banks was to start accessing liquidity from the CBK discount window, a market that was virtually dead prior to the new measures. Before MPC made the announcement, banks had accessed only Kshs. 6 Bn from the window between January and July 2023. Following the announcement of the new measures, banks borrowed Kshs. 57 Bn between August and December 2023. Overall, banks borrowed Kshs. 63 Bn from the window in 2023 up from Kshs. 54 Mn in 2022, representing a growth of 1170%. Total interbank volumes, increased by 17% from Kshs. 4.6 trillion in 2022 to 5.4 trillion in 2024.

Despite the average Interbank rate increasing from 4.9% in 2022 to 9.8% in 2023, the spread between highest rate and the lowest rate declined from an average of 2.52% in 2022 to 1.94% in 2023. A lower interbank spread is an indicator of improved liquidity distribution across the banking sector.

3. Other developments in Monetary policy

- During the year, the Central Bank received a new Governor and Deputy Governor, following the conclusion of Dr. Njoroge and his deputy 's tenure. Our 9th June Issue (Click here to view) reviewed the tenure of Dr. Njoroge discussing his achievements and failures. We also pointed out the ideological differences we expect to see in the new regime.
- The Central Bank increased Mobile money transaction limits and wallet size in a bid to improve digital transactions. (Click here to view)
- Central Bank introduced a new central securities depository platform named DhowCSD to support users with registry, custodial and settlement services for both primary and secondary market operations. (Click here to view)

AN ECONOMY IN TRANSITION

1. What we are seeing

In 2023, the Kenyan government implemented radical fiscal policy changes touching on taxation, public spending, government operations and public debt management. The radical changes were meant to narrow the fiscal deficit that was under pressure due to low tax yields, rising debt service obligations and spending pressures. The economy was also struggling with low productivity, high unemployment, balance of payment pressures and a cost-of-living crisis. The economic situation was caused by a combination of geopolitical shocks, tight financial markets, climate crisis, global inflation, and internal missteps in public finance management.

When things get tough like in our case, policy makers tend to change policies from liberal welfare-oriented policies and move to more conservative market-oriented policies. In this section, we argue that our economy has started this transitional journey, moving away from government spending driven economic growth to a more market driven economic growth. With little fiscal space to stimulate the economy, the transition may take longer than expected and may be more painful than usual. We however believe that small wins during the transition can act as positive signals for future investments. which we view as a necessary bitter pill. Later we will discuss the opportunities that we see during the transition.

"The Kenyan economy has started a transitional journey, moving away from government spending driven economic growth to a more market driven economic growth."

2. How we got here

Between 2013 and 2022, the government had operated an average budget deficit to GDP ratio of -6.8% to fund infrastructure projects. Government financed the deficit primarily using, both domestic and foreign debt. As a result, the public debt to GDP ratio increased from 44% in 2013 to an estimated 73% in 2023. Debt servicing ratio (debt repayments/tax revenue) grew from 36% in 2013/14 fiscal year to an estimated 75% in 2023/2024 fiscal year. According to central bank data, 53% of the current Kshs. 10.5 trillion public debt is foreign currency debt meaning any local currency depreciation adds more pressure to future debt servicing obligations. Tax yields (tax revenue/GDP) on the other hand have been dwindling, declining from 16.2% in 2013 to 14.1% in 2023, meaning revenue collections has not kept pace with economic expansion.

The reality of debt servicing is now catching up with the government. 77% of its ordinary revenue in this fiscal year will go to debt service obligations. With a poor risk profile (informed by the deteriorating metrics we've discussed above) combined with uncertainties in the financial markets, the government is finding it difficult to refinance the debts that are falling due in a sustainable fashion.

3. How the transition began

In trying to manage the tight fiscal situation, government had no choice but to seek help from IMF and World bank, both of whom have placed strict conditions in return for their support. The conditions include, but not limited to increased taxes, elimination of subsidies, privatization of state companies, defunding universities, and strengthening public finance laws & regulations. The multilaterals placed tight deadlines for the policy reforms, meaning government had to implement most of these policies in 2023.

Through its November 2023 supplementary budget, the government has also realigned its spending priorities by moving resources away from mega projects and investing in primary sectors like education, agriculture, and healthcare. All these changes in policies & priorities are clear signals of an economy that is transitioning from government spending driven economy to one that relies on real economic sectors like agriculture, services etc.

4. Key risks to the transition

- Public resistance-Transitions are often difficult and painful, especially to citizens who fund them. If policy makers don't handle public relations well, citizens may act through public protest, litigations, civil unrest and even tax evasion & avoidance. Failing to communicate effectively to the citizens during the journey may limit the success of the transition.
- Lack of fiscal discipline- Kenya government officials and politicians have a reputation of being wasteful and unethical when managing public funds. This tends to erode trust and goodwill that citizens have given the government. It also diverts resources from the intended use leading to slow to no progress.
- External shocks- As we observed during the Covid crisis and during the Russia-Ukraine conflict, external shocks can disrupt economies greatly. This remains a key risk to our economy.

BUSINESS PERFORMANCE: *How do we measure?*

Depending on what economic metric/ indicator you look at, you are likely to make different conclusions on how the business environment faired in 2023. A double-digit growth in 2023 private sector credit for instance may give an indication of improving business conditions. On the other hand, sentiments by respondents through the Purchasers Managers Index (PMI) survey collected throughout 2023 indicate difficult business conditions. Another case is the Q3 2023 GDP data which reports that the financial services sector grew by 14.7%, a very robust growth given that it was the second fastest growing sector after tourism. On the other hand, the combined market capitalization of the Banking and Insurance sectors indicate that the sector declined by 13.2%. It is therefore difficult to make an informed decision on business performance purely based on Macro indicators.

To understand the health of businesses in the country, it is important to identify, analyse and interpret the right signals. They may not necessarily represent all businesses and industries, but they give an indication of overall business activities. For our case, we look for signals that give us an indication of business productivity, consumer demand and disposable incomes. Below is a list of the signals and how they performed in 2023.

No	Indicator/ metric	Period	2022	2023	Change	+/-
1	Local Electricity Generation (Mn KW/hr)	Jan-Nov	11,593	11,527	-0.6%	Negative
2	Local Electricity Consumption (Mn Kw/hr)	Jan-Nov	9,179	9,495	3.4%	Neutral
3	Diesel Consumption (000 MT)	Jan-Sept	1,721	1,652	-4.0%	Negative
4	Super Petrol (000 MT)	Jan-Sept	1,141	1,102	-3.4%	Negative
5	Kerosine (000 MT)	Jan-Sept	69	46	-33.2%	Negative
6	LPG (000 MT)	Jan-Sept	247	271	9.7%	Positive
7	Jet Fuel & Aviation fuel (000 MT)	Jan-Sept	439	497	13.0%	Positive
8	Cement Production (Tons)	Jan-Sept	7,333,609	7,334,225	0.0%	Neutral
9	Cement Consumption (Tons)	Jan-Sept	7,098,713	7,027,522	-1.0%	Negative
10	Tourist Arrivals (Number)	Jan- Oct	962,157	1,238,330	28.7%	Positive
11	Maize (Million Bags)	Jan- Dec	34.2	44.6	30.4%	Positive
12	Wheat (Million Bags)	Jan- Dec	3	4.9	63.3%	Positive
13	Beans (Million Bags)	Jan- Dec	5.7	11.7	105.3%	Positive
14	Irish Potatoes (Million Bags)	Jan- Dec	20	25.3	26.5%	Positive

- Electricity production & consumption- In the first eleven months of 2023, Kenya generated 11.5 billion KW/hr of electricity which was a 0.6% decline from a similar period in 2022. Electricity consumption on the other hand improved slightly by 3.4% over the same period. The two metrics indicate that both producers and consumers did not increase their activities during the year, signalling minimal growth in economic activity.

- Fuel consumption- Diesel, Super and Kerosine consumption declined in the first 9 months of 2023 by 4%, 3.4% and 33.2% respectively. This signals reduced movements, low production and low consumption all indicating low to muted economic activity during the year. Consumption of LPG and Jet fuel increased during the year. The increase in LPG consumption signals a shift by users to cleaner energy solutions while the increase in Jet fuel consumption signals increased activity in the tourism sector.

- Cement Production & Consumption- The first nine months of 2023 indicate stagnation in the production and consumption of cement, indicating muted investment activities (capital formation). This may signal a decline in future production.

- Tourist arrivals- The first ten months of 2023 saw a 29% increase in the number of tourist arrivals through our main airports, signalling a vibrant tourism sector in 2023.

- Food Production- Following good rainfall during both the 2023 long and short rain season, the ministry of agriculture estimates that food production will grow by strong double-digit figures. Maize is expected to grow by 30%, Wheat 63%, beans 105% and Irish potatoes by 27%. Increased food production signals an improvement in future disposable incomes since producers get higher incomes and consumers get lower prices. It is also an indicator of lower inflation in the near future.

Overall, 2023 was a year characterised by high input and output prices for most businesses which may have led to low to muted output levels. The high prices were driven mainly by increased food prices, high energy costs, depreciating shilling and higher taxes. The same factors also dampened demand from consumers, leading to lower orders. Things improved as the year progressed as food prices started trending downwards, which was a positive for consumption. Fuel prices also stabilised towards the end of the year, giving further reprieve to both consumers and producers. Currency depreciation, high electricity costs and high taxes remained a bother to businesses and households as they both increased production costs, while reducing disposable incomes of consumers. As our indicators show, sectors like hospitality and agriculture enjoyed a good year while others like manufacturing and construction struggled to maintain prior levels of production.

2024 OUTLOOK AND OPPORTUNITIES

1. Outlook

The metrics discussed above are good leading indicators that we can use to forecast business performance going forward. We expect the improvement in food production towards the end of 2023 to have positive ripple effects going into 2024. High production leads to lower food prices which translate to improved disposable incomes for households. This may spark a rebound in consumer demand. Increased food production also means more and cheaper inputs for manufacturers which will in turn boost production. On that front we expect to see improved production across industries in the first quarter of 2024. We expect manufacturing and construction sectors to enjoy the improved consumer demand even as other sectors like agriculture and hospitality continue to thrive.

2. Opportunities

As discussed earlier under 2023 fiscal policy, the country is undergoing an economic transition that will change the way government, households & businesses interact with each other. Current economic realities are opening new opportunities while closing old ones. It is important that businesses adapt early to increase their chances of surviving. Below are a few of the areas we see new opportunities going into 2024.

a) First, we expect to start to see government expenditure slowly having less impact on local markets. Businesses with high reliance on government related business should start diversifying their markets to private entities and individuals.
b) Secondly, with rising input costs, local businesses will start investing in new production models aimed at improving the competitiveness of their products. Households will also start to demand cheaper and efficient energy solutions in response to the high cost of energy.
c) Third, new markets for Kenyan products & services have started to emerge outside our borders as the depreciating shilling has made locally made products cheaper to oversees clients. Businesses should start marketing their products overseas. With improvements in cross border logistical solutions, exporting local products is now possible through ecommerce platforms. Service providers can take advantage of internet powered communication to offer services anywhere in the world.

d) Fourth, financial markets are poised to get a government driven ‘market cap injection’ following introduction of the new privatisation policy. Financial market participants can take advantage of the expected wave of IPOs to attract new clients while expanding options for existing clients.
e) Fifth, businesses should start negotiating with oversees suppliers for alternative trading currencies to the dollar. They should also explore possibilities of changing their country sources of inventory/ raw materials to minimise exposure to dollar fluctuations. For example, our company recently purchased an American software program through a Namibian distributor, which was 27% cheaper than buying directly using Kenya shillings.
f) Lastly on taxes, businesses should engage the services of tax professionals to explore the best ways of ensuring they are tax compliant without exposing their businesses to unnecessary tax bills.

VIRTUAL CFO 13