Highlights

- Emerging economies which have been the engine of global expansion, accounting for slightly over 45% of growth over the last five years, seem to be losing their dynamism. To be sure, countries that only a few years ago, were hailed for their resilience in the face of global headwinds are now facing a myriad of headwinds, both domestically and externally generated and the fear of contagion is threatening to impair the rather upbeat global economic outlook. Is the risk of contagion too small to ignore?.....Will Kenya sustain its resilience?

- Kenya - The viability of the bullish medium term economic growth projections for Kenya may be dependent on the policy makers’ ability to balance two seemingly contradictory imperatives – reducing the negative output gap which require running a bigger deficit on one hand and on the other, putting the country on a sustainable long term fiscal path, which requires bringing the deficit lower. While the latter is crucial for an enabling growth environment with greater access to capital, increased public and private investments and enhanced business and consumer confidence, the tradeoffs are rather painful. Will policy makers rise to the occasion?

- Tanzania: Tailwind from stronger agricultural output and increased public investment will anchor growth above 6.5% in 2018. The construction of the Standard Gauge Railway (SGR) has begun in earnest with the anticipated ripple effects of the ongoing spending expected to bolster aggregate demand. However, slower growth in the mining sector due to resource nationalism may weigh on investment in the extractive sectors while slower monetary easing pass-through could undermine business investment and consumer spending.

- Uganda: Multiplier effect of heavy public infrastructure spending, strong agricultural productivity and stronger consumer and business spending continue to shore up Uganda’s economic performance. The economy is estimated to have expanded by 5.8% in the year to June 2018 with stronger showing by both industry and service sectors. The momentum may be sustained through the second half of the year, underpinning the 5.5% growth forecast for 2018.

- Rwanda: Government led infrastructure projects and continued expansion in services and agriculture will sustain the strong growth momentum of the first half of 2018. Median forecasts place growth above 7.5% for 2018 up from 6.1% a year earlier. Consumer spending may be bolstered by a combination of low inflation and loose monetary conditions. Moreover, nationalist programmes by the government should support robust growth especially within the retail and wholesale space. Furthermore, its impact on the country’s external position cannot be gainsaid.
Kenya shilling shrugs off the selloff in emerging markets….Can the currency sustain its relative strength?

Emerging economies which have been the engine of global expansion, accounting for slightly over 45% of growth over the last five years, seem to be losing their dynamism.

To be sure, countries that only a few years ago, were hailed for their resilience in the face of global headwinds are now facing a myriad of headwinds, both domestically and externally generated and the fear of contagion is threatening to impair the rather upbeat global economic outlook.

Almost like a déjà vu of the tapper tantrum of 2015, a combination of rising US interest rates, a strong US dollar and risks of a fully-fledged global trade war are proving toxic for emerging markets. Global risk aversion has increased with notable depreciation in emerging market assets and currencies as the dollar offers both safety and higher returns.

The US dollar has been on the front foot gaining 6.6% against a basket of other currencies since mid-April. The greenback’s resurgence is underpinned by rising interest rates, strong economic output as well as its haven appeal in the face of heightened trade, political and economic uncertainty across the globe.

The economy is estimated to have expanded by 4.0% in the second quarter, a decent shot above the projected global average of 3.5% for 2018, supporting the push for interest normalization in the US. To this, the Fed is on course to hike interest rates by an additional 25bps in September and possibly once more in December. The dollar’s bullish bias is further buttressed by relatively slow output growth and lower interest rates in other major economies.

In Europe, a blend of slow growth, fears of further political disintegration due to heightened protectionism and concerns over the impact of trade tariffs by the US has soured the investment landscape and weakened near term prospects of interest rate hikes. Italy’s populist government remains a major political concern for the Euro with potential for anti-EU policies likely to sustain caution.

Meanwhile, in the UK, the cloud of Brexit uncertainty continues to linger over the future path for monetary policy with the anticipated damage of a potential “No Deal” outcome, expected to keep investors and consumers guarded.

Source: Bloomberg
For emerging markets, in addition to the risk of capital flight and the need for higher interest rates to protect their currencies, countries with high dollar denominated debt could find it difficult to service these loans.

The Institute of International Finance estimates that dollar debt in emerging markets increased from $9.0 Trillion in 2002 to $21.0 Trillion in 2007 and $63.0 Trillion in 2017. An appreciation in the US dollar could see this debt increase remarkably in local currency terms and inability to generate sufficient revenues could lead to debt servicing strains. Moreover, the rising premium on emerging and frontier market debt could reduce the ability of these countries to raise funds for deficit financing from the external markets, further weakening their growth outlook.

As earlier indicated, the volatility in emerging markets has been aggravated by domestic challenges in some countries. In August, Turkey rocked markets as its diplomatic tensions with the US worsened what was an already precarious local economic situation. Limited policy response to the crisis due to state capture exacerbated the flight of capital from the country.

The resultant near 40% depreciation in the Lira ignited contagion concerns as prospects of corporate debt default threatened to spill over to European banks. While markets discounted the fear of contagion from Turkey, treating it as an isolated case later in August, the developments in Argentina considerably diluted the resultant gains for emerging market assets.

Coming hot on the heels of the Turkey crisis, Argentina surprised markets after it approached the IMF for an emergency loan. This saw the currency lose nearly 50.0% of its value causing short term interest rates to jerk up to 60.0%.

Relatedly, South African Rand is down 18.0% this year with the slip back to recession likely to aggravate the devaluation. Other key emerging market currencies also depreciated to record lows with the Indian rupee and Brazilian peso losing 10.6% and 18.5% respectively, so far this year.

Evidently the yield search in emerging markets has somewhat waned amid this potentially simmering crisis. With dollar offering both safety and yield, the dilemma for most international investors may now be how much exposure to maintain and in which emerging and frontier markets!

Amidst all these fragilities in emerging markets and the persistence of the twin deficits, Kenya shilling has remained an enigma, gaining 2.5% against the US dollar year-to-date.
The shilling’s bullish bearing has been underpinned by a number of factors. Whereas the country has not been entirely immune to the selloff, evident by the double digit stock losses at the Nairobi Securities Exchange, outflows have been offset by steady flows into the country especially from the diaspora. In the last one year, the flows have been incentivized by the government’s tax amnesty on repatriated funds.

Moreover, following the sharp shilling depreciation in 2015, structural adjustments including sufficient foreign reserve build up have helped provide a buffer for the shilling. Foreign exchange reserves have risen to USD 8.6Bn an equivalent of 5.7 months import cover. This could in future be underscored by continued economic and export diversification.

Additionally, the evident ‘tightening ‘effect of the interest controls has helped contain overall demand for dollars in the market.

While these could still keep the shilling strongly supported in the near term, risks are increasingly tilting to the upside. A combination of upcoming heavy government foreign currency obligations, unfavorable interest rate differentials and the persistence of high current and fiscal deficit may warrant stronger buffers to sustain this enviable stability to the medium term.

To this, the conversation around the precautionary facility with the IMF is likely to remain on the table. While it is evident that the immediate need for the USD 1.5Bn stand-by agreement may have considerably waned, the aforementioned exposures warrant more caution.

The facility may help sustain investor confidence in the currency given concerns over the sustained use of reserves as a stabilizing tool especially in an environment where the government seems too keen on keeping interest rates low and stable. Granted, the shilling may in the near term continue to surprise relative to its frontier and emerging market peers However, the pressure on emerging and frontier market economies especially as a result of interest rate normalisation should eventually catch up.

Even then, losses may be relatively measured given the diverse economic base and a proactive monetary authority. Ultimately, sustaining lower interest rates, a stable currency and Central Bank independence, with a liberalized capital account may be difficult – The impossible Trilemma. To this either the exchange rate or interest rates will have to eventually give way.
The viability of the bullish medium term economic growth projections for Kenya may be dependent on the policy makers’ ability to balance two seemingly contradictory imperatives – reducing the negative output gap which may require running a bigger deficit on one hand and on the other, putting the country on a sustainable long term fiscal path, which requires bringing the deficit lower. The latter is crucial for an enabling growth environment with greater access to capital, increased public and private investments and enhanced business and consumer confidence. While the government had attempted to address this dilemma through the 2018/19 budget, proposed amendments to the Finance Bill 2018 could undermine government success in addressing this impasse. The legislature shot down most of Treasury’s proposals aimed at bringing in an estimated over KES 50Bn in new taxes, undermining the achievement of the already ambitious KES 1.95 Trillion revenue forecast.

Funding the gap will require either increased borrowing, which could aggravate recent debt concerns or reallocation/expenditure cuts which could occasion some slack in economic activities. Outright spending cuts, which seem inevitable in our view should see investors discount the 5.8% growth forecast for the year. Indeed, the strong agriculture output will still support solid growth but a weaker fiscal lever could sustain a negative output gap.

Meanwhile, monetary policy remains fairly supportive. Transmission could be bolstered by the proposed removal of the lower cap of interest rate controls where commercial banks will no longer be required to pay a minimum of 70% of CBR on interest earning deposits. This gives banks some flexibility in managing their cost of funds. Resultant better margins may incentivize increased lending activities. Even then, limitation to risk pricing due to the cap on lending rates could still keep credit growth below levels consistent with the country’s growth potential.

Inflation eased to 4.04% in August from 4.35% in July suggesting some scope for further accommodation. However, this has been somewhat overriding by rising inflation expectations with the re-introduction of the 16.0% VAT on fuel. The resultant increase in overall commodity prices has potential to push inflation beyond the upper limit of the target band. This could be a source of caution for the regulator. Meanwhile, increased volatility in emerging markets coupled with a persistently strong US dollar could also keep the regulator guarded, in spite of the steady flow of dollars from diaspora.

Despite the emerging risks from inflation and fiscal position, short term interest rates outlook remains benign. This is evident in the continued heavy subscriptions on 182 and 364 day T-bills. The rates on the paper have continued to ease albeit gradually. Besides lagged effects of recent monetary policy easing, improved liquidity conditions have sustained a downward bias on the curve. Moreover, continued price discovery on the risk free rates following the reduction in maximum lending rate to 13.0% will favor further drop in yields in the near term, holding all else constant.

Meanwhile, the currency remains calm despite concerns of fiscal implosion and the fate of the $1.5Bn precautionary facility with the IMF. Despite the considerable depreciation of emerging market currencies, the shilling remained well anchored only giving up a few cents in August to 100.65 against its US counterpart. Strong Central Bank reserves and improving current account dynamics should keep the shilling well supported between 100.50 and 101.50 in September.

<table>
<thead>
<tr>
<th>Forecasts</th>
<th>Quarter ending</th>
<th>March 2018 (A)</th>
<th>June 2018</th>
<th>Sept 2018</th>
<th>Dec 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td></td>
<td>5.70%</td>
<td>6.01% (F)</td>
<td>5.56%</td>
<td>5.16%</td>
</tr>
<tr>
<td>Inflation</td>
<td></td>
<td>4.16%</td>
<td>4.28%</td>
<td>6.07%</td>
<td>7.07%</td>
</tr>
<tr>
<td>USDKES</td>
<td></td>
<td>100.85</td>
<td>101.05</td>
<td>102.00</td>
<td>102.70</td>
</tr>
<tr>
<td>CBR</td>
<td></td>
<td>9.50%</td>
<td>9.50%</td>
<td>9.00%</td>
<td>9.00%</td>
</tr>
</tbody>
</table>

Source: CBA Research, Bloomberg
Tailwind from stronger agricultural output and construction sector on the back of strong public investment will anchor growth above 6.5% in 2018. The construction of the SGR has begun in earnest with remarkable progress already being noted on the Dar-es Salaam-Morogoro-Makutupora section of the project. The expansion of Dar es Salaam and Mtwara port in a bid to boost the country’s shipping capacity will also sustain activity in the sector. However, slower growth in the mining sector due to resource nationalism will likely weigh on investment into the extractive sectors.

Meanwhile, while monetary policy remains largely accommodative, the pass through of recent policy actions remains weak. The Bank of Tanzania cut the discount rate to 7.00% from 9.00% as it intensifies its effort to bolster private sector lending. Credit extension to the productive sector improved marginally to a growth of 4.0% in June compared to 2.7% in May and 2.3% a year earlier. The Central Bank had targeted credit growth of 12.0% which it deems consistent with its price stability target and solid economic performance. While this could bolster liquidity conditions in the market, translation to credit growth is likely to be limited. Discount rate hasn’t proved so effective in bringing down the overall cost of credit as lending rates remain fairly elevated at over 17.0%.

Moreover, potentially higher fiscal deficit could push up the benchmark interest rates, undermining the signal from the reduction in the discount rate. Sustaining the fiscal measures that were aimed at incentivizing borrowing by the private sector may prove difficult as government ramps up spending. Initial figures from the government indicate that budget absorption increased to 79% in the year to June 2018 with development budget absorption increasing to 67%. This was supported by a 90% revenue performance with TZS 17.97Bn in collections. In the period, the government only borrowed TZS 0.60 Trillion against a target of TZS 1.22 Trillion, reducing potential crowding out effects of increased government borrowing.

Contrary to the easing signal, the yield curve shifted north in the month as investors price in potential for fiscal dominance in coming months. The benchmark 91, 182 and 364 day papers auctioned at 2.93% (+3.0bps), 5.33% (+26.0bps) and 8.16% (+19.0bps) respectively. The pressure is expected to persist as government intensifies borrowing to finance its ambitious infrastructure projects.

Meanwhile the currency was under some mild pressure in the month mostly due to a relatively weak current account position. The shilling which was quoted at 2278/88 in the period exhibited some vulnerability although regulatory intervention helped stem losses on the unit. Inflows from foreign funding and tourism in the month were mostly absorbed by increased foreign currency obligations from by the government. The shilling is expected to sustain its mild depreciation towards 2300 by year end.

Forecasts

<table>
<thead>
<tr>
<th>Quarter ending</th>
<th>March 2018</th>
<th>June 2018</th>
<th>Sept 2018</th>
<th>Dec 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>6.60%(F)</td>
<td>6.70%(F)</td>
<td>6.67%</td>
<td>6.76%</td>
</tr>
<tr>
<td>Inflation</td>
<td>3.90%</td>
<td>3.10%</td>
<td>4.52%</td>
<td>4.73%</td>
</tr>
<tr>
<td>USDTZS</td>
<td>2256</td>
<td>2272</td>
<td>2279</td>
<td>2288</td>
</tr>
<tr>
<td>CRR</td>
<td>5.25%</td>
<td>5.25%</td>
<td>5.25%</td>
<td>5.25%</td>
</tr>
</tbody>
</table>

Source: CBA Research, Bloomberg
Uganda

- Multiplier effect of heavy public infrastructure spending, strong agricultural productivity and stronger consumer and business spending continue to shore up Uganda’s economic performance. The economy is estimated to have expanded by 5.8% in the year to June 2018 with stronger showing by both industry and service sectors. The momentum is expected to be sustained through the second half of the year, underpinning the 5.5% growth forecast for 2018.

- Business investments and consumer spending has been buttressed by recovery in private sector lending. For the second consecutive month, growth in private sector lending remained at 10.0%, a considerable increase from an average of 6.1% in the year to June 2018. Recent survey by Central Bank indicate that banks expect to lend more in the quarter ending September 2018 to fund increased business opportunities and the ongoing investments in the mining sector.

- Even then, the narrowing output gap may raise medium term inflation concerns. Inflation has remained fairly low supported by lower food prices. In August, headline inflation ticked up to 3.8% from 3.1% in July. While food prices are expected to remain tame, risks to overall inflation are increasingly tilting to the upside driven by higher taxes, depreciation of the exchange rate and increasing aggregate demand. Core inflation also increased by 100bps to 3.5% in the period. This could signal an end to the Bank of Uganda’s easing cycle. While the Bank of Uganda (BoU) has in the past showed high sensitivity to inflation, we reckon that prospects of tightening may be limited in the near term unless demand pressures pick up considerably.

- Meanwhile, after rising steeply in June due to fiscal imbalances, yields have corrected somewhat although the downside remains fairly limited. In August, yields on the benchmark 91 and 364 day papers declined to 10.384% (-37.7bps) and 13.600%(-90.2bps) respectively. The correction has been driven by heavy liquidity in the market following the extended period of monetary easing. However, risks to interest rates remain largely tilted to the upside. Increased borrowing to fund the 6.6% budget deficit (4.7% -2017) will see domestic borrowing increase to nearly UGX 2.0 Trillion this fiscal year. The risk of increased local borrowing may be aggravated by tightening external markets which should make external borrowing more expensive. Expected dollar appreciation could also increase potential instability in high countries with high dollar debt. In Uganda, approximately 70% of the Public Debt is in foreign currency.

- The shilling lost 1.6% against the US dollar in August, partly reflecting a correction from the unexpected 4.6% appreciation in July. The shilling is expected to remain vulnerable to a widening current account deficit and a fairly bullish US dollar. Further depreciation towards 3800 is expected albeit with some fluctuation in the interim. Central Bank intervention will remain limited given the fragile reserves currently at $3.44Bn (4.7 months import cover).

Forecasts

<table>
<thead>
<tr>
<th>Quarter ending</th>
<th>March 2018 (A)</th>
<th>June 2018</th>
<th>Sept 2018</th>
<th>Dec 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>6.37%</td>
<td>7.00%(F)</td>
<td>6.00%</td>
<td>5.00%</td>
</tr>
<tr>
<td>Inflation</td>
<td>2.00%</td>
<td>2.00%</td>
<td>5.50%</td>
<td>6.00%</td>
</tr>
<tr>
<td>USDUGX</td>
<td>3660</td>
<td>3840</td>
<td>3800</td>
<td>3840</td>
</tr>
<tr>
<td>CBR</td>
<td>9.00%</td>
<td>9.00%</td>
<td>9.00%</td>
<td>9.00%</td>
</tr>
</tbody>
</table>

Source: CBA Research, Bloomberg
Rwanda

- Government led infrastructure projects and continued expansion in services and agriculture will sustain the strong growth momentum of the first half of 2018. Median growth forecasts still place growth above 7.5% for 2018 up from 6.1% a year earlier. Composite Index of Economic Activities (CIEA) increased by 15.8% compared to 7.8% increase in the previous period reflecting strong agriculture performance, resilient service sector and recovering industry performance.

- Consumer spending may be bolstered by a combination of low inflation and loose monetary conditions. Moreover, nationalist programmes by the government should support robust growth especially within the retail and wholesale sectors. Moreover, its impact on the country’s external position cannot be gainsaid.

- The external position has considerably improved partly due to the deliberate efforts by the government to diversify the export base and reduce reliance on imports. In the first half of the year, Rwanda’s trade deficit narrowed by 2.0% to USD 664.2Mn driven by faster increase in exports (23%) compared to imports (7.0%). The share of traditional exports has dropped from 47% in 2015 to 32.4% in the first half of 2018, reflecting the success in government’s export diversification. Private investments increased across the spectrum with the country receiving increased grants in the period.

- Meanwhile although monetary conditions remain generally supportive, risks remain tilted to the upside. Although inflation remains generally benign at 1.4%, the persistent currency depreciation could limit the Central Bank’s wiggle room for further accommodation. The Franc has depreciated by 2.6% so far this year. While this is fairly measured, it’s obvious that Central Bank action in the market has undermined price discovery in the currency market.

- Interest rate outlook could be further undermined by a wider fiscal deficit. Increased infrastructure spending could see the budget gap widen to over 5.0% of GDP in 2018/19. Even then, monetary policy stance is foreseen to remain accommodative in the near term on the back of subdued inflationary and exchange rate pressures and low though improving aggregate demand. The Central Bank is expected to move to a price targeting policy regime by year end from its current monetary targeting regime. So far, the regulator has indicated that preparations are at an advanced stage to facilitate the transition.

- Elsewhere, Standard& Poor revised Rwanda’s outlook for short-term and long-term credit outlook from stable to positive, maintaining the country’s rating at B. The rating was informed by the country’s on-going external adjustment efforts aimed at reducing external financing needs as well as a shoring up of foreign-exchange reserves.

Forecasts

<table>
<thead>
<tr>
<th>Quarter ending</th>
<th>March 2018(A)</th>
<th>June 2018</th>
<th>Sept 2018</th>
<th>Dec 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>10.60%</td>
<td>6.30%(F)</td>
<td>6.50%</td>
<td>7.00%</td>
</tr>
<tr>
<td>Overall Inflation</td>
<td>-1.40%</td>
<td>1.40%</td>
<td>2.60%</td>
<td>4.00%</td>
</tr>
<tr>
<td>USDRWF</td>
<td>852.68</td>
<td>859.76</td>
<td>881.54</td>
<td>889.49</td>
</tr>
<tr>
<td>Repo Rate</td>
<td>5.50%</td>
<td>5.00%</td>
<td>5.00%</td>
<td>5.00%</td>
</tr>
</tbody>
</table>

*Source: CBA Research, Bloomberg*
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 Bank 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