Financial News

cba
time for more.

June 08th, 2018

Highlights

- ✓ ***Kenya****: Good public financial management requires that the level of public debt be consistent with a framework that ensures macro-economic stability. The recent surge in government debt to over 60% of GDP, has raised concerns over the country's fiscal sustainability and broader medium term macroeconomic stability, making restoration of fiscal balance a policy priority for the government. This is expected to underlie the 2018/19 budget statement even as spending priorities shift towards the government's Big Four Agenda.*

- ✓ *Monetary and fiscal policies seem somewhat aligned towards a common goal of economic expansion at the moment. The monetary authority has demonstrated a clear bias towards accommodation whereas the fiscal policy is also expected to remain stimulative, debt concerns notwithstanding. We believe that the Monetary Policy Committee has scope to cut interest rates by a further 50bps this year. Meanwhile, we expect expenditure to top KES 2.5 trillion in the next fiscal year as government fires on all cylinders with regards to the Big Four initiative.*

- ✓ ***Tanzania****: The economy continues to reel from effects of subdued lending and an uncertain regulatory environment. Credit growth has stunted as banks, concerned about the deteriorating quality of assets in the fluid regulatory landscape, reduce lending to the productive sector. Despite the transmission challenges, we believe that the Bank of Tanzania will continue to pursue an easing stance in a bid to support growth. This will be complemented by low debt uptake in the domestic market.*

- ✓ ***Uganda****: Following two years of lethargy, economic growth is expected to pick up supported primarily by rebound in agriculture and service sectors. The recovery will also be supported by improvement in public investments after World Bank restored project financing to Uganda. That said, the continuous lethargy in the private sector, due to subdued private sector could keep growth below potential.*

- ✓ ***Rwanda****: Economic prudence and discipline has been at the core of Rwanda's relative economic success. Growth will be buttressed by the private sector and government infrastructure spending. Additionally, monetary policy could ease further supported by low inflation and the need to boost credit growth tow levels consistent with the country's growth potential.*

Efforts to cut deficit welcome but sustainability will be fundamental

Good public financial management requires that the level of public debt be consistent with a framework that ensures macro-economic stability. The recent surge in government debt to over 60% of GDP, has raised concerns over the country's fiscal sustainability and broader medium term macroeconomic stability, making restoration of fiscal balance a policy priority for the government. This is expected to underlie the budget statement even as spending priorities shift towards the government's Big Four Agenda.

Last month, the CBK governor, Dr. Patrick Njoroge, warned that the headroom for further borrowing had declined remarkably and that the country could not continue on the recent borrowing path. The rebalancing of the fiscal position will involve a combination of solutions including spending reductions, revenue increases as well as leveraging on public private partnerships (PPPs) for capital. Even so, the little success of PPP in Kenya thus far underscores the need to create a conducive framework to encourage their crucial participation in the country's development journey.

That said, recent fiscal pronouncements including proposals in the draft Income Tax Bill 2018 suggests some deliberate focus on this crucial policy priority. However, questions have emerged over the sustainability of some of the measures in bringing down the deficit.

Recent estimates from Treasury reveal that the government will maintain an easy fiscal policy bias with expenditure estimates projected to top KES 2.50 Trillion in the 2018/19 financial year. This will be funded through aggressive revenue collection, estimated at KES 1.9 Trillion, the bulk of which will be generated through taxation. To be sure, Treasury last month through the draft Income Tax Bill, 2018 proposed a raft of measures aimed at bolstering tax revenues.

Most notable is the increase in the rate for top cadre earners to 35.0% from the current 30.0%. The incremental charges targets corporates earning over KES 500Mn in annual taxes and individual earnings above KES 9.0Mn annually. Moreover, the government has proposed a reduction in tax incentives including tax holidays for investors in special economic zones. Developers, operators and enterprises may also be subjected to a 5.0% withholding tax on dividends, which were previously tax exempt. The government has also proposed to increase capital gains tax from 5.0% to 20.0% upon disposal of property and a 10% withholding tax on repatriated profits on branches of foreign companies.

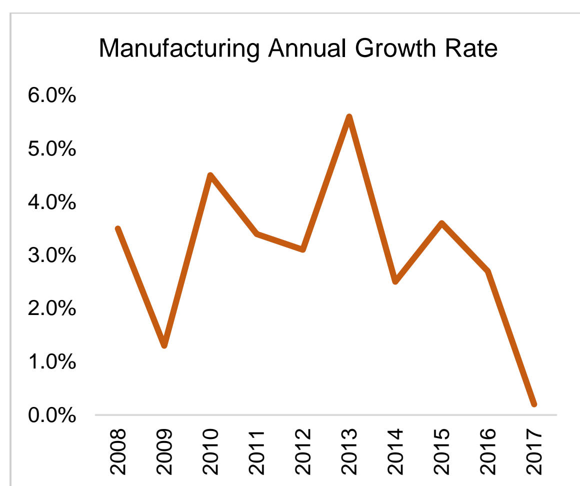
While the effort to cut the deficit by increasing revenue is welcome, the fact that parts of the proposal could weaken the competitiveness of Kenya's tax regime brings to question the feasibility of some of these measures in the longer run. The efficacy of tax incentives, in isolation, in attracting foreign direct investments (FDIs) is debatable. That said, its increased use in recent years speaks to the growing competition for this capital among nations and therefore the need for a competitive tax regime.

However, empirical evidence, on balance, suggest that higher corporate taxes may be damaging for an economy in the longer run. In the short run, the move could boost income tax revenues which accounts for about 45% of total government revenues. To be sure, based on 2017 earnings, the proposed corporate increase in corporation tax could raise at least an additional KES 14.0Bn in revenue from companies listed at the NSE.

Needless to say, a competitive business environment is fundamental for sustainable productivity and crucial for economic and income growth. Lowering corporation taxes could bolster government revenues by enabling more retained earnings to be used for investments. This supports economic

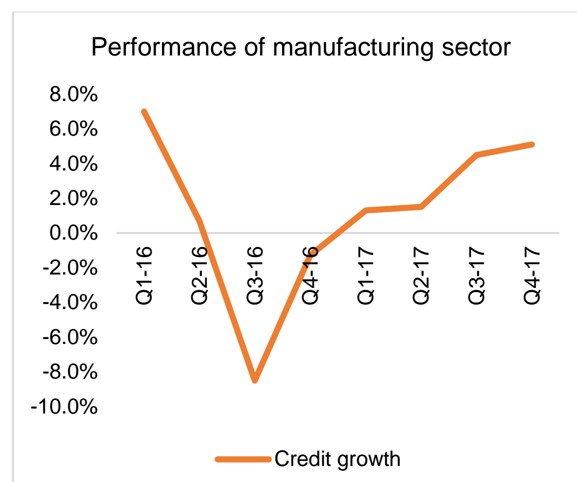
development, job, income growth and overall consumption in the economy. This is good for tax growth. The question however is how much of the incremental retained profit will re-invested!

The concern for Kenya is that the increase in taxes could worsen the already precarious situation. The performance of the manufacturing sector for instance has been declining over the last five years due to uncompetitiveness of the sector.



The poor performance of the manufacturing sector has partly been attributed to an unfavorable tax regime that made it easier to import cheaper goods into the market. In fact, it is estimated that goods manufactured in Kenya are about 12% costlier than the global average.

An increase in tax will reduce retained earnings for companies at a time when access to credit has been somewhat stifled by the interest rate controls and high nonperforming loans. While there seems to be a pick-up in recent months, the 5.0% growth in credit to the manufacturing sector is inflated by a weak base and remains significantly below the historical average. On brighter note, this could reflect a pickup in investment in the sector after contracting in the last quarter of 2017.



While sentiments have improved, lending is expected to remain subdued in the near term as banks remain risk averse. That said, the proposed sector approach to cost of credit controls could provide some flexibility for banks to price risk, bolstering appetite to lend. This will be another key highlight in the budget statement.

The reality of international economics is that countries compete with each other for investments and any advantage is critical. Raising taxes could make the businesses environment more uncompetitive, reducing investments. This has negative implications for job growth and overall economic performance, crucial for growth in tax revenues.

Kenya

- Monetary and fiscal policies seem somewhat aligned towards a common goal of economic expansion. The monetary authority has demonstrated a clear bias towards accommodation and could cut interest rates by a further 50bps this year. This will be supported by within target inflation, stable currency, and fairly balanced risks from the external environments. On the fiscal side, we expect expenditure to exceed KES 2.0 trillion in the next fiscal year as government fires on all cylinders with regards to the Big Four Agenda. Budget absorption in the current fiscal year has been fairly low, partly due to the ongoing realignment of the state's priorities towards this crucial initiative.

- That said, the efficacy of monetary easing has been somewhat minimal in generating growth partly due to the fiscal policy adopted by the government. This could still be a challenge in 2018 as government is projected to maintain its recent pace of debt uptake from the local market. Estimates for the fiscal year 2018/19 reveal that, while the government may cut the nominal deficit to just about KES 500Bn, the bulk of the funding (KES 276Bn) will be from the local market. This risks crowding out the private sector at a time when lending is expected to start picking up, subject to the proposed sector/segment approach to capping. The government through the Financial Markets Conduct Bill has proposed that the maximum lending rate be commensurate to the nature and extent of the risk the requirements are intended to address. The importance of coordination of the two policies cannot therefore be gainsaid.

- Relatedly, concerns have recently emerged following the publishing of the Financial Conduct Bill 2018 which if passed in its current state could considerably interfere with the objectives of the Central Bank. The Bill seeks to establish the Financial Markets Conduct Authority which will supervise the conduct of financial service providers in a bid to ensure a fair, accessible and efficient financial sector. The committee will regulate the cost of credit which has direct implications for the conduct of monetary policy. Ideally, central banks world over ensure price stability by adjusting the cost of credit. That said, we expect that the proposal to be improved to ensure coordination of the two bodies while guaranteeing the independence of the Central Bank.

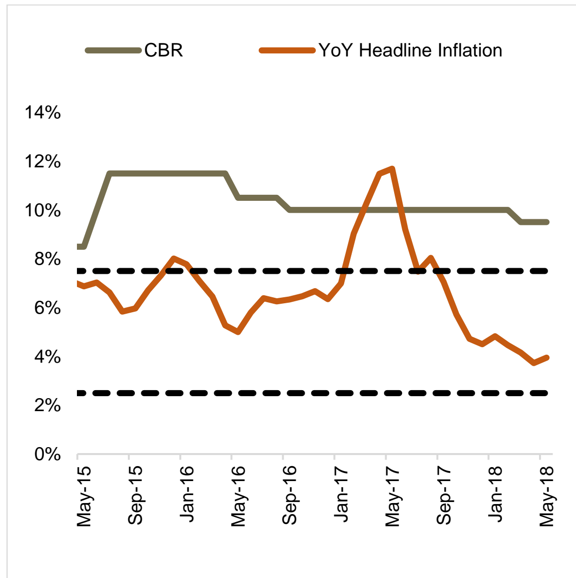
- Meanwhile in the markets, yields maintained a slight downward bias across the curve supported by heavy liquidity. T-bill rates eased to 7.938% (Down 6.20bps), 10.196% (Down 7.20bps) and 11.083% (Down 6.00bps) for the 91, 182 and 364 day papers respectively. During the month, Treasury accepted KES 152.55Bn against a target of KES 120.00Bn, having received KES 205.42Bn in bids. Thus far, Treasury has raised KES 287Bn in new debt, slightly more than its target. Reduced appetite for new borrowing going forward coupled with heavy liquidity should see interest rates drop further this month. The curve could steepen further with expected faster drop on the short end amid persistent stickiness on the longer end of the curve. While inflation which rose by 22bbps to 3.95% in May is expected to accelerate, this will not alter course for interest rates in the near term as liquidity remains the domineering factor amid thin investment options.

- The local currency may still outperform our forecast for June given the increased inflows amid fairly subdued demand. The current account position has improved on the back of improved exports and slower import growth. Pressure from the selloff in the local stock market by foreign investors has was sufficiently neutralized through central bank intervention. CBK reserves are currently at USD8.96Bn, translating to 6.05 months import cover, and should provide an adequate buffer against external shocks. The shilling weakened to 101.35/45 to the dollar in May.

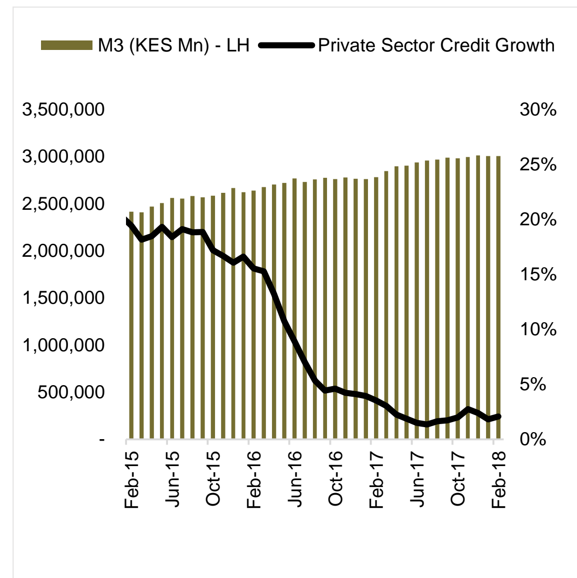
Forecasts

Quarter ending	March 2018	June 2018	Sept 2018	Dec 2018
GDP	5.34%	6.01%	5.56%	5.16%
Inflation	4.18%	5.18%	6.07%	7.07%
USDKES	101.08	102.80	103.61	103.90
CBR	9.50%	9.50%	9.00%	9.00%

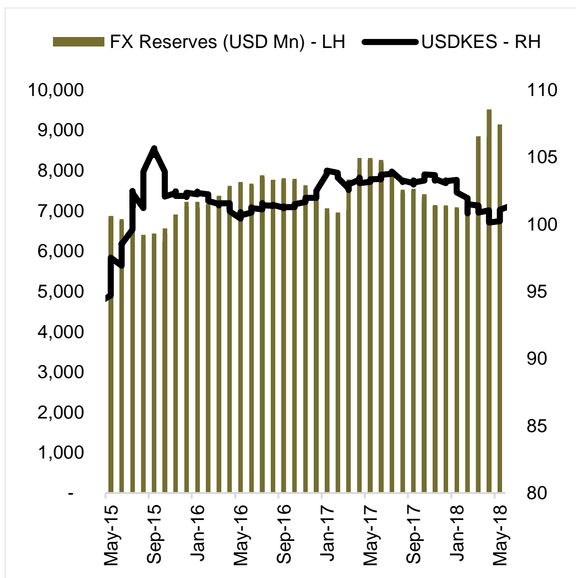
Source: CBA Research, Bloomberg



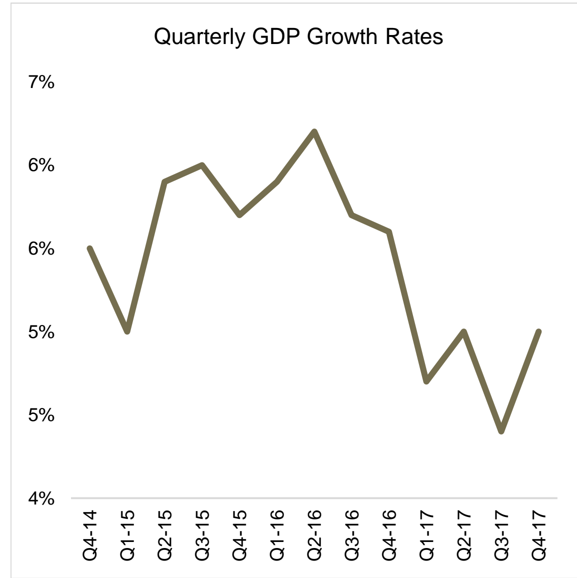
Source: Central Bank of Kenya, CBA Research



Source: Central Bank of Kenya, CBA Research



Source: Central Bank of Kenya, Bloomberg, CBA Research



Source: Central Bank of Kenya, CBA Research

Tanzania

- The economy continues to reel from the effects of subdued lending and an uncertain regulatory environment. Credit growth has stunted as banks, concerned about deteriorating quality of assets in the fluid regulatory landscape, reduce lending to the sector. Credit extension to the productive sector expanded by 1.1% in March 2018, a further deceleration from the January growth of 2.1%. Growth in private sector investments have shrunk considerably following the radical policy shifts. That said, we believe that the Bank of Tanzania will continue to offer support to the economy by pursuing an easing stance despite emerging questions on banks' willingness to lend given the uncertainty in the business landscape.

- Heavy liquidity following recent easing measures by the Bank of Tanzania (BoT) has seen lending rates drop by about 124bps in the three months to March 2018. This has been complemented by lower borrowing by the government which in the first nine months of the 2017/18 financial year only absorbed TZS 368Bn in local debt against a target of TZS 3,077Bn. Although revenues have underperformed expectations with a 90% performance rate to TZS 13,536Bn, the existence of Treasury Single Account has helped in public finance management, which provides oversight of spending activities and allows for reallocation of funds across state department given the low budget absorption of 68% (TZS 14,023Bn) which is 97% covered by revenues. Even so, this has failed to tee up credit as banks remain risk averse.

- The economy is nonetheless expected to outperform its peers to grow by 6.7% in 2018. The growth will be underpinned by intensive infrastructure spending especially in the transport and energy sectors. In May, the government secured USD1.50Bn in funding from the African Development Bank (AfDB) for power and airport projects and USD500Mn from the Indian government for water projects. Meanwhile, the government could this year make its debut in the Eurobond market although this remains subject to developments in the global interest rate space. Despite the policy fluidity we believe the search for yield could still support sovereign exposure on Tanzania.

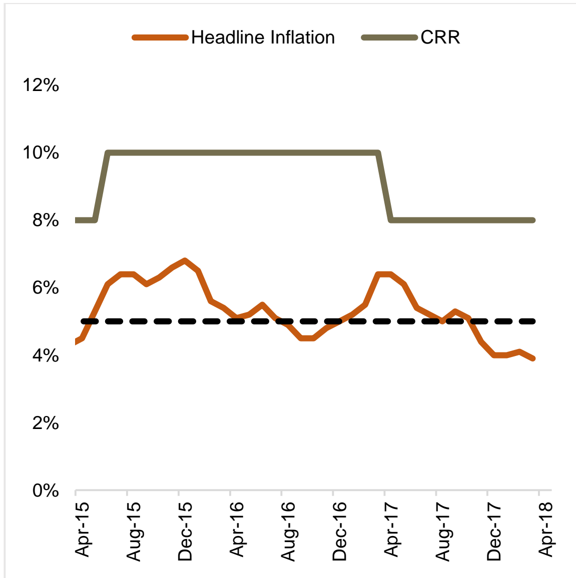
- Meanwhile, yields continued to ease across the spectrum. Benchmark T-bill yields were recorded at 1.89% (Down 7.00bps), 2.73% (Down 23bps) and 5.48% (Up 110bps) for the 91, 182 and 364 day papers respectively during the month. This somewhat highlights the high risk perception in the market given lending rate remain high above 17.0%. It's worth noting that the policy shifts have considerably affected bank performance. High NPLs have eaten into some banks capital, causing significant segmentation in the market. The high cost of funding for these banks could somewhat explain the heavy premium between lending rates and risk free rates.

- The Tanzania shilling steadied in the 2275 – 2288 range against the US dollar in May supported by inflows from the agriculture sector amid subdued demand. Moreover, the Central Bank remains an active player on both the demand and supply counters. The shilling is expected to maintain its gradual depreciation towards 2300 levels as crucial hard currency flows from mining sector remains subdued. Lower interest rates could also trigger capital flight

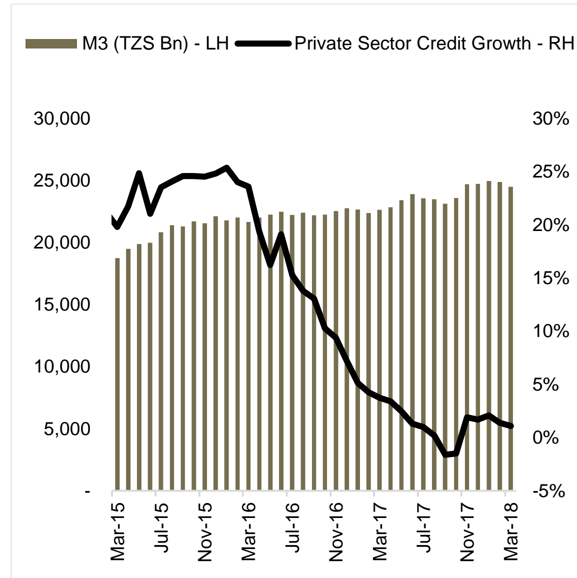
Forecasts

Quarter ending	March 2018	June 2018	Sept 2018	Dec 2018
GDP	6.60%	6.70%	6.67%	6.76%
Inflation	3.90%	3.77%	4.52%	4.73%
USDTZS	2260.00	2271.55	2279.30	2288.25
CRR	5.25%	5.25%	5.25%	5.25%

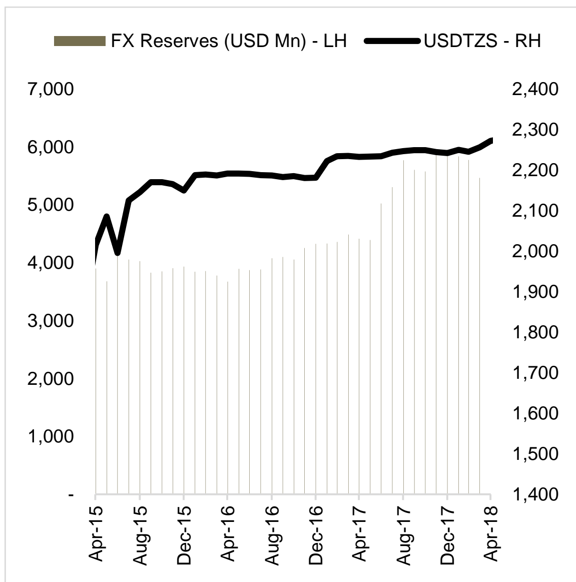
Source: CBA Research, Bloomberg



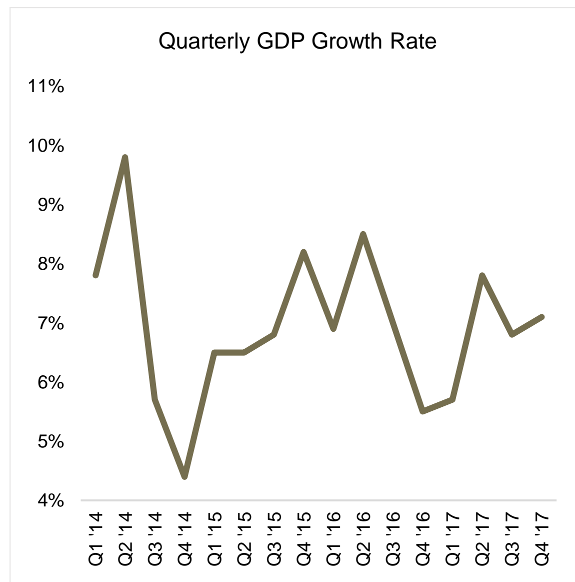
Source: Bank of Tanzania, CBA Research



Source: Bank of Tanzania, CBA Research



Source: Bank of Tanzania, CBA Research



Source: National Bureau of Statistics, CBA Research

Uganda

- Following two years of economic lethargy, economic growth is expected to pick up supported primarily by the agriculture and services sectors. Even so, the continuous drop in the Business Tendency Index suggests that private sector recovery may remain somewhat subdued. The index fell for the seventh straight month to 55.7 in May from 56.1 in April reflecting the persistence of some structural issues in the economy including that of the lethargy in credit.

- Credit growth has remained sluggish despite the aggressive monetary easing cycle by the Bank of Uganda (BoU) which has flooded markets with liquidity. Further rate reductions going forward will be limited by renewed pressure on the currency, which could be exacerbated by low interest rates. Headline inflation slowed to 1.7% in May from 1.8% in June on lower food prices. Meanwhile, demand pressures thus far remain subdued with core inflation slowing to 1.10% in May. Inflation is projected to rise going forward but will remain below 5.0% in the next three months.

- The spotlight now shifts to the budget statement due to be read on 14th June. According to the Budget Policy Framework for 2018/19 published in April, GDP is expected to accelerate to 5.5% from 5.0% in 2017/18. This will be partially driven by improvement in public investments, increase in private sector investment as well as the rebound in the agriculture sector. Government expenditure is projected to increase marginally to UGX 22,520Bn from UGX 22,351Bn while revenues are expected to grow to UGX16,809Bn from an estimated UGX 15,979Bn in the 2017/18 financial year. This will see deficit reduce to 5.4% from 6.2% in 2017/18.

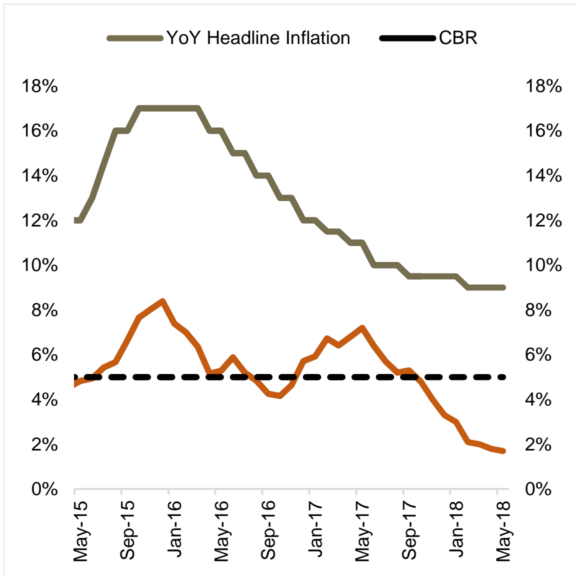
- While the bulk of the funds are to be sourced externally, we reckon that the tightening dollar debt market could undermine this effort compelling government to revert to local markets for deficit financing. Treasury only envisions borrowing UGX 940Bn from the domestic market. The fall back to the local market has seen yields on local debt rise considerably in recent days. Yields rose to 8.796% (Up 8.00bps), 9.490% (Up 18.40bps) and 10.283% (Up 51.00bps) on the 91, 182 and 364 day papers respectively. Relatedly, the government, towards the end of May, increased its T-bill auction size from UGX 175Bn to UGX 205Bn.

- The local currency depreciated at a faster than anticipated pace losing 65 shillings against the US dollar in May. Demand for dollars picked up in the period driven by higher activity from the private sector as well as foreign exchange reserve build up by the Bank of Uganda. Foreign exchange reserves stood at USD 3.39Bn in April (4.9 months of import cover). Given the anticipated pressure on trade balance and government's external debt servicing, the BoU has been building it buffers to provide a cushion against any such shocks. Trade deficit widened to USD 215.8Mn in April from USD 100.8Mn at the beginning of the year. The shilling could depreciate beyond 3800 by end of the year. Given the level of reserves, the Central Bank intervention will, at best, moderate the depreciation.

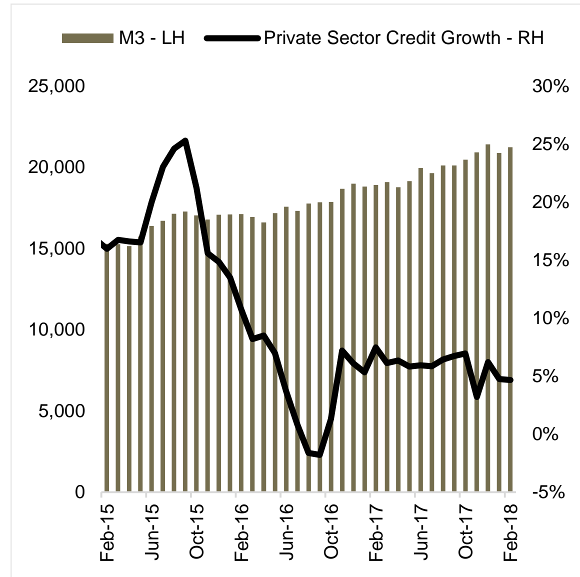
Forecasts

Quarter ending	March 2018	June 2018	Sept 2018	Dec 2018
GDP	7.50%	7.00%	6.00%	5.00%
Inflation	2.00%	2.58%	5.50%	6.00%
USDUGX	3660.10	3719.60	3775.40	3785.16
CBR	9.00%	9.00%	9.00%	9.00%

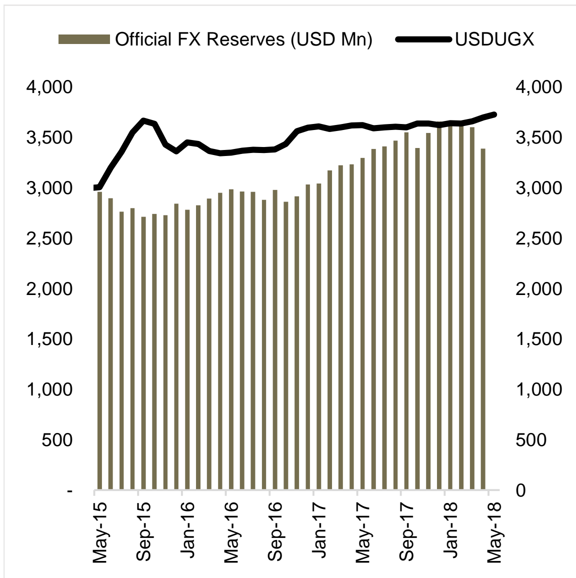
Source: CBA Research, Bloomberg



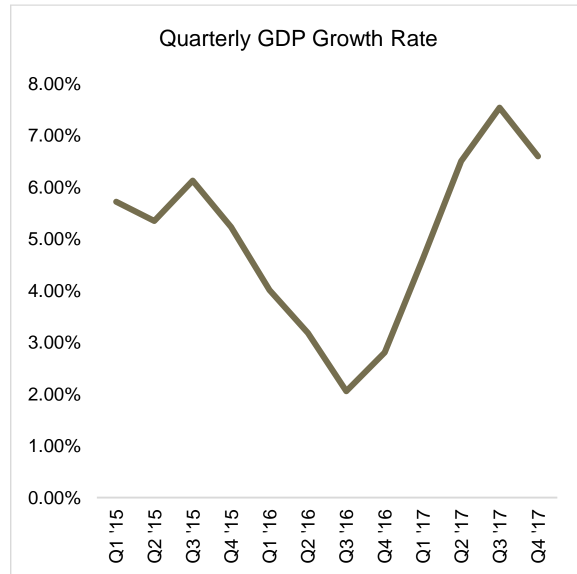
Source: Bank of Uganda, Bloomberg, CBA Research



Source: Bank of Uganda, Bloomberg, CBA Research



Source: Bank of Uganda, Bloomberg, CBA Research



Source: Bank of Uganda, Bloomberg, CBA Research

Rwanda

- Economic prudence and discipline has been at the core of Rwanda's relative economic success. Priority expenditure, prudent public finance management and deliberate efforts in improving the business environment in Rwanda has supported stronger growth in the country. Meanwhile, deliberate structural adjustments especially on the current account position will buttress growth and general sentiment for Rwanda going forward. The government has committed to promoting its import substitution and export diversification initiatives as a longer term solution to its current external fragilities.

- On fiscal policy, the government is projected to spend Rwf 2,443.5 Bn in the 2018/19 fiscal year, Rwf 328.2Bn higher than in 2017/18. Development expenditure is estimated at Rwf 897.1Bn of which a substantial percentage will go towards Bugasera airport and Rwandair operations to boost traffic into the country. The budget will be funded by Rwf 1508.7 Bn in revenues, representing 62% of the total 2018/19 budget. Grants are estimated at Rwf 396.3Bn while external and domestic loans are estimated at Rwf 400.9 Bn and Rwf 137.7Bn respectively.

- Although external borrowing may be expensive due to rising dollar interest rates, the need to bolster the foreign exchange reserves in the near term as well as stimulate domestic borrowing may support the external borrowing bias. The Franc has been steadily depreciating losing 2.72% against the US dollar so far this year.

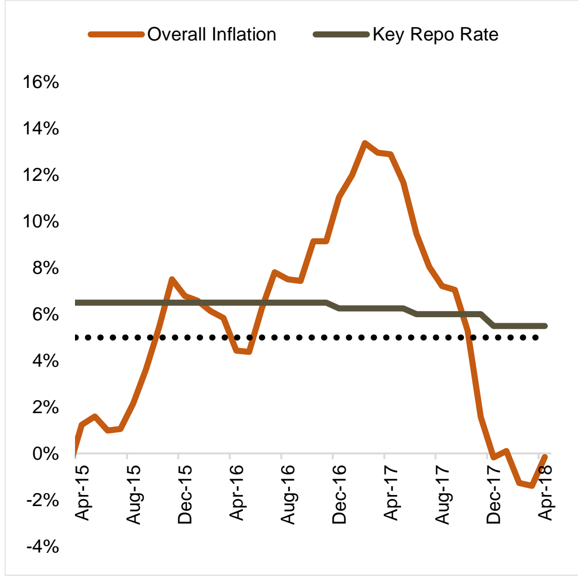
- Even so, the cautious approach to external financing could see rates rise in the near term as preference shifts to the local market. In May yields edged generally higher with the six and twelve month papers rising to 6.282% (Up 18.90bps) and 7.400% (Up 100.20bps) respectively. The 91 day eased mildly to 5.275% (Down 7.30bps).

- Private sector credit growth improved bolstering the overall economic outlook. Given inflation remains low and credit growth is still below levels consistent with the country's growth potential, prospects of further easing remain high. Credit growth has slowed to 7.9% after picking up to 14.0% in December 2017.

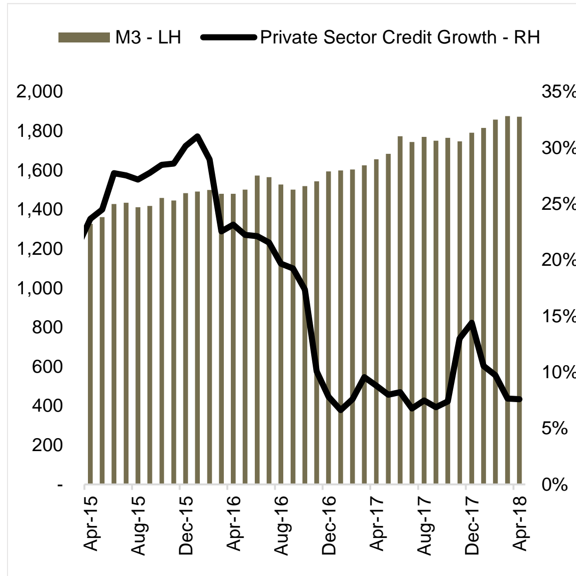
Forecasts

Quarter ending	March 2018	June 2018	Sept 2018	Dec 2018
GDP	6.25%	6.30%	6.50%	7.00%
Overall Inflation	-1.90%	2.00%	2.60%	8.60%
USDRWF	852.68	871.21	881.54	889.49
Repo Rate	5.50%	5.00%	5.00%	5.00%

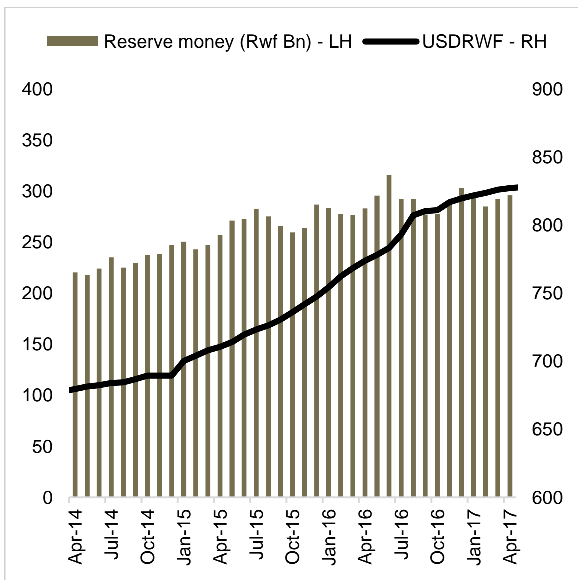
Source: CBA Research, Bloomberg



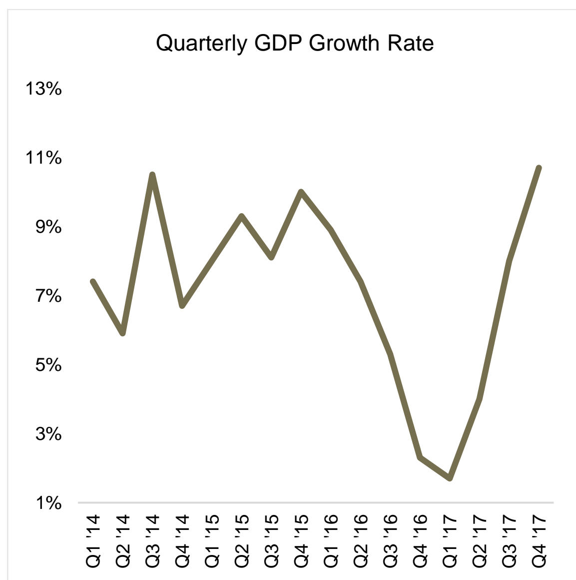
Source: National Bank of Rwanda, CBA Research



Source: National Bank of Rwanda, CBA Research



Source: National Bank of Rwanda, CBA Research



Source: National Bank of Rwanda, CBA Research

Disclaimer:

Any opinion or other information in this document is not an invitation to buy or sell any asset class. Legally binding obligations can only arise for or be entered into on behalf of Commercial Ba of Africa by means of a written instrument signed by a duly authorized signatory. You are cautioned to ensure that you have made an independent decision in accordance with your own objectives, experience, operational and financial resources and any other appropriate factors including independent professional advice. No guarantee, warranty, or representation is made in respect of the performance or return on any transaction.

CBA Research

Commercial Bank of Africa Limited

Head Office: CBA Centre, Mara & Ragati Roads, Upper Hill,

P O Box 30437 00100, Nairobi, Kenya

Direct Line: +254 020 288 4548 or +254 020 288 4725

Email: faith.atiti@cbagroup.com or stephanie.kimani@cbagroup.com

Telex: 23205 (COMAFBANK); SWIFT BIC: CBAFKENX; Reuters Dealing: CBAF; Reuters Information: CBAN

Website: www.cbagroup.com