Cytonn INVESTMENTS

The IMF Precautionary Credit Facility 2018, & Cytonn Weekly #35/2018

Focus of the Week

Recently, the International Monetary Fund (IMF) concluded their review under a precautionary Stand-By Arrangement (SBA), which was extended to Kenya on 14th March 2016. The SBA is a lending arrangement extended by the IMF to member countries in emerging markets in need of financial assistance in case of occurrence of exogenous shocks such as drought, increase in global oil prices or changes in international financial markets. Previously, we had highlighted the IMF's various forms of lending and the reasons why Kenya may benefit from the IMF standby facility (for more information, see our focus on Kenya's IMF Standby Facility), while in this focus we shall highlight on the possible economic implications of missing out on the IMF's precautionary credit facility. In a press statement after the visit, the IMF stated that their mission to assess the Kenyan economy achieved significant progress, but remained uncertain whether Kenya's access to the standby facility would be extended. The Executive Board of the IMF was set to make a decision on Friday 14th September, on whether or not to grant Kenya access to a precautionary credit facility of USD 989.8 mn (Kshs 99.0 bn), having extended a similar facility amounting to USD 985.9 mn (Kshs 99.0 bn) in March 2016. The program expired on September 14th 2018 after being extended from 14th March 2018, and the Treasury announced that it would not renew the precautionary credit facility with the IMF despite having requested an extension of the same in March 2018, arguing that the country had kept macroeconomic fundamentals stable, occasioned by the low inflation levels and stable shilling. This week, we highlight on the current economic environment, the government's efforts to comply with the conditions for the IMF to extend the facility, and give a view going forward on the economic implications after the precautionary credit facility expired. As such, we shall address the following items:

i. IMF Visit to Kenya 2018 and Key Take Outs from the IMF Review;
ii. Commitments laid out by the government in order to qualify for the IMF precautionary credit facility, and the efforts made by the government to address economic challenges relating to these commitments;
iii. Possible economic implications should the Government not take advantage of the IMF's precautionary credit facility; and,
iv. Our View and Way Forward.

Section I: IMF Visit to Kenya 2018 and Key Take Outs from the IMF Review

A team from the International Monetary Fund (IMF) visited Kenya from July 23rd to August 2nd, 2018, to hold discussions on the second review under a precautionary Stand-By Arrangement (SBA). From the discussions with the Kenyan authorities, it was noted that:

1. Kenya's economy had continued to perform well with the GDP having expanded by 5.7% in Q1'2018, up from 4.9% growth experienced in Q1'2017, with the growth being driven by improved investor confidence following the conclusion of the prolonged electioneering period, improved weather conditions in 2018 and a recovery in tourism sector, which can be evidenced by an

increase in the total number of visitors arriving through Jomo Kenyatta International Airport (JKIA) and Moi International Airports, that increased by 2.1% to 76,608 in June 2018 from 75,028 in May 2018, despite a 4.4% decline y/y from 80,121 in June 2017, as per data from Kenya National Bureau of statistics (KNBS),

2. Inflation has remained within the government's set target of 2.5% - 7.5% target, averaging 4.2% in the 8 months to August 2018, compared to 9.5% in a similar period in 2017. We expect inflation to remain within target in 2018 despite the expectations of upward pressure in H2'2018, partly due to the base effect, and other tax reforms proposed under the Finance Bill 2018,
3. Kenya had managed to meet the IMF's program fiscal target for the FY2017/2018, with the budget deficit for the 2017/2018 fiscal year coming in at Kshs 614.6 bn (equivalent to 7.0% of GDP), significantly narrowing from 9.0% of GDP previously,
4. The current account deficit has started to improve in 2018, after widening to 6.7% of GDP in 2017 from 5.2% in 2016, which was mainly driven by higher food imports and weaker agricultural exports as a result of the drought experienced during the year, coupled with higher fuel imports owing to rising global oil prices. The lower current account deficit so far in 2018, which narrowed to 5.8% in the 12-months to June 2018 from 6.3% in March 2018, has been attributed to improved agriculture exports, and lower capital goods imports following the completion of Phase I of the SGR project, and,
5. The Kenyan Shilling has remained resilient against major currencies, while foreign exchange reserves have been relatively high currently standing at about USD 8.5 bn, equivalent to 5.7-months of imports cover.

Based on the above, we are of the view that Kenya is on the right trajectory towards improving the macroeconomic conditions in the country. From the FY'2018/2019 budget, the government is set to focus on a fiscal consolidation plan aimed at narrowing the fiscal deficit to 5.7% of GDP from 7.2% of GDP in the FY'2017/18 and further to around 3.0% of GDP by FY'2021/22. The government plans to achieve this through measures aimed at improving revenue collection by the Kenya Revenue Authority, which is projected to grow by 17.5% to Kshs 1.9 tn (equivalent to 20.0% of GDP) in the FY'2018/19 from the estimated Kshs 1.7 tn collected in the FY'2017/18, and a reduction in Government expenditure, which will in turn lead to reduced dependency on debt with the total borrowing requirement to plug in the deficit expected to decline to Kshs 558.9 bn from Kshs 620.8 bn, in a bid to reduce Kenya's public debt burden.

Section II: Commitments laid out by the government in order to qualify for the IMF precautionary credit facility, and the efforts made by the government to address economic challenges relating to these commitments

The Executive Board of the IMF had approved the Government's request for a 6-month extension of the Stand-By Arrangement (SBA) on 12th March, 2018, to allow more time for the completion of the two outstanding reviews. In a letter of intent dated 6th March 2018, the government stated that the extension was needed, giving reason that the second and third reviews had not been completed as the performance criteria on the primary balance (the difference between government revenues and its non-interest expenditures) for December 2016 and June 2017 were missed, due to revenue shortfalls and spending pressures partly on account of the drought, therefore no common ground could be reached on corrective policies to address the fiscal slippages resulting from the extended election period. The IMF agreed to extend the tenor of precautionary credit facility by 6 months on condition that certain requirements were to be met to necessitate eligibility for the insurance loan. Among the requirements included:

A. **Fiscal consolidation in order to reduce the budget deficit and public debt through rationalization of expenditure**: The IMF had raised concerns that the public debt would reach nearly 60.0% of GDP this year. The government promised strong action to put the deficit and debt firmly on a downward path and reduce financing risks associated with the high debt levels. This

would be done through corrective measures including steps to rationalize expenditure in the near-term and measures to increase revenues over the medium-term. Specifically, the government had committed to a reduction in the fiscal deficit to 7.2% of GDP by the end of the last fiscal year (June 2018), to be achieved by postponement of lower-priority capital projects. In addition, the government committed to a further 1.5% of GDP adjustment in 2018/19 to reach a deficit of 5.7% of GDP, to be supported by widening of the tax base by reducing exemptions in the VAT and income tax, as well as on-going improvements in revenue administration. By comparison, the FY'2017/2018 fiscal deficit decreased to 6.2% of GDP from 9.1% in FY'2016/2017, on the back of improved revenue collection by the government as businesses recovered from the effects of drought and the prolonged electioneering period. This was better than the 7.2% deficit that the IMF had expected by the end of the fiscal year 2017/2018. However, increased debt appetite by the government has pushed the debt burden to 55.6% of GDP from 48.9% in June 2016, with concerns that it may reach 60.0% by June 2019 if left unchecked. High recurrent expenditure by the government may increase the government's financing needs, thereby increasing the public debt.

B. **Removal, or significant modification of the interest rate controls by Parliament**: The IMF was of the strong view that interest rate controls, which were adopted in 2016, have contributed to a collapse in bank lending to the private sector and lower tax revenues from the banking sector, and have also reduced the effectiveness of the monetary policy framework. To minimize the adverse effect of the rate cap, the IMF required government to eliminate or significantly modify interest rate controls such that they would no longer hinder lending and access to finance, or hinder the conduct of monetary policy. However, legislators rejected the repeal of the rate-cap law among other tax reforms proposed in the Finance Bill 2018, arguing that most banks are still profitable despite the reduced lending margins. Legislators voted to keep the rate cap in place while removing the floor on pricing of deposits, which was set at 70.0% of the CBR.
C. **Monetary policy framework modernization**: This was to follow the removal or modification of interest rate caps, whereby the government would be required to introduce an interest rate corridor around the Central Bank's policy rate. This would help to strengthen the monetary policy transmission channel and allow the Central Bank of Kenya to move toward a full inflation-targeting regime. However, the Treasury's efforts to convince legislators to repeal the Banking (Amendment) Act, 2016, did not bear fruit as MPs declined to repeal the interest rate cap legislation.
D. **Other reforms**: The authorities had indicated keenness in pursuit of efforts to deepen financial sector reforms, improve the transparency and efficiency of public spending, and strengthen the quality of macroeconomic statistics. To address this, the Treasury proposed a number of taxes in its Budget statement for the 2018/2019 fiscal year to try and reduce the widening budget deficit, including:
   a. The 'Robin Hood' tax on bank transfers, which required banks to remit 0.05% tax on transfers above Kshs 500,000;
   b. The Housing Development Fund Levy that required workers in formal employment to submit 0.5% of their gross salary towards a National Fund for Affordable Housing, with employers required to match employee's contribution;
   c. Excise tax on mobile money transactions were increased to 12.0% from 10.0%;
   d. Increase in excise duty for cars above 2,500cc to 30.0% from 20.0%; and,
   e. Capital gains tax of 5.0% on property transfers by insurance firms.

The Robin Hood tax was suspended by the High Court on grounds that due process was not followed in engaging stakeholders through public participation. In addition, the tax would stifle the flow of funds and curb investments, thereby compromising efforts to consolidate regional leadership as a financial hub, according to the Kenya Bankers' Association (KBA). The housing levy fund, meant to finance the construction of 500,000 affordable housing units in five-years, was also rejected by MPs on grounds that it would be costly to companies while putting Kenyans at a disadvantage due to

double taxation. The legal obstacles facing implementation of the additional taxes will likely serve to widen the budget deficit and cripple additional revenues that would go into servicing the huge debt stockpile, which is currently at 55.6% of Kenya's GDP. The government may have to fill in the revenue gaps using more debt, which, in our view, will result into deteriorating debt levels.

Section III: Possible economic implications should the Government not take advantage of the IMF's precautionary credit facility

This section will examine the implications to the economy should the Government fail to take advantage of the precautionary facility offered by the IMF.

i. **Depreciation of the Kenya Shilling:** The announcement by the Treasury on Thursday 13th September that the government will not be seeking the extension of the tenor for the IMF's facility triggered weakening of the shilling by 0.2% against the dollar to cross 101.22 units to the dollar. However, with the intervention of the CBK by pumping dollars into the market, the shilling regained marginally to close at 100.85 units to the dollar. So far, the shilling has been held steady during the year as a result of increased inflows from export earnings, diaspora remittances and foreign direct investments (FDIs). The Central Bank of Kenya (CBK) forex reserves currently stands at USD 8.5 bn (Kshs 850.0 bn), which the CBK believes will cushion the local currency against depreciation, now that Kenya chose not to renew the precautionary credit facility. However, should the local currency weaken, the country's stock of dollar-denominated debt will rise sharply making it even more expensive for the country to service its debt obligations.
ii. **Adverse Movements in Balance of Payments Position**: These may arise from the vulnerabilities to exogenous shocks such as increase in global oil prices, drought or adverse changes in the international financial markets. Kenya has become more integrated into the global financial system over the years, hence it is exposed to such possible occurrences in the future which could negatively affect the current account deficit due to increased outflows of foreign capital.
iii. **Reduced Investor Confidence**: The above implications would mean a reduction of investor confidence in the country as international investors may view Kenya as a high-risk investment destination. This would slow down economic growth, stifle access to capital and raise fears of an economic meltdown.

Section IV: Our View and Way Forward

The announcement by the Treasury not to renew the USD 989.8 mn (Kshs 99.0 bn) precautionary credit facility with the IMF caused some uncertainty around the future of the economy, with the current facility having ended on Friday 14th September 2018. As a result, there are concerns that the shilling may depreciate and investor confidence in the country may wane, hence reducing foreign investment and stunting economic growth.

In our view, however, while the facility is a nice to have, there is no immediate threat to the economy as a result of the failure to renew the IMF facility, due to

a. Sufficient forex reserves of USD 8.5 bn, equivalent to 5.7 months of import cover,
b. The stability of the shilling, having appreciated 1.9% year-to-date despite the government having not drawn down on the IMF facility, and,
c. The expected narrowing of the current account deficit to 5.4% of GDP by the end of the year, from 5.8% in June 2018, according to the CBK.

In addition, according to IMF representative Jan Mikkelsen, Kenya's external position remains strong and foreign exchange reserves are at a comfortable level. The government should continue with its efforts to work on a fiscal consolidation plan aimed at narrowing the fiscal deficit to 5.7% of GDP from 7.2% of GDP in the FY 2017/18 and further to around 3.0% of GDP by FY 2021/22. This can be achieved through revenue enhancement measures, which will in turn lead to reduced dependency on

debt in a bid to reduce Kenya's public debt burden. Therefore, despite the possible implications of failure by the government to renew the precautionary credit facility, we perceive no immediate adverse effects on the economy. However, the government needs to work on the conditions set by the IMF since the improvement in these areas stand to benefit the economy with or without the IMF precautionary credit facility.

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