STATE OF THE ECONOMY

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Outline

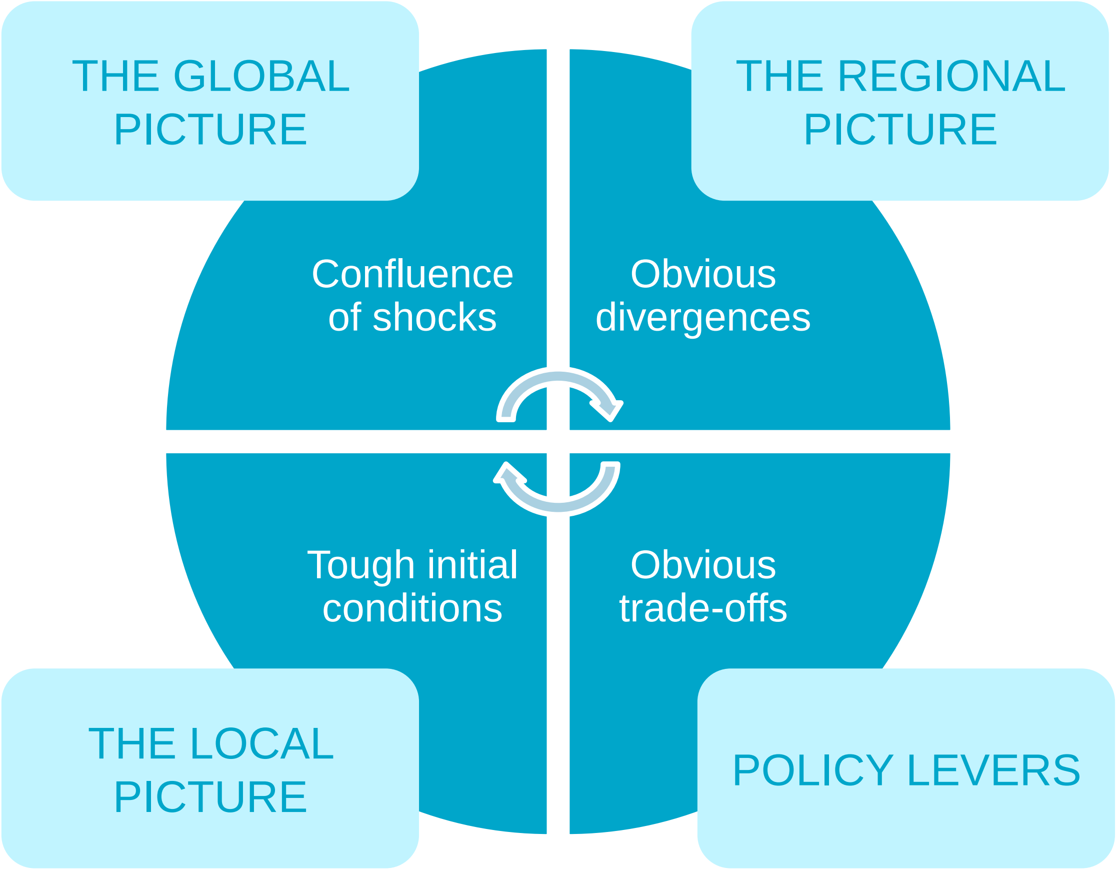
Grounding state of the economy perspectives on:

i. Expectations management – reconciling official upbeat positions with extreme (even cynical) household/enterprise viewpoints

ii. Appreciation of policy conundrum on the back of market dislocations

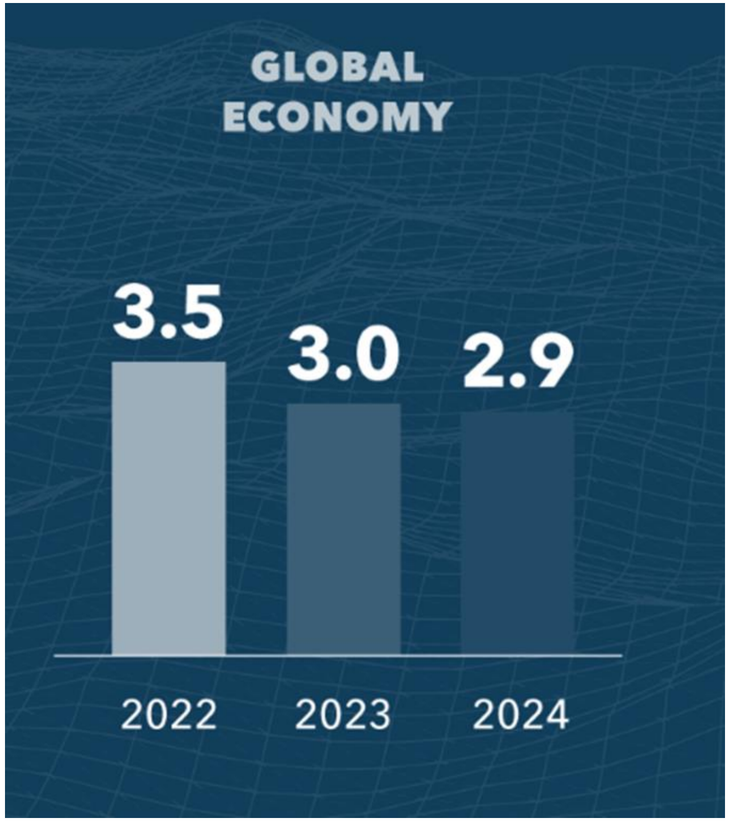
iii. A spotlight on public debt and its implication on financial markets and overall economic performance

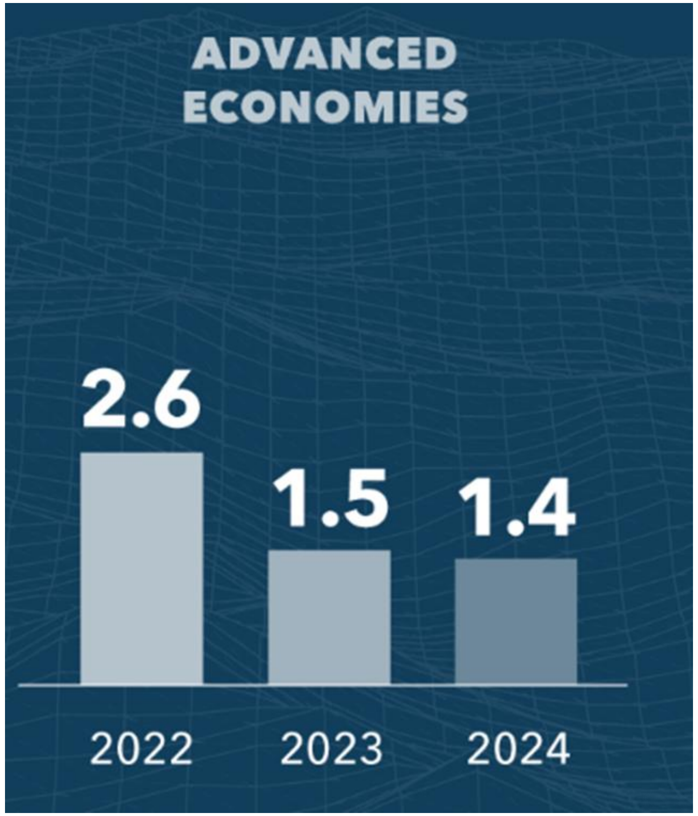
iv. An outlook underpinned by several moving parts – a year ahead (meaningful); medium term (speculative)

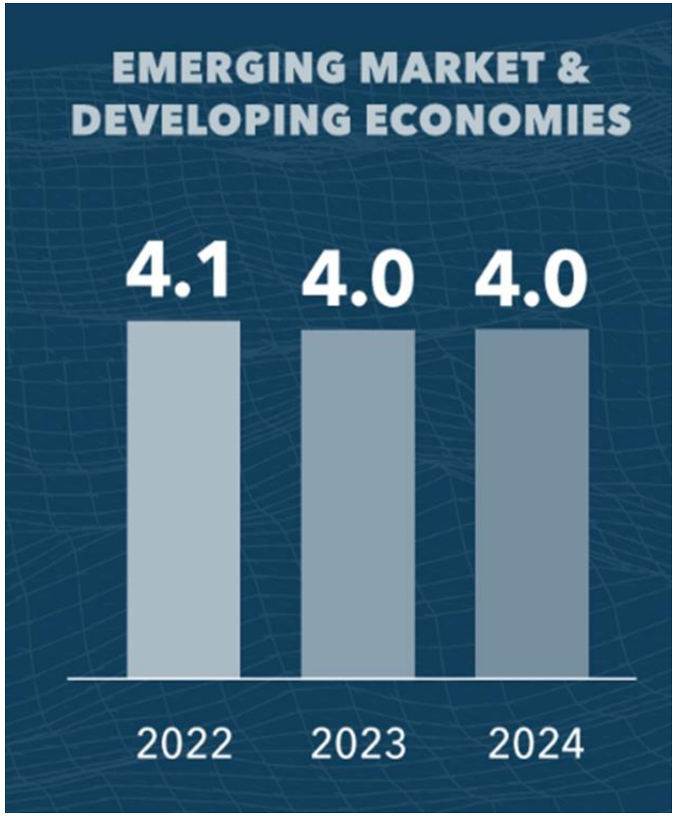


THE GLOBAL PICTURE

Global Economy “Resilient,… but limping along”



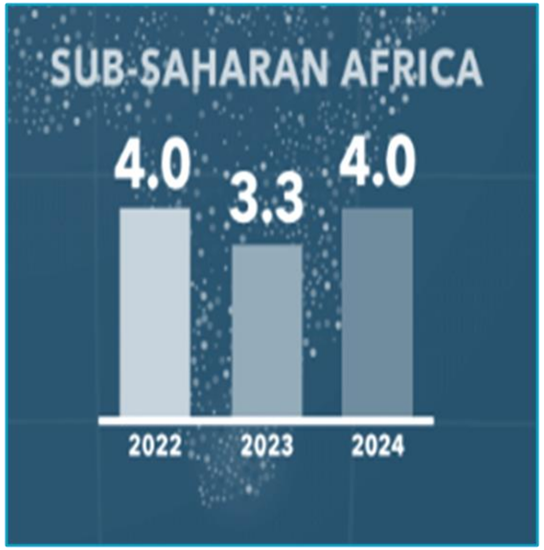




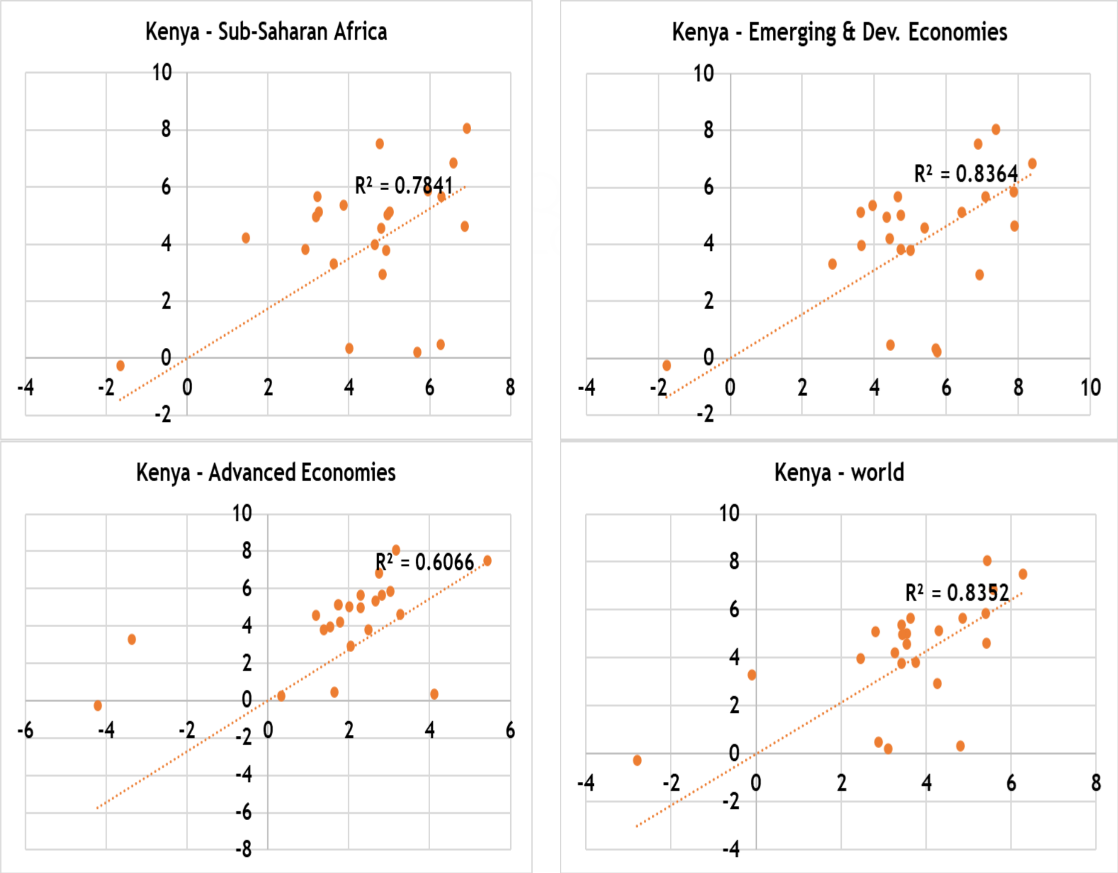
Source: IMF, WEO Database

Sub-Saharan Africa - worsen before getting better?

That matters.



Source: IMF, WEO Database



WHY IT MATTERS:

i. Intertwined fortunes

ii. Spillovers amidst geoeconomic fragmentation

iii. Small-open-economy attributes at play

Global and regional picture - short-term "terrible twos"?

That depends on whether inflation and public debt are considered inevitable wobbles before long-term progress

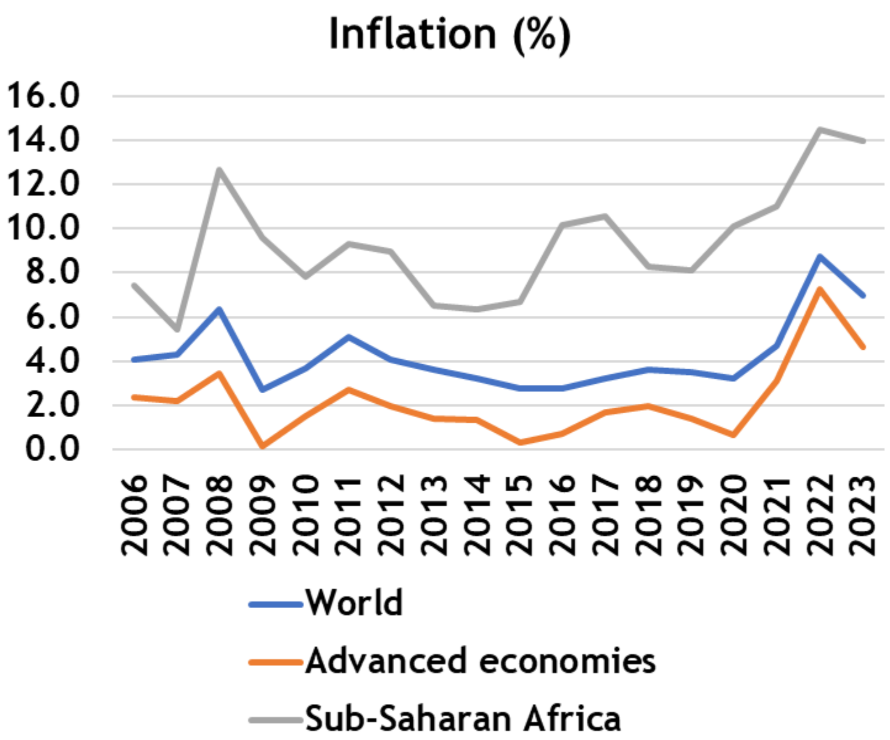
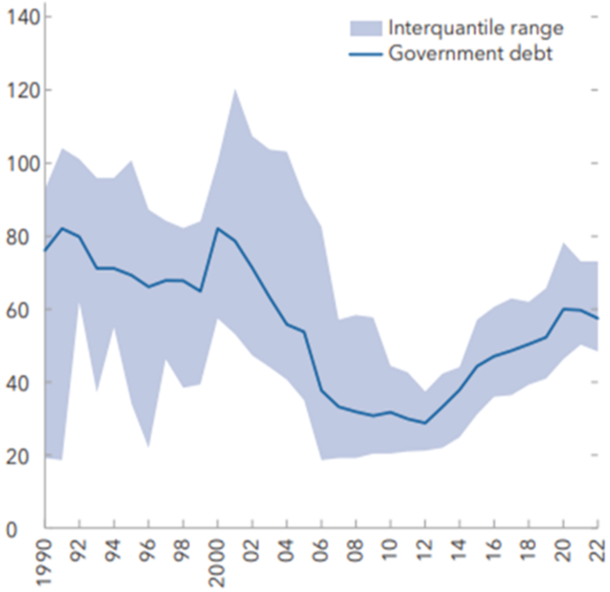
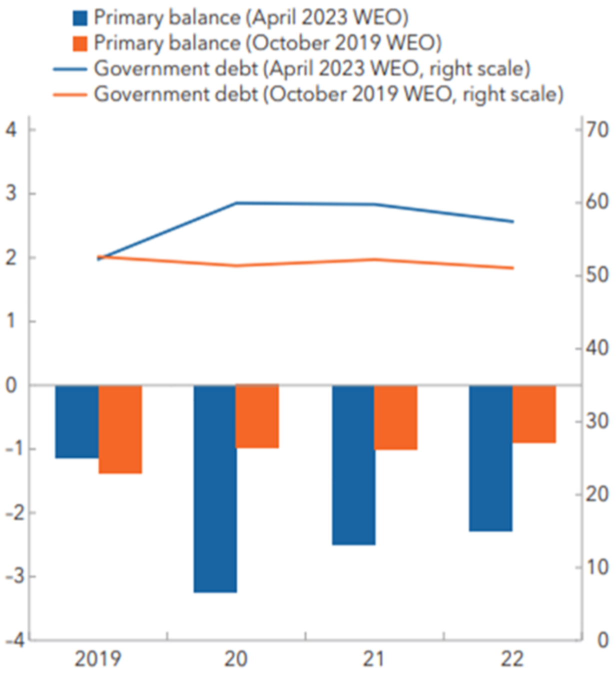


Figure 1. Sub-Saharan Africa General Government Gross Debt 1990-2022
(Share of GDP, median)



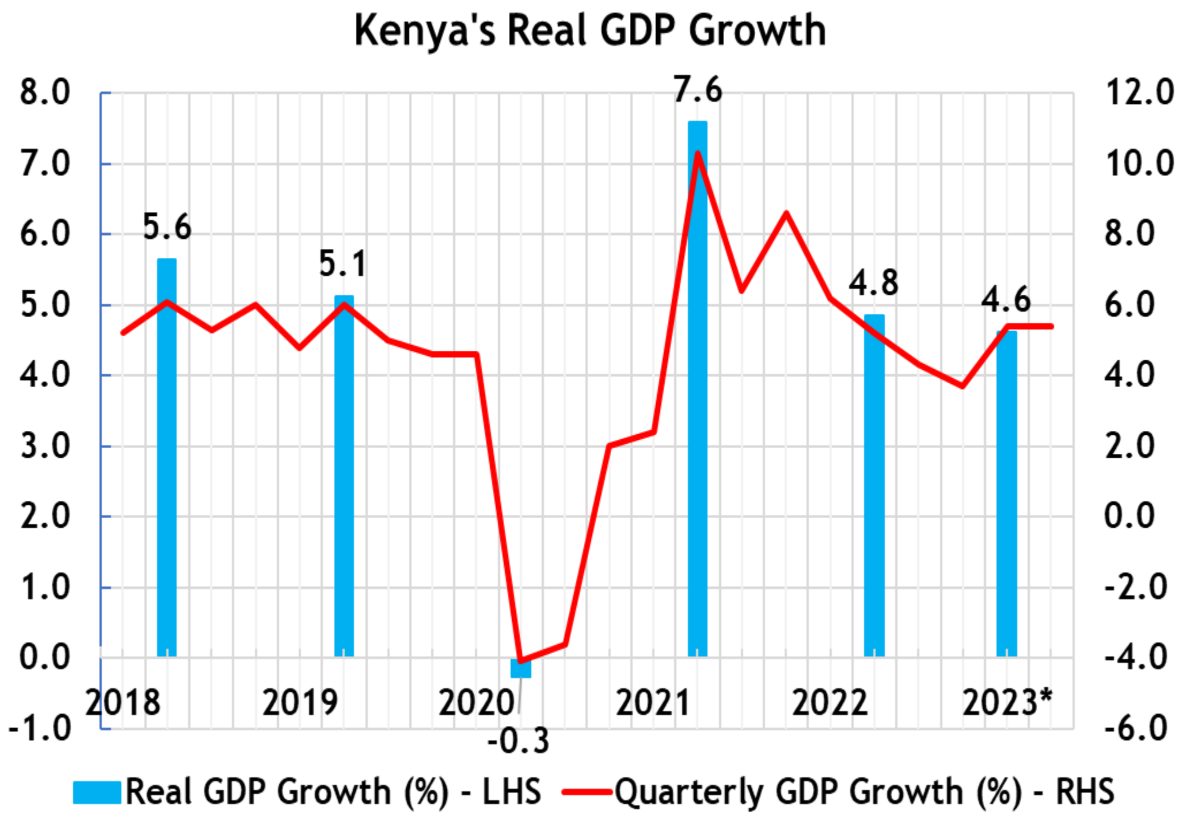
Source: IMF, World Economic Outlook database.

Figure 2. Impact of Pandemic on Sub-Saharan Africa Fiscal Path
(Share of GDP, median)



THE KENYAN ECONOMY - ZOOMING IN

Kenya's real output growth - is recovery entrenched?



Source: KNBS

- Agriculture (accounting for over 30% of GDP) is core to the growth trend
- Services – financial, tourism related, and information and communication – are key too
- Pre-covid growth rates have not been realized

i. Evidence of negative output gap (actual growth less potential growth) abound): businesses operating at excess capacity

ii. Price increase driven by weak supply, not strong demand

iii. Scope for new investment is limited

Macroeconomic policy setup – tough initial conditions

INITIAL CONDITIONS

- Overlapping shocks – some recovery (2021); moderation (2023 onward)
- Inflationary pressure – exchange rate pass-through; fuel prices pass through; weak demand
- Glaring domestic and external imbalances – fiscal deficit (unsustainable); current account (unsustainable)
- Persistent negative output gap on the back of infrastructure deficits

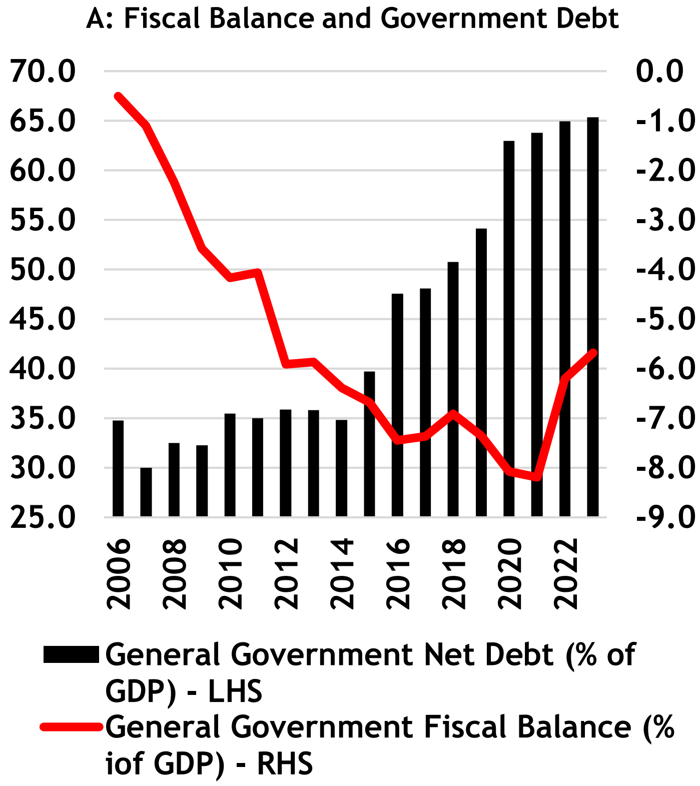
FISCAL POLICY

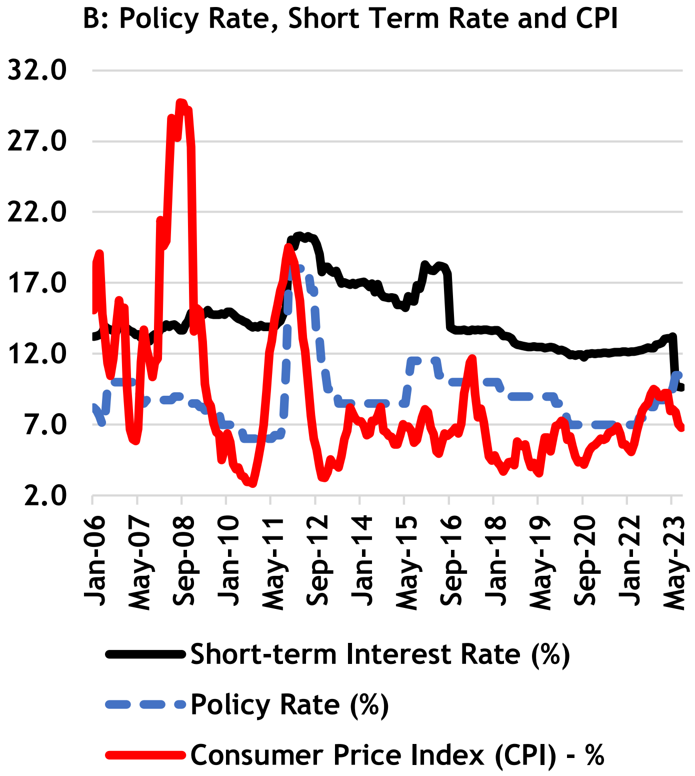
- With IMF program, fiscal policy is predictable – Extended Credit Facility& Extended Loan Facility (2021); Resilience and Sustainability Facility
- Policy reform - fiscal consolidation
- Dilemma – is the stance expansionary or contractionary? Expenditure points to expansion; tax measures point to contraction

MONETARY POLICY

- Accommodative stance coincided with expansionary fiscal policy (safe for 2016 – 2019)
- Tight policy was untenable during the period of economic shocks
- Tightening stance as the major central banks commenced the tightening cycle in line with “*domestic objectives using domestic instruments*”
- Dilemma- a blunt tool with implications on fiscal sustainability

Buildup to a policy conundrum - Exhibit 1

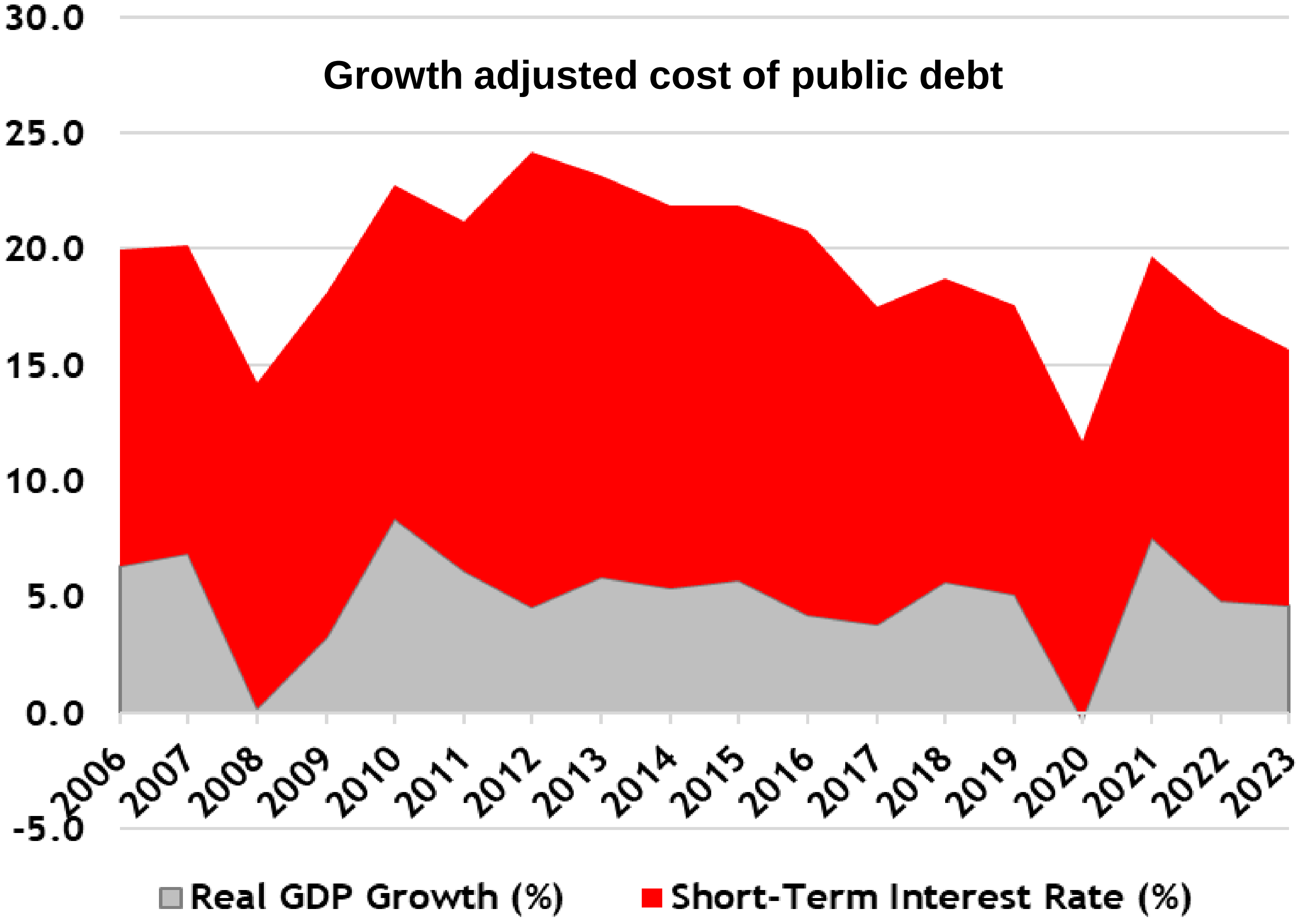




Source: CBK

- Monetary Policy and Fiscal Policy predisposed to optimism – the risks emerge with a lag
- Wide fiscal balance reveals itself in steady debt accumulation
- Short-term rate is consistently at double digit level, as policy rate tracks the inflation trend

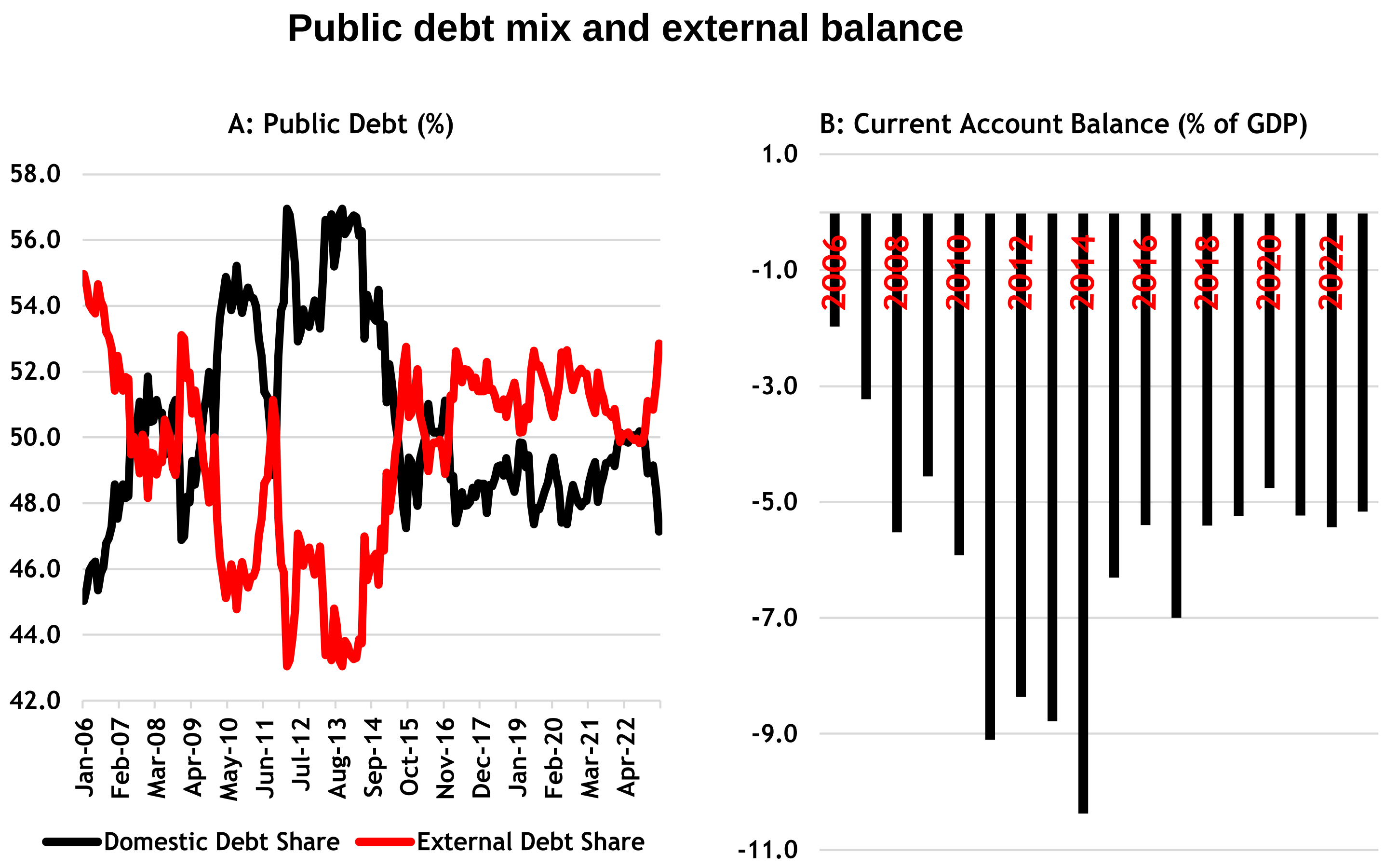
Buildup to a policy conundrum - Exhibit 2



Source: CBK; KNBS

- Significant debt accumulation makes fiscal consolidation an obvious policy proposition
- So long as growth-adjusted cost of borrowing is positive and growing, even a positive primary balance many not sufficiently offset debt accumulation
- Aggressive fiscal consolidation that comes with adverse outcomes

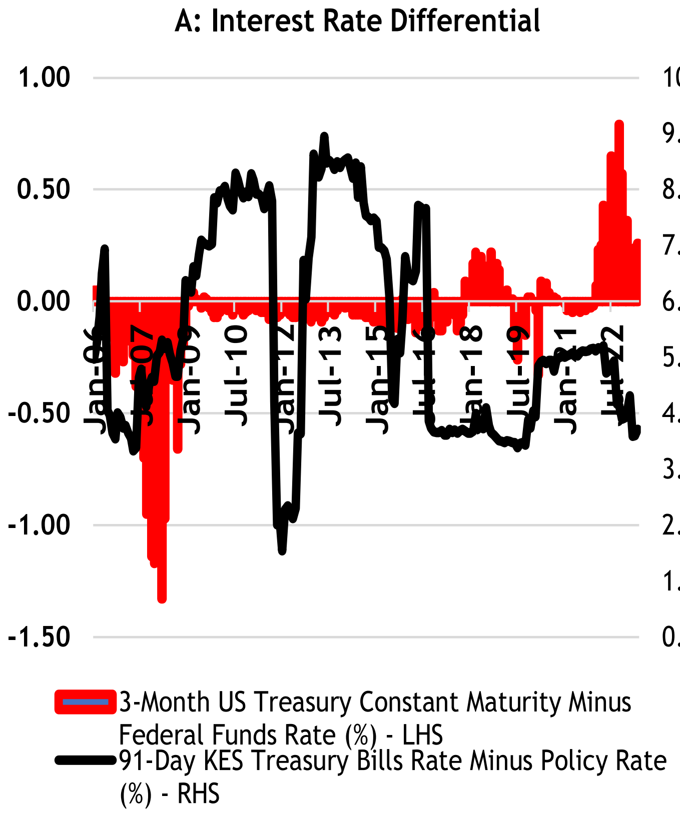
Buildup to a policy conundrum - Exhibit 3

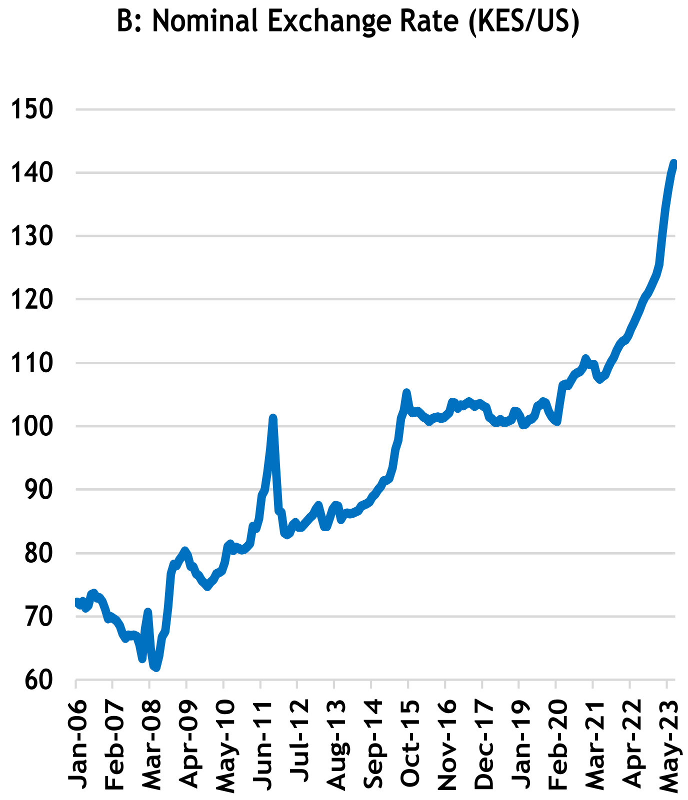


Source: CBK

- A shift from a domestic-external public debt substitution to a balanced proportion
- The reduction of the external proportion coinciding with a weakening external balance a pointer to external flows being intermediated by the private sector
- Private sector external risks aren't given the deserved prominence

Buildup to a policy conundrum - Exhibit 4

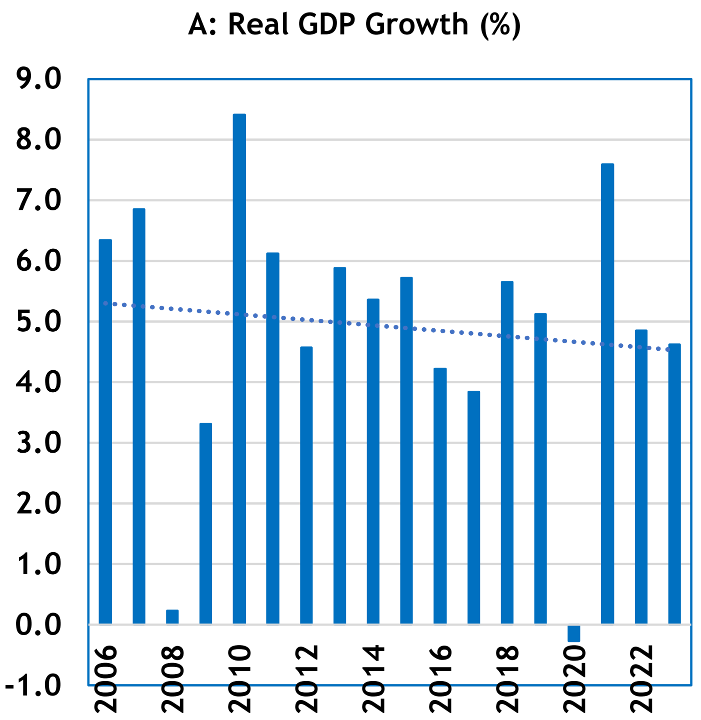


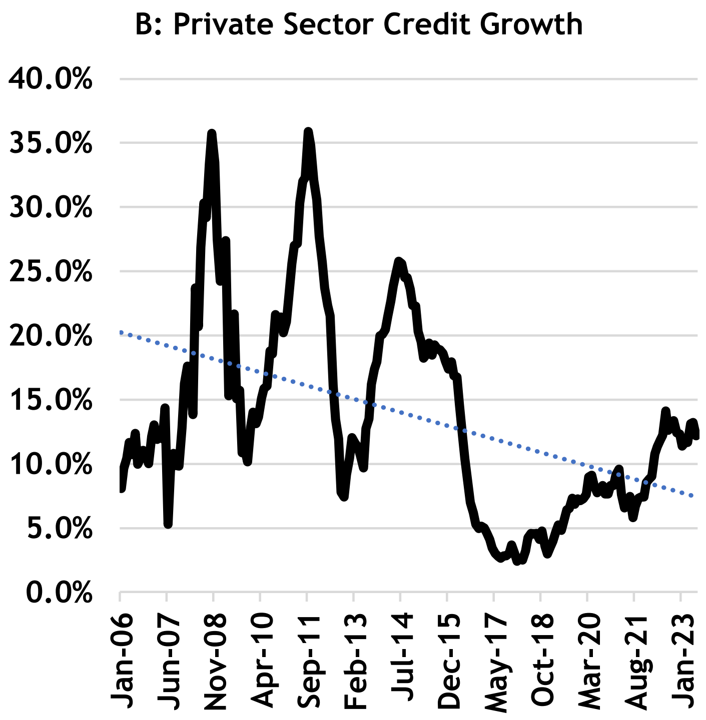


Source: Federal Reserve Economic Data (FRED); CBK.

- The "low for long" interest rate regime was abruptly interrupted
- The munition for "protecting" the local currency was exhausted
- Monetary policy has been fighting fiscal wars
- The "trilemma" was shelved – tricky expectations of a stable currency and stable (low) interest rates on the back of an open capital account

Buildup to a policy conundrum - Exhibit 5





Source: CBK; KNBS

- A strong causal relationship between private sector credit and real GDP growth
- Output growth on the back of weak private sector credit points to a public sector-led growth
- Crowding-out effect is evident
- Businesses are seeking working capital credit, not investment capital
- Digital credit to is a small portion of overall credit
- Risk profile is elevated – bank NPLs almost 15% of gross loans

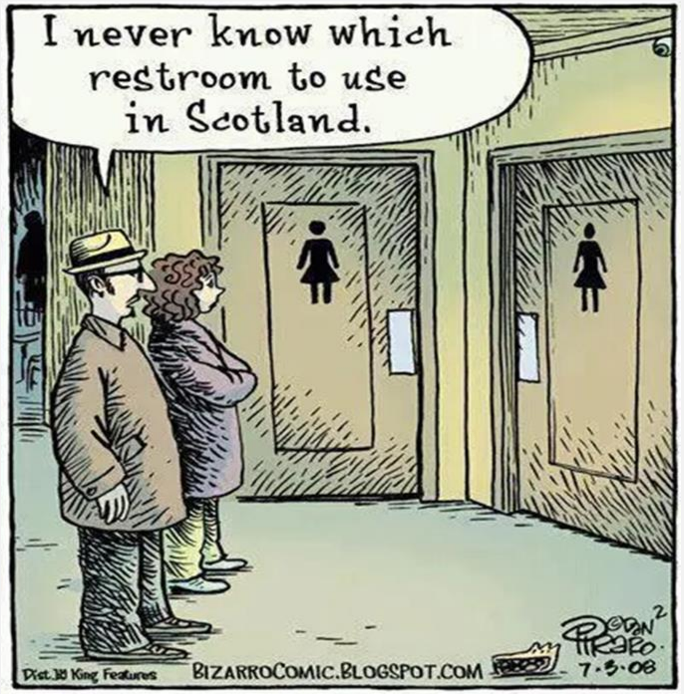
The conundrum

Fiscal –

Monetary policy interaction

- Inextricable link between fiscal policy and monetary policy
- On the surface we see policy alignment – underneath are elements of fiscal dominance

The dilemma



Spotlight on public debt

- The buildup is evident, fiscal consolidation notwithstanding
- The focus is on the debt stock (a binding constraint), but the structure of the debt is equally a binding constraint
- It matters who provides the debt – commercial debt disguised as official debt; implications on the multiplier effect are key
- Contingent liabilities are now an issue of concern – KPLC; KQ (akin to Eskom, Transnet) prominently feature in IMF conversations
- Move from debt ceiling to nominal anchor is important

Implication for the financial sector

Market dynamics

- Persistent profitability regardless of the economic cycle implies high risk taking during shocks
- Elevated NPLS (deteriorating asset quality) invites an inclination to government securities
- Depending on the size of a market player, there are profitability – liquidity tradeoffs based on the "small bank -big bank" dichotomy

Perspectives

- Prolonged periods of stability motivating enhanced risk-taking could mean: system being stable until suddenly it is not (Silcom Valley Bank, Credit Suisse) – *Wile Coyote* moment
- Watch thresholds around three parameters:

i. NPLs

ii. Risk Weighted Capital Adequacy

iii. Yields on government securities (risk-free assets?)

Possible Wile E. Coyote Moment?

Outlook

Key consideration – qualifies optimism

- Private sector credit on a gentle but upward trajectory – quality issues linger; sustenance of the trajectory and issue
- Service sector seems to be picking – capacity to drive overall growth is limited
- Agriculture as key growth driver hinges on – weather; how effective interventions such as fertilizer subsidy (tractors from Belarus?)

Key considerations – grey areas

- The capacity – appetite – for big infrastructure is low; the need is undiminished
- Obvious competitiveness issues remain unaddressed – e.g. energy costs; playing into production for regional and international markets
- Sovereign external debt issues overshadow external private obligations
- Credibility of the overall policy on the back of headwinds
- Under 5% real growth – cascading effect given that projections are based on a higher growth outlook

The risk of missing the growth target

Final thoughts

Inclusive growth cannot be revealed by the broad levels of real output growth – the drivers of growth reflects skewness away from MSMEs

Inclusive finance cannot be revealed by conventional measures of financial inclusion as supported by FinTech – behavioral biases drive a wedge between access and enhanced usage

The wisdom of Leo Tolstoy in Anna Karenina (1877) rings true:

"All happy families resemble one another, but each unhappy family is unhappy in its own way"

THANK YOU