2017 ECONOMIC REVIEW

Highlights:

January 10th, 2017

Global *- Economic growth could be characterized as a broad-based cyclical recovery. According to latest estimates, global GDP accelerated by 3.00% in 2017 from 2.40% a year earlier – supported by improved growth in more than 50.00% of the world's nations.*

While growth in advanced economies is expected to slow, emerging and developing economies are expected to register accelerated growth attributable to commodity exporters underpinned by a recovery in global commodity prices.

Kenya *– In 2017, the country battled lagged effects of drought, weak private sector credit growth and an extended election cycle. The said headwinds contributed to a general slowdown in economic activity with latest estimates placing growth at 4.40% in the third quarter.*

Uganda *– Despite a rocky start to the year, economic activity rebounded on an improving agricultural landscape. Latest estimates place growth at 7.50% in the third quarter of 2017 compared to 2.10% in a comparable period a year earlier.*

Tanzania *– The economy remained resilient in the year registering one of the highest growth rates in the East African region. According to latest statistics, the economy expanded by 7.80% in the second quarter of 2017 compared to 8.50% in a similar period a year earlier.*

Rwanda *- Economic growth gradually rebounded in the year to an impressive 8.00% in the third quarter of 2017 according to latest statistics. The economic recovery was underpinned by improved agricultural production that facilitated a rise in agriculture and horticulture exports reinforced by improved global prices.*

Forecasts:

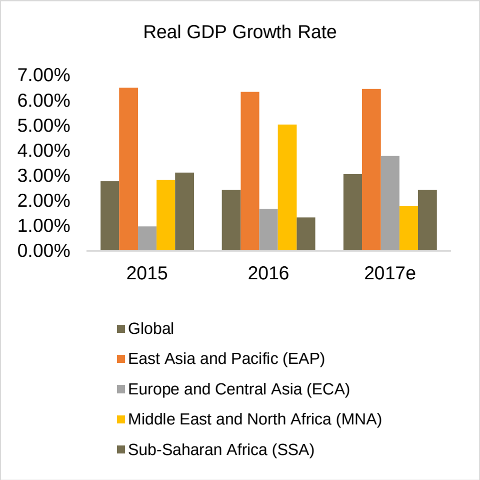
Real GDP growth (%)	**2015**	**2016**	**2017e**	**2018f**	**2019f**	**2020f**
Global	2.77%	2.42%	3.05%	3.08%	2.98%	2.91%
East Asia and Pacific (EAP)	6.50%	6.33%	6.45%	6.18%	6.07%	5.96%
Europe and Central Asia (ECA)	0.96%	1.67%	3.78%	2.90%	3.03%	2.97%
Middle East and North Africa (MNA)	2.82%	5.03%	1.77%	2.99%	3.20%	3.23%
Sub-Saharan Africa (SSA)	3.11%	1.32%	2.42%	3.20%	3.46%	3.55%

Source: Global Economic Prospects, World Bank (January 2018) CBA Research

Global Review

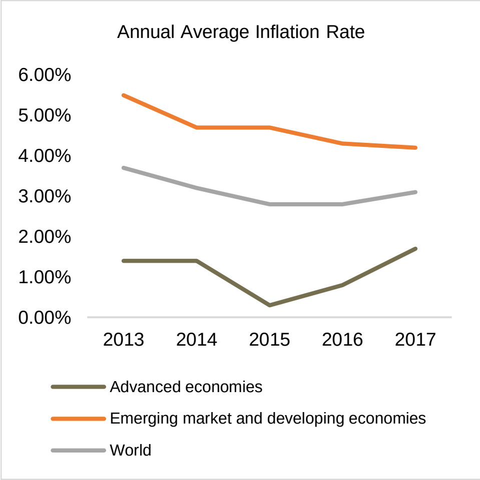
Global economic growth in 2017 could be characterized as a broad-based cyclical recovery. According to the World Bank (Global Economic Prospects, January 2018), global GDP accelerated by 3.00% in 2017 from 2.40% a year earlier – supported by improved growth in more than 50.00% of the country's in the world.

Economic growth was underpinned by enhanced investment spending owing to favourable financing and broadly improved investor sentiments. These investments bolstered global trade through enhanced global export and import demand. While growth in advanced economies is expected to slow, emerging and developing economies are expected to register accelerated growth attributable to commodity exporters underpinned by a recovery in global commodity prices.



Source: World Bank, CBA Research

Notwithstanding strengthening economic activity, global inflation has remained subdued. In 2017, average inflation stood at 3.10% compared to 2.80% a year earlier (World Economic Outlook, October 2017). Depressed inflation in advanced economies could have been a result of negative global output gaps and subdued wage growth. Meanwhile, stable exchange rates and easing food inflation (owing to improved weather conditions) supported the deceleration in inflation in most emerging and developing economies.



Source: IMF, CBA Research

Despite stubbornly low inflation, the US Federal Reserve (Fed), raised its policy rate three times during the year and announced a gradual reduction of its balance sheet perhaps in an effort to manage expectations and also aid the economy that is at near full employment.

On the flip side, subdued wage growth and a strengthening Euro delayed a pick-up in inflation instigating the European Central Bank (ECB) to leave its monetary policy stance unchanged though it did announce that it would gradually taper its bond purchase program.

Meanwhile, the Bank of England (BoE) hiked its policy rate for the first time in a decade presumably to counter accelerating domestic prices. However, this did not immediately translate into lower inflation as inflation broke above 3.00%.

Nevertheless, both transitory and structural factors were at play in global inflation dynamics during the year proving difficult for Central banker’s to predict the direction of inflation.

The 2017 political landscape was indeed heated. From the in-house drama in the White House (US) to the rising populist wave in the Euro area – Brexit not being left out of the mix.

The US economy had an interesting 2017 given President Trump’s ‘un-presidential antics’ that caused the US and the world over, to adjust to his new form of leadership. In the year, there were rising geopolitical risks stemming from the US-North Korea conflict but that has since eased and investors remain cautious of any new developments.

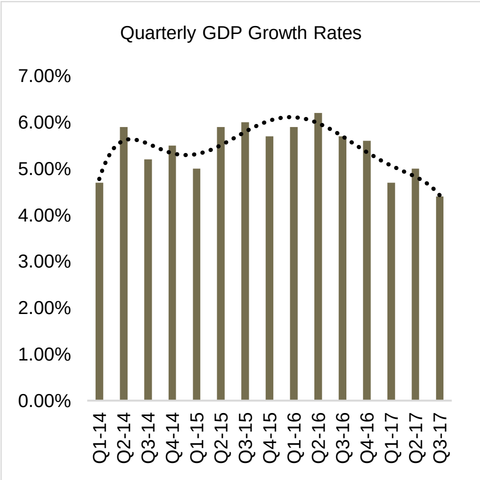
President Trump’s administration has faced its fair share of scandals and conspiracies highlighting potential frictions. Nevertheless, the market awaited Trump’s tax reforms that was eventually signed into law at the end of the year. Though the government is fairly optimistic that the reforms will bolster US economic activity, the Fed has stated that the tax reforms will only have a modest impact on the economy.

Meanwhile, investors were jittery as populist waves hit the Euro area raising concerns of the common currency’s future. However, the populist wave soon faltered though risks remain with the fluid political landscape in Spain and Germany.

The impact of Brexit on the British economy was instant with the British Sterling plummeting whilst general economic activity remained subdued. Investor sentiments towards the country turned negative after the negotiations took much longer than anticipated with a potential ‘no deal’ outcome by the end of the year. That notwithstanding, Prime Minister Theresa May battled a minority government, impeachment and a vote of no confidence with respect to the Brexit negotiations. At the end of the year, there was a light at the end of the tunnel – albeit faint, for a smooth Brexit negotiation in 2018.

Kenya

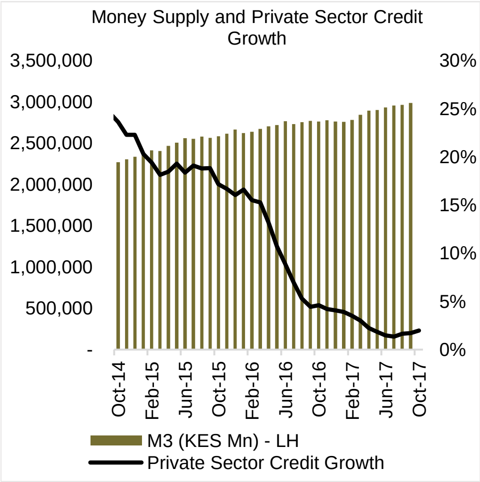
2017 was a whirlwind of a year with the country combatting lagged effects of drought, weak private sector credit growth and an electioneering period that lasted for an extended period of time. The aforementioned headwinds contributed to a general slowdown in economic activity with latest estimates placing growth at 4.40% in the third quarter. That said, the economy has proved resilient – despite the odds. Current forecasts place GDP growth at a range of 4.90% - 5.10% for the full year. However, given the unanticipated slowdown in the third quarter, the economy could ostensibly expand by 4.70% - 4.90%.



Source: Economic Survey (KNBS), CBA Research

Meanwhile, private sector spending remained subdued in 2017 on account of the slowdown in private sector credit growth - the impact of the election period notwithstanding. Subdued private sector credit activities could be blamed on a number of factors but it cannot be understated that the interest rate controls framework aggravated the situation at a time of a deteriorating borrower risk profile that placed a challenge on commercial banks to efficiently price for risk at the current cap of 14.00% (CBR+4.00%).

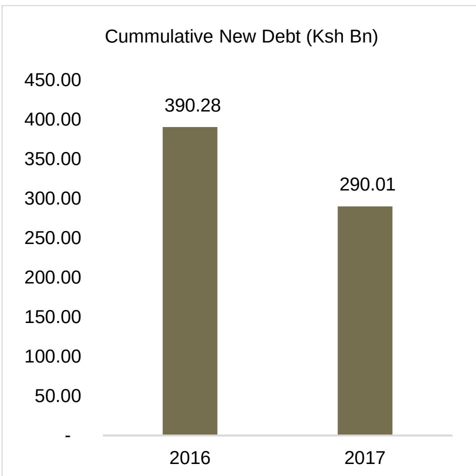
According to latest Central bank estimates, private sector credit has registered single digit growth since June 2016 thereafter touching a low of 1.35% in July 2017. In October 2017, there was a slight uptick to 1.98%. However, this may not be substantive enough to infer a trend given the implications of the new accounting framework, IFRS 9 that took effect on 01st January 2018. The framework is expected to complicate the current dynamics in private sector credit given the strict provisioning guidelines.



Source: Central Bank of Kenya (CBK), CBA Research

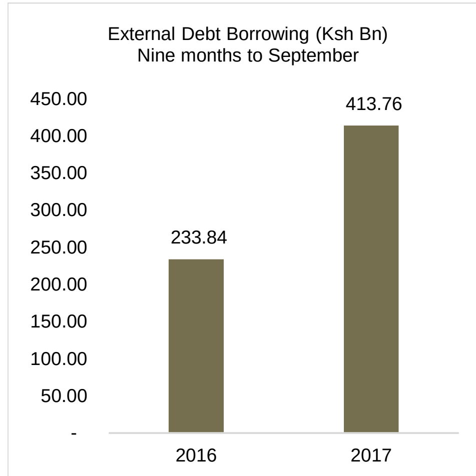
While private sector activity remained largely subdued in the year, government spending fell short of supporting the overall economy. Expenditure growth outpaced revenue collection as economic activity plummeted. The government then revised its domestic debt target by 48.78% to KES 410.20Bn and external debt target by 8.32% to KES 277.30Bn according to the latest Budget Review and Outlook Paper (BROP'17) for the fiscal year 2017/2018.

Nevertheless in the full year 2017, the government borrowed KES 290.01Bn, in new debt, from the domestic market, translating to a 25.69% decline compared to a similar period in 2016. The low debt absorption was attributed to the government's inability to entice investors with attractive yields given the 14.00% interest rate cap.



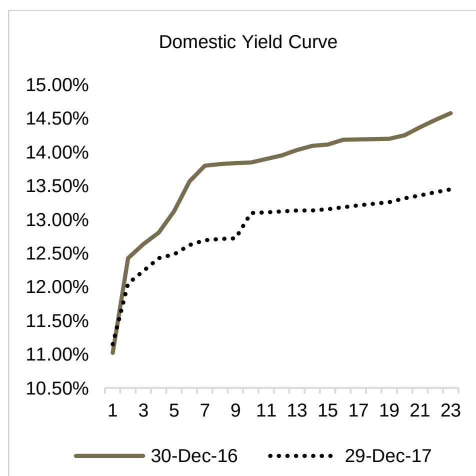
Source: Central Bank of Kenya (CBK), CBA Research

That said, the noted shift to external borrowing seemed somewhat justified given the unfinanced expenditure needs. The government borrowed KES 413.76Bn in the nine months to September 2017, a 76.94% increase compared to a similar period in 2016. However, the external borrowing came at a time of a deteriorating country risk profile given the shifting political landscape and policy tightening in some developed economies – warranting a premium on the debt.



Source: Central Bank of Kenya (CBK), CBA Research

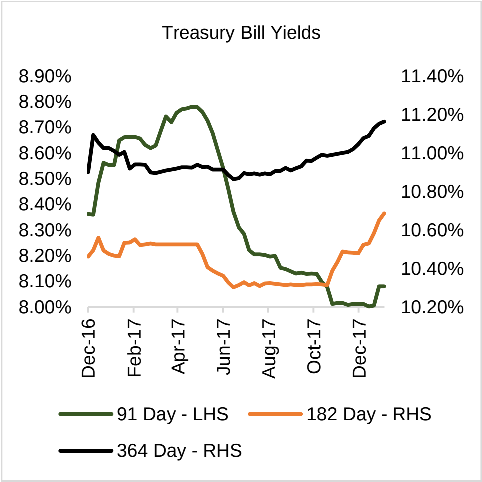
Meanwhile, the domestic yield curve shifted lower by an average of 0.80% in the last one year on account of the interest rate cap and Central bank rejection of aggressive bids in Treasury auctions. Additionally, the liquidity predicate in the interbank market, due to subdued private sector credit activities, resulted in more conservative bidding behavior by commercial banks.



Source: Kenya National Bureau of Statistics (KNBS), CBA Research

Relatedly, the overnight rate was generally higher in the year compared to 2016 owing to skewed liquidity conditions towards the election period. The political uncertainty resulted in a shift of funds to commercial banks that were considered safe in the event of a 'crisis'. Nevertheless, given the skewed liquidity conditions, higher lending rates attracted commercial bank funds to the overnight market - away from government debt auctions. This as well contributed to low Treasury subscription towards the end of the year.

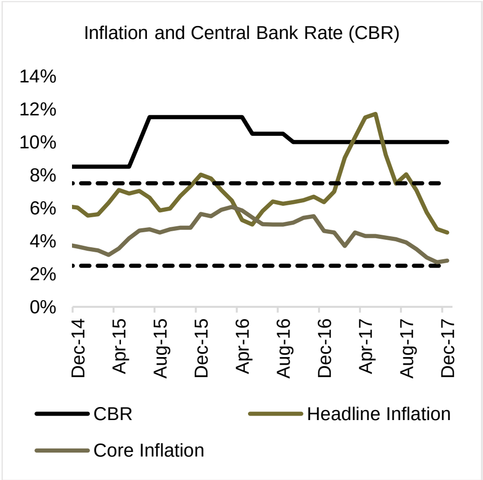
Treasury yields registered mixed performance with yields on the six and twelve month papers recovering to highs of 10.649% (Up 17.40bps) and 11.151% (Up 12.70bps) respectively while the yield on the three month paper touched a low of 8.08% (Down 47.30bps). While the decline in the three month yield could be attributed to conservative bidding behavior, it could be assumed that the overall oversubscription in the auction could be a factor of investor caution in light of the political fluidity. Investors also demanded a premium on the longer dated papers for the same reason.



Source: Central Bank of Kenya (CBK), CBA Research

Meanwhile, the Treasury bond auction was generally undersubscribed with yields on the issued bonds with 1.40 – 12.00 years to maturity ranging between 11.33% - 13.56%. The tight yields could have resulted in the Central bank's decision to issue short to medium term bonds in the year – perhaps in an effort to increase its domestic debt absorption. The issue of shorter dated bonds, however, sparked criticisms from stakeholders given the concentrated debt maturity structure that could impact the government's future fiscal strength.

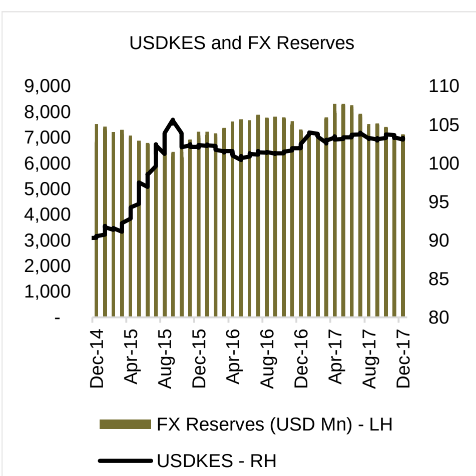
Domestic prices rose faster in 2017, with the average inflation rate at 8.02% compared to 6.32% a year earlier. The acceleration was largely as a result of elevated food prices in the first half of the year that resulted in a peak inflation rate of 11.70% in May 2017. Given subdued private sector spending, core inflation averaged 3.88% compared to 5.36% a year earlier. That said, headline inflation has since decelerated to lows of 4.50% as at December 2017 owing to subdued food inflation as a result of improving weather and the temporary government food subsidy that ended in December.



Source: Kenya National Bureau of Statistics (KNBS), CBA Research

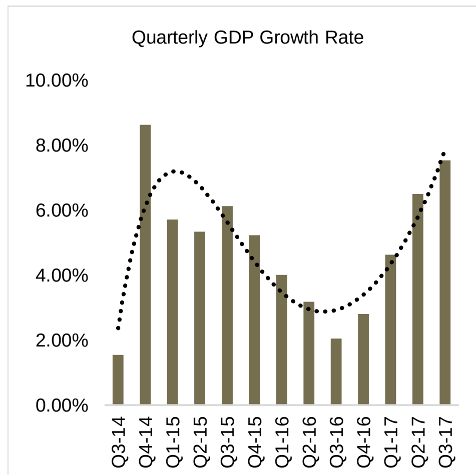
Despite volatile domestic prices, monetary policy remained unchanged during the year. Intuitively, the interest rate cap has limited the Central bank's ability to effectively shift its policy stance as it could aggravate the current fragile private sector credit dynamics. While calls for a review of the interest rate controls framework have heightened, it cannot be ignored that borrowing rates have been too high for too long and the interest rate cap has brought some sanity into the system.

The shilling traded in the 103.00-104.00 range against the US dollar for the better part of the year largely supported by the Central bank. The Central bank buoyed local currency volatility given shifting investor sentiments in light of the fluid political landscape. In its capacity, the Central bank acted directly in the FX market and also through its open market operations in an effort to manage shilling liquidity. Nevertheless, the last few months of the year were characterized by mute dollar demand as business operations slowed during the extended electoral cycle. The shilling ended the year on a strong footing against the US dollar.



Source: Central Bank of Kenya (CBK), CBA Research

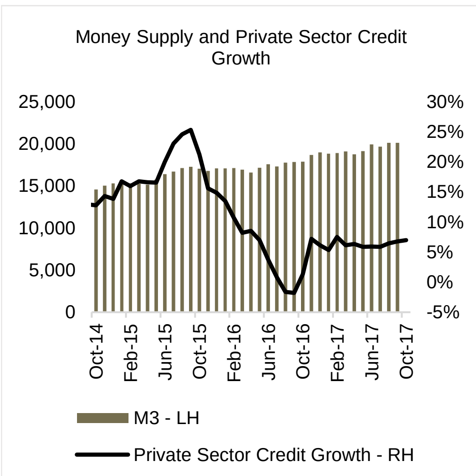
Despite starting the year on rocky ground, economic activity rebounded on an improving agricultural environment. Latest estimates place growth at 7.50% in the third quarter of 2017 compared to 2.10% in a comparable period a year earlier. The economy is expected to expand in the 6.70% - 7.00% range in 2017. Economic growth will remain supported by improved activity in the agricultural sector and enhanced government spending on development and infrastructure projects.



Source: Bank of Uganda, CBA Research

Private sector activity remained largely subdued in the year given limitations in access to credit from commercial banks. Private sector credit sustained its 2016 single digit growth to 6.95% as at October 2017. The slowdown in private sector credit growth has been attributed to a deteriorating borrower risk profile that led commercial banks to remain adverse to lending activities.

In support of the private sector, the Bank of Uganda (BoU) continued on its monetary policy easing path reducing the policy rate by 750.00bps since April 2016 to its current level of 9.50%. Relatedly, the government's debt absorption discipline has helped steer excess liquidity to private sector credit activities. Going forward, the recovery in the agricultural sector is expected to continue improving confidence and consumer demand thus having a positive impact on private sector spending.

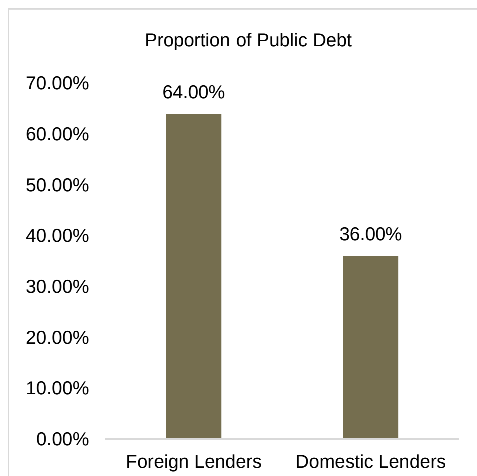


Source: Bank of Uganda, Bloomberg, CBA Research

Given the usual concerns over rising social unrest owing to the unequal gains from economic prosperity, the introduction of the bill to remove the 75-year old age limit for presidential candidates led to fresh protests and uproar from various stakeholders. However, the bill received enough support in parliament and was successfully passed – thereafter igniting internal infighting among the ruling National Resistance Movement (NRM) party even from the lawmakers who backed the bill. With the bill now signed into law, the underlying political fluidity could bring about challenges in policy formulation going forward.

Despite ongoing budget implementation challenges due to problems in administration, the government has remained committed to reeling in its expenditure and debt in an effort to narrow its budget deficit. However, the heavy capital expenditure on key development and infrastructure projects targeting the transport and energy sectors could deter the government from achieving its fiscal consolidation objective.

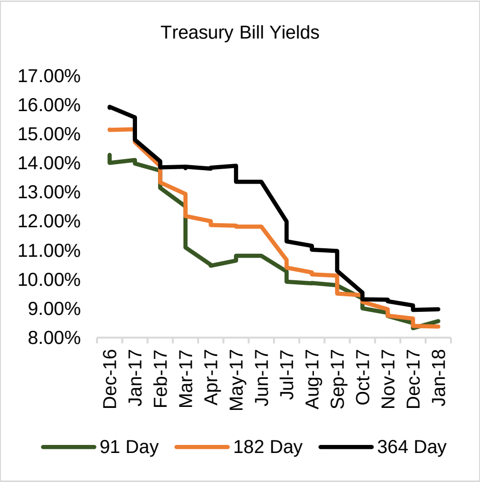
In the year, government budgetary needs outpaced revenue collection causing the government to turn to debt financing. However, the government's disciplined debt absorption in the domestic market could induce increased appetite for external debt to meet the shortfall. Currently, about 64.00% of the country's public debt is held by foreign institutions.



Source: CBA Research

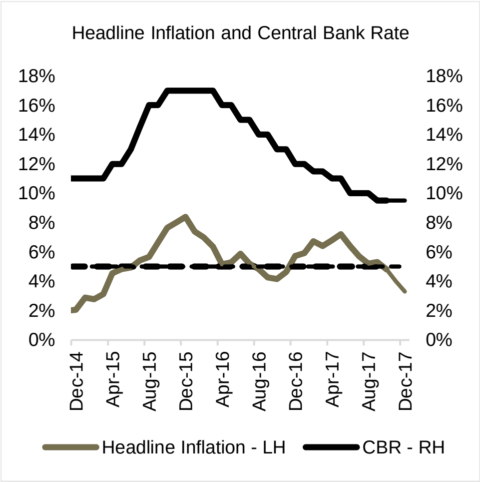
Conversely, external government borrowing has been at concessional rates and this is expected to keep debt servicing costs low. This suggests that the rising public debt stock may not pose a significant risk to the country's economic outlook. Going forward, the country's improving economic landscape could support increased revenue collection complimented by the implementation of measures to increase revenue mobilization.

Domestic interest rates continue to reflect the downward trend in the policy rate and the ample liquidity conditions in the market. Yields on the three, six and twelve month papers ended the year at 8.569% (Down 567.50bps), 8.386% (Down 673.30bps) and 8.979% (697.70bps) respectively. The downward trend in the Treasury bill yields has as well been attributed to conservative bidding behavior in the oversubscribed debt auctions and the government's domestic debt absorption discipline. Treasury bond yields followed a similar downward trend.



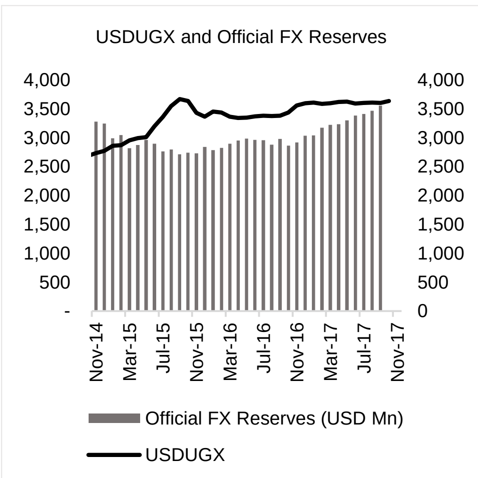
Source: Bank of Uganda, CBA Research

Headline inflation averaged 5.65% in the year 2017 compared to 5.48% in the previous year. Inflation registered a high of 7.20% in May 2017 and a low of 3.30% in December 2017. Domestic prices were driven by the lagged effects of the drought that hampered crop production. Nevertheless, improving weather conditions have resulted in cooling food prices that have anchored the downward trend in inflation. Meanwhile, demand side pressures have remained subdued due to lackluster private sector spending. With an expected pick up in private expenditure, the boost to consumer spending could generate demand side inflationary pressure in the near term.



Source: Bank of Uganda, Bloomberg, CBA Research

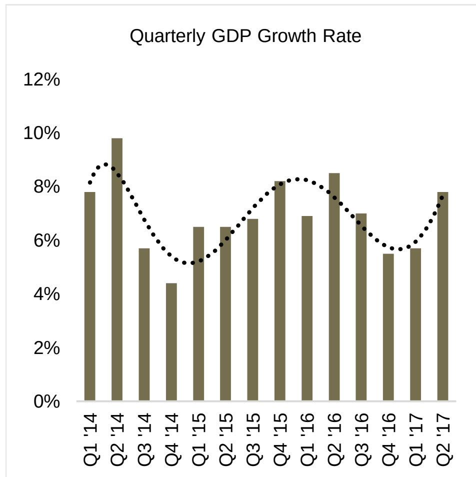
The Uganda shilling weakened in the year perhaps reflective of lower real interest rates and the uncertain political landscape. The shilling traded in the 3600-3660 range against the US dollar. The currency could find some reprieve as it is expected that the monetary policy easing cycle is now over given that inflation is well anchored below its 5.00% medium term target. However, a pick-up in dollar demand from importers could place pressure on the shilling's trading value as economic activity improves.



Source: Bank of Uganda, Bloomberg, CBA Research

Tanzania

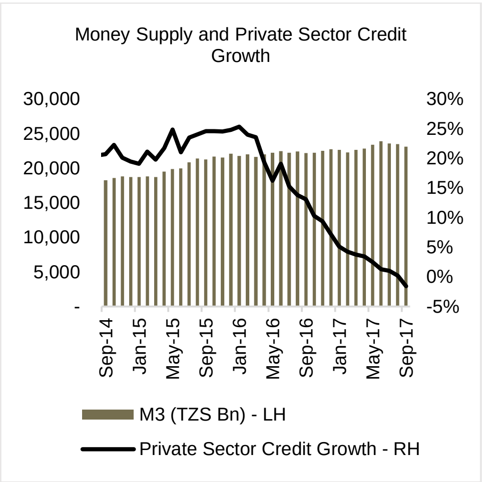
Economic activity in 2017 remained resilient registering one of the highest growth rates in the East African region. According to latest statistics, the economy expanded by 7.80% in the second quarter of 2017 compared to 8.50% in a similar period a year earlier. Economic activity is expected to continue expanding owing to improved crop production, continued infrastructure development expenditure and general consumer demand despite a dreary 2017.



Source: National Bureau of Statistics, CBA Research

In an effort to support economic growth and spur credit to the private sector, the Central bank reduced its discount rate from 16.00% to 12.00% during the year. This bumped up liquidity in the market and resulted in lower borrowing costs to the general public. However, the faltering business environment, induced by increased policy and regulatory risks, dampened investor sentiment in the private sector. Additionally, subdued credit extension to the private sector aggravated the situation.

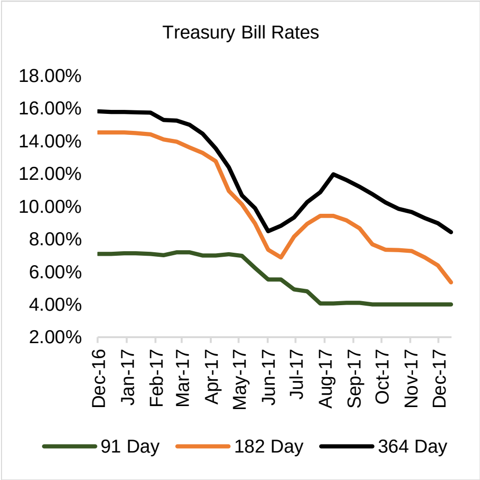
According to latest figures, private sector credit growth contracted by 1.60% in the nine months to September 2017 as business activity slowed amid policy fluidity.



Source: Bank of Tanzania, CBA Research

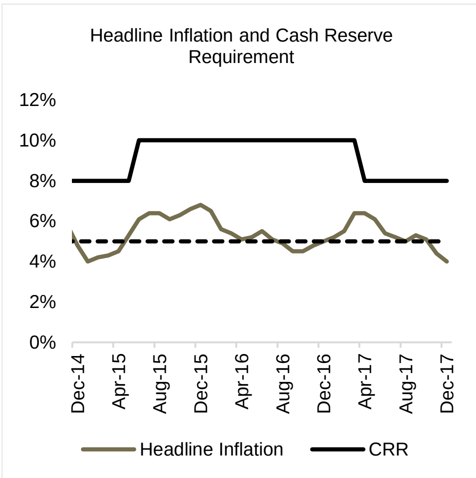
Meanwhile, the government is focused on implementing its National Five Year Development Plan (NFYDP) targeting the construction and transport sectors. Implementation of infrastructure and development projects is expected to remain supportive of the economic growth agenda though barriers to funding remain. Intuitively, given increased capital spending and low revenue collection, the government's budget deficit is expected to widen. The fiscal body has however managed to secure a few concessional loans to finance its deficit though shifting policy dynamics could warrant a premium on Tanzanian debt and thus shift the government's focus to the domestic debt market.

Domestic interest rates were expected to rise in tandem with the government's increased debt appetite but the ample liquidity in the market resulted in a significant decline in Treasury bill yields. At the end of the year, Treasury bill yields stood at 4.00% (Down 309.00bps), 5.35% (Down 919.00bps) and 8.43% (Down 736.00bps) for the three, six and twelve month papers respectively. Treasury bond yields fell on account of the oversubscription in the auctions but it could be noted that some investors began demanding a premium on the bonds causing the government to absorb slightly less than the amount on offer.



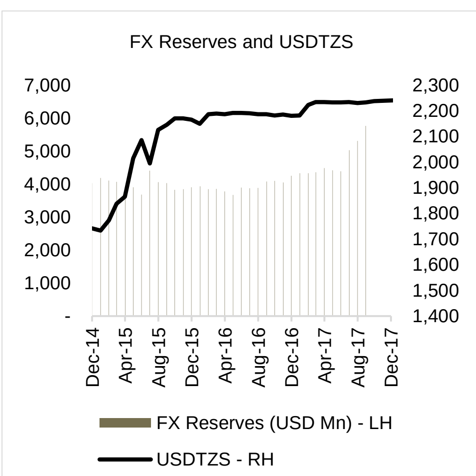
Source: Bank of Tanzania, CBA Research

Meanwhile, headline inflation ticked up to 5.33% in 2017 compared to 5.18% in the previous year owing to sustained pressure on food prices in the first half of the year. However, improving weather conditions contributed to a deceleration in inflation to a 36-month low of 4.00% in December 2017.



Source: Bank of Tanzania, CBA Research

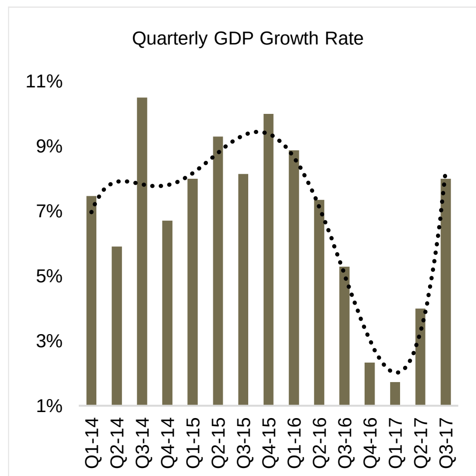
The local currency traded within a tight range of 2190-2250 against the US dollar. Generally higher inflation has diminished the country's export market competitiveness while shifting policy reforms have weighed on investor sentiment placing mild pressure on the shilling. However, the Central bank continued to be at hand to intervene in the FX market so as to limit extreme volatility of the local currency.



Source: Bank of Tanzania, CBA Research

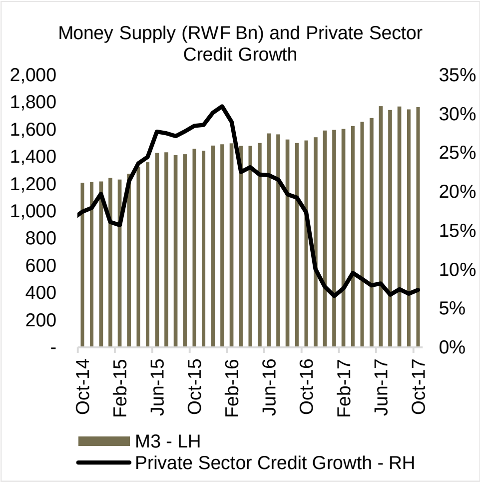
Rwanda

Economic growth slowly rebounded in the year to an impressive 8.00% in the third quarter of 2017 according to latest statistics. The economic recovery has been underpinned by improved agricultural production that facilitated a rise in agriculture and horticulture exports reinforced by improved global prices. The economy is expected to expand in the range of 6.00% - 8.50% in the full year bolstered by improved public and private spending and investments.

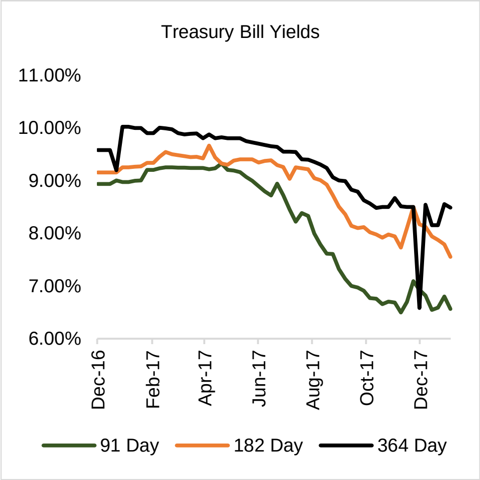


Source: National Bank of Rwanda, CBA Research

Meanwhile, private sector credit remained largely subdued in the year contributing to mute consumer spending in the economy. To support the private sector, the Central bank cut its key repo rate in June 2017 and December 2017 by a total 75.00bps to 5.50%. Though the impact of the policy easing has been slow, it is expected that the Central bank's monetary policy stance could remain unchanged given the strengthening economic landscape amidst mute inflationary pressures.



Source: National Bank of Rwanda, CBA Research

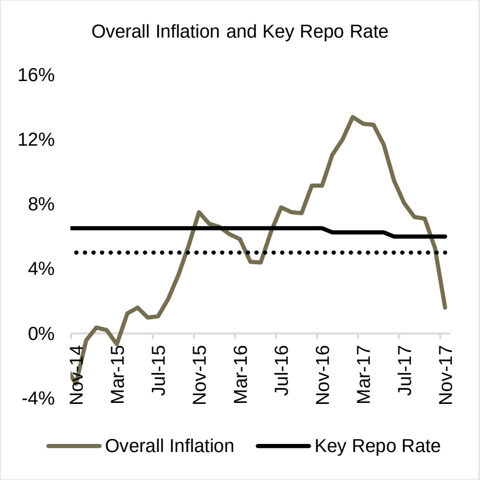


Source: National Bank of Rwanda, CBA Research

In line with fiscal consolidation measures, the government has continued to temper its recurrent expenditure while also reducing its reliance on external financing. Stronger economic growth and improved revenue collection are expected to help narrow the budget deficit and compliment the implementation of modest fiscal consolidation over time. Meanwhile, the overwhelming victory of President Kagame in the 2017 elections was in line with market expectations. The continuity of government offers policy certainty that bodes well with investor sentiments and economic prosperity.

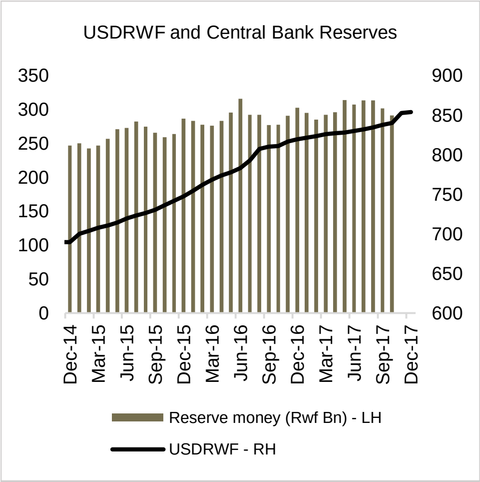
Meanwhile, Treasury yields exhibited a downward trend in the year with the three, six and twelve month papers dropping 217.10bps, 145.90bps and 146.80bps to 6.80%, 7.79% and 8.55% respectively. The decline was reflective of the monetary policy easing cycle and the ample liquidity conditions in the market given subdued credit extension activities to the private sector.

Headline inflation decelerated in the year owing to the waning effects of the drought on the agricultural sector. This caused food prices to cool, knocking inflation to 1.60% in November 2017 from a high of 13.40% in the same year. Core inflation remained largely mute owing to subdued private sector credit growth. Inflation is expected to remain below the Central bank's medium term target of 5.00% in the near term primarily on account of reduced food supply constraints.



Source: National Bank of Rwanda, CBA Research

The Franc depreciated 2.19% in the year to end the year at 840.00 against the US dollar. This was attributable to the Central bank's willingness to match both demand and supply orders. The Franc has also benefited from improved export receipts amid improved economic activity.



Source: National Bank of Rwanda, CBA Research

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