East Africa and Kenya in 2018

After all the elections are done and dusted

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The global economy shows robust growth?

Although policy choices are becoming more difficult

The headline global growth numbers have been good

And there are signs that investment is recovering with a moderate rise in inflation

- Our global forecasts have been little changed since late 2017. We expect Advanced Economy (AE) growth to have been around 2.3% in 2017, and to rise modestly to 2.4% in 2018:
  - With global growth about a percentage point higher in both years, and unusually, broad-based across a wide range of economies
  - Recently most revisions to growth have been positive and there are now signs of recovery in global investment, which has been lower than in recent years
- Arguably, the three main risks to the global economy are:
  - Faster-than-expected tightening of monetary and fiscal policies
  - Disappointing reform outcomes, notably in the US and France
  - An escalation of political, geopolitical and trade tensions, notably in the Middle East or involving North Korea
- In terms of inflation in AEs, this has been very subdued despite the growth data – we recently started to refer to "still stuck-flation". For AEs, weak inflationary pressures in the US have been a particular problem
  - But there are signs that tighter labour markets and external factors, such as rising commodity prices, are starting to push up inflation
    - But these upward pressures are still modest with headline AE inflation estimated at 1.6% in 2017 and staying broadly at this level in 2018

The policy focus remains on AE central banks

Central banks are moving in a more hawkish policy direction

- All three major central banks, the US Federal Reserve, the European Central Bank (ECB) and the Bank of Japan (BoJ) are now in the process of starting to reduce the size of their balance sheets
  - We think, this means that net asset purchases by AE central banks are likely to fall from around US$100bn a month in early 2017 to roughly zero by the end of 2018, while the value of central bank balance sheets are now around their peak
- This change in policy is mainly driven by the better global macroeconomic backdrop, although there is also a political element. Moreover, given that it has been well signposted, we still think the impact on the global economic outlook will be limited to a modest rise in interest rates and a minor slowdown in growth
  - But there is still a downside risk, if the moves trigger a major correction in global asset prices. Asset prices are currently quite stretched on a range of metrics while financial conditions remains loose. The start of this could potentially be less liquid assets such as equities and corporate bonds.
- But the bottom line is that we do expect increases in policy interest rates by central banks in most AE's in 2018, led by the US Federal Reserve as it "gradually normalises policy"
  - With the BoJ a likely laggard in raising rates, while the ECB laggard will eventually move, but not quickly given current Euro strength and its commitment not to raise rates before ending net asset purchases

The Euro Area (EA)

Upward revisions to growth in 2017 have created momentum as we head into 2018

- Euro Area (EA) growth picked up sharply to 2.3% in 2017, but we think the upward momentum is slowing and growth will be 2.4% in 2018
  - It is also still not clear to us whether the EA is in the late recovery stage of the business cycle or the early boom phase
  - In case of Germany, despite the potential for political uncertainty and even new elections, we expect business sentiment and growth to remain robust at 2.7% in 2018, up from 2.6% this year. The big question is to what extent a tightening labour market starts to translate into more significant wage pressure and inflation
  - In France, we think the first of President Macron's reform initiatives will feed through into a modest pick up in growth to 2% in 2018, from 1.7% in 2017
- Despite this, we think the road to headline inflation overshooting the ECB target of "below, but close to 2%" is still quite distant, with our forecasts of inflation being 1.5% this year and moderating to 1.3% in 2018
- Despite this overall positive story, there are some risks to think about, notably a cliff-edge Brexit, growing supply constraints and potential non-market friendly election outcomes in Italy and Catalonia/Spain

The implications of these trends on global currencies

Central banks are moving in a more hawkish policy direction

- We broadly expect to see further appreciation of the Euro (EUR) against the US dollar (USD) in the medium term as the US dollar rally, underway since 2011, continues to lose momentum
  - This leaves us forecasting that EUR:USD1.22 by June 2018, and then gradually appreciating to the EUR-USD1.25-1.30 level by the end of 2018
- The rally is currently being driven more by the market view of potential developments in the Euro Area (EA)
  - In particular, as the ECB moves to reduce its balance sheet, against the background of a positive current account outlook, we expect that the balance of payments position is supportive of the Euro
- A more rapid appreciation is also possible if the US dollar bear market sentiment was to gain strength and/or the EA outlook was to improve further than we currently forecast
  - Conversely progress in US policy implementation and a faster than expected Federal Reserve tapering would be US dollar positive

Global oil markets

2018 is likely to be a transition year for oil

Global oil markets

The market is likely to move from deficit to surplus over the course of 2018

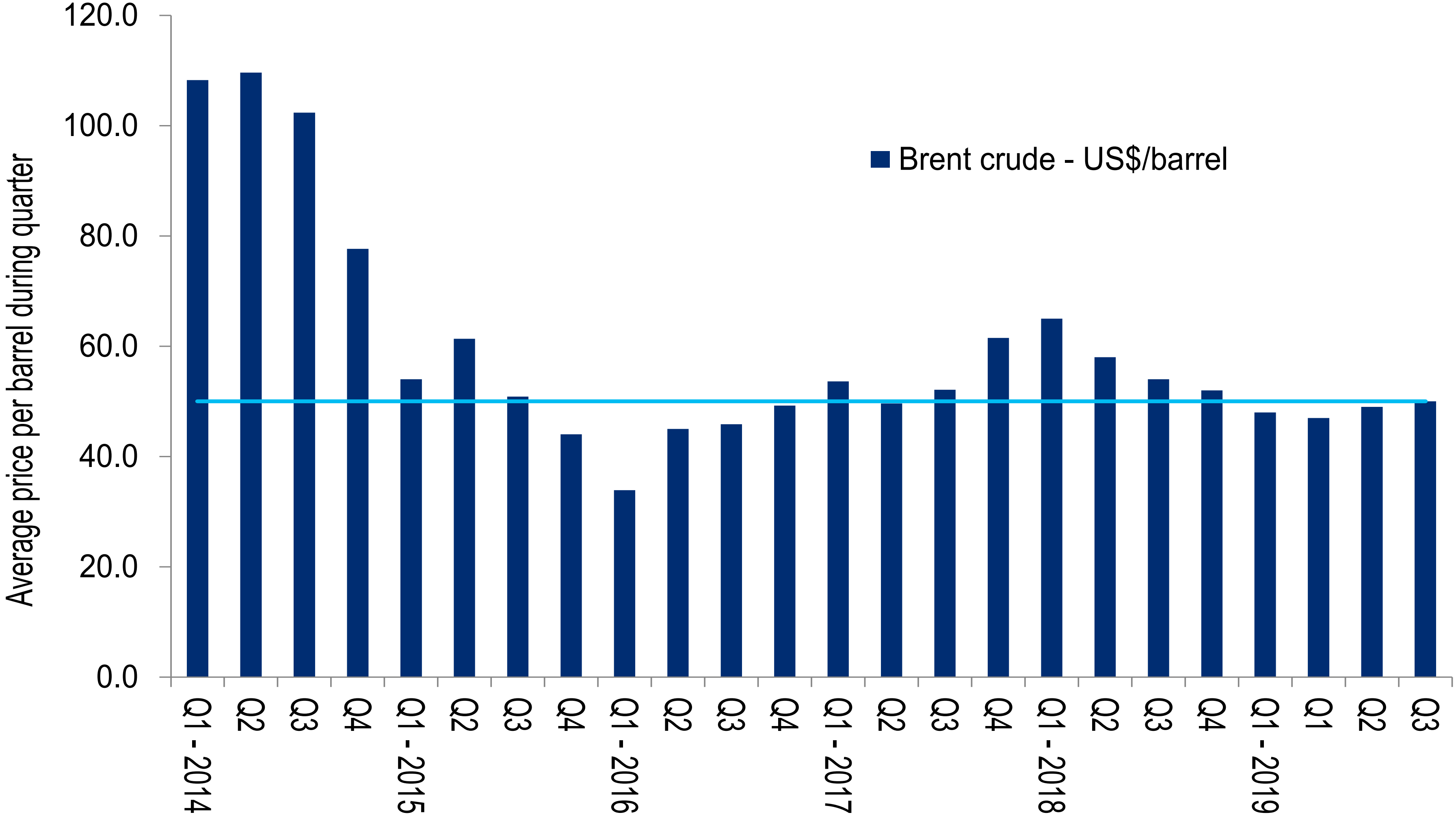
- In 2016 and 2017 we witnessed a slow rebalancing of the oil market as US shale production declined, OPEC production cuts helped curtail supply from the cartel and demand growth remained robust. This has helped prices grind higher, and with inventories slowly starting to be drawn down, lead to the recovery in oil prices in 2H 2017 to current levels of over US$60/barrel

- **However, our central scenario is that oil prices will end the year lower than current spot levels as the market moves from deficit back into surplus**. This is because although demand will continue to grow, supply will grow more robustly
  - This will be driven by US supply – rig count is already up from the November 2017 low - but also Brazil and Canada, which means that OPEC and Russia will only need to meet a small part of the rise in demand
    - Citi expects the current OPEC deal to last only to mid-year or Q3, not to the end of 2018
  - We currently forecast that the price of Brent crude will slip to US$52/b by Q4 2018

- Moreover, heading into 2019 we become even more bearish forecasting an average oil price of US$49/b with growth in supply continuing to outpace growth in demand
  - With this lower oil price only slowly reining in US production because Citi currently estimates that the average breakeven production costs for larger US shale producers at just under US$50/b

The outlook for the oil price

Prices will remain above US$50/b in 1H 2018, but after that they are forecast to slip back



Source: Haver Analytics and Citi Research forecasts from 2018

Global oil markets

The bull and bear arguments around our central price scenario

- **The bull case is for prices to stay at current levels of over US$60/b**
  - This reflects a combination of faster oil demand growth, against the background of delays to OPEC expansion plans and additional geopolitical supply disruptions (most likely from Libya, Iran, Iraq and Nigeria)
  - In addition in the short run, higher shale production cost inflation limits US supply growth, but eventually leads to stronger US crude production given higher prices
    - **The bull shock case** would be for an even more elevated price due to the impact of a sustained 1-m b/d geopolitical supply loss, probably in one or two of the countries listed above

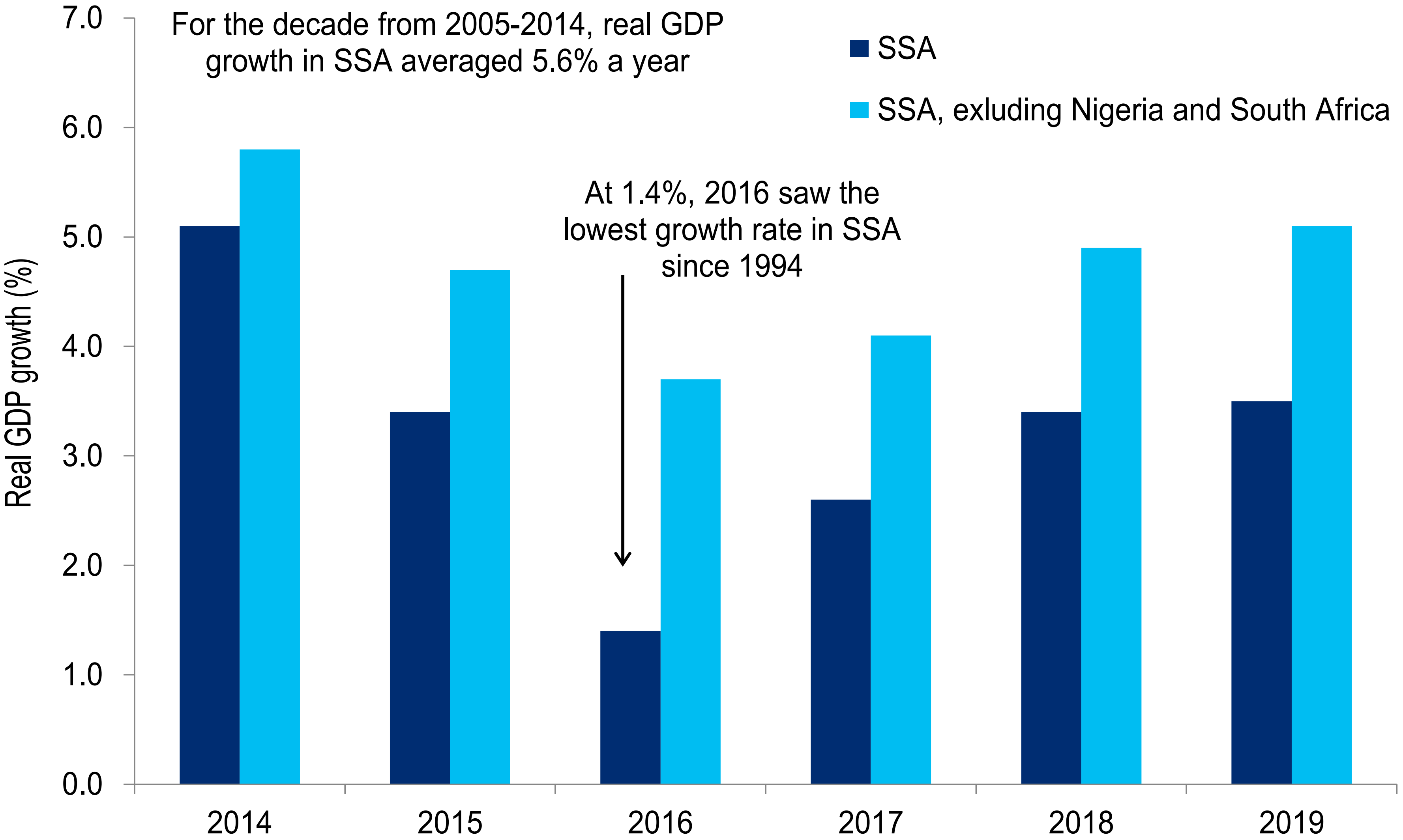
- **The bear case is for a more rapid weakening of prices**
  - This is driven by non-OPEC supply growing faster than expected, slower global oil demand growth and a general lack of geopolitical supply disruptions (Citi estimates that global supply disruption reached a five year low in September 2017)
  - But the most likely driver would be a more robust and earlier than expected increase in OPEC supply than we are currently assuming
    - **The bear shock case** would be for a sustained 0.5-m b/d return of currently disrupted supply quickly pushing prices back to below US$50/b

Growth in SSA has shown signs recovery in 2017

Some sub-regions continue to do well, others less so, a trend we expect to continue in 2018

There are good indications that growth picked up in 2017

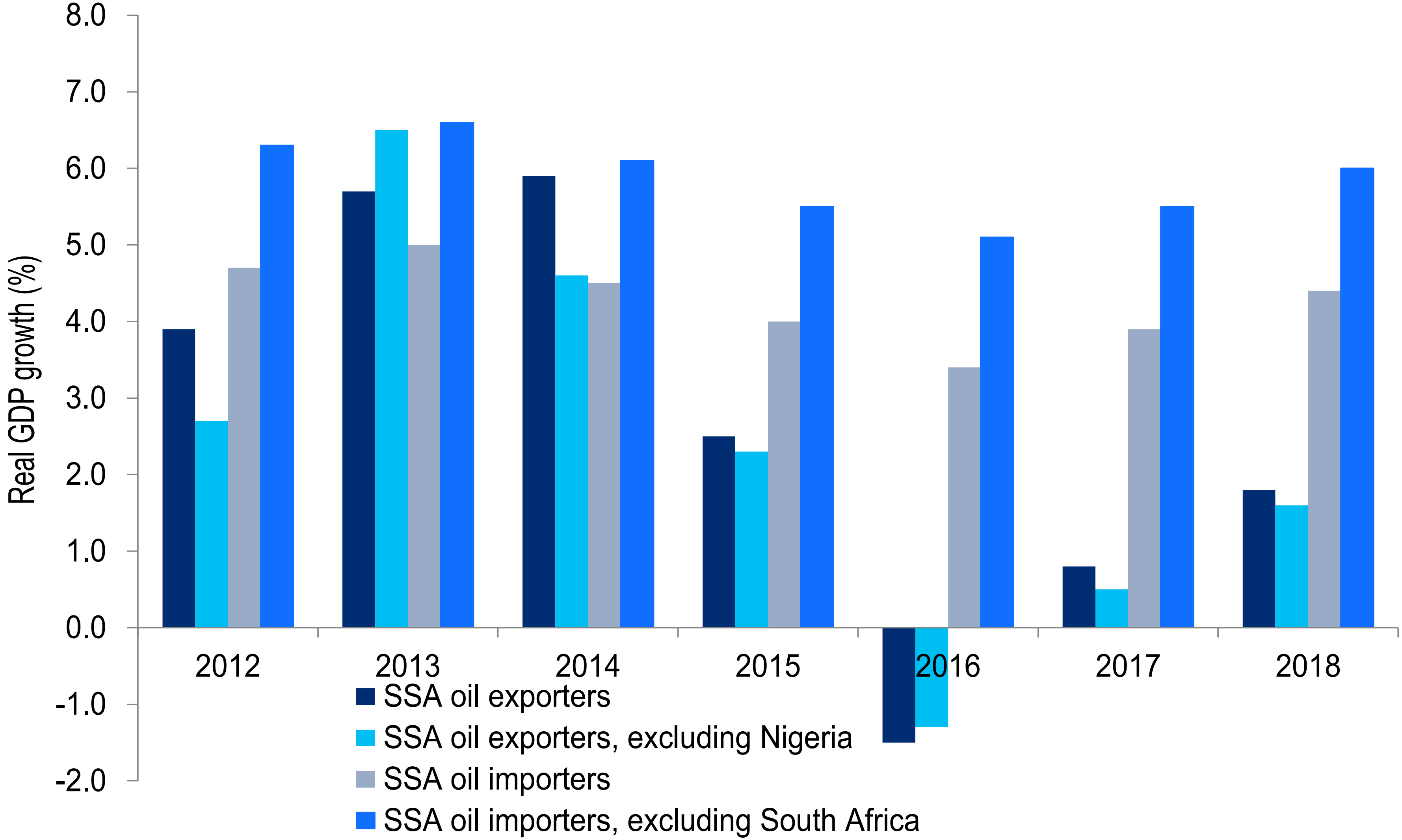
And we expect this to gain more traction in 2018-19, although the overall growth number will still be low



Sources: IMF and Citi Research forecasts for 2017-19

Nigeria and South Africa continue to matter

As does the distinction between oil exporters and oil importers



Sources: IMF and Citi Research forecasts for 2017-18

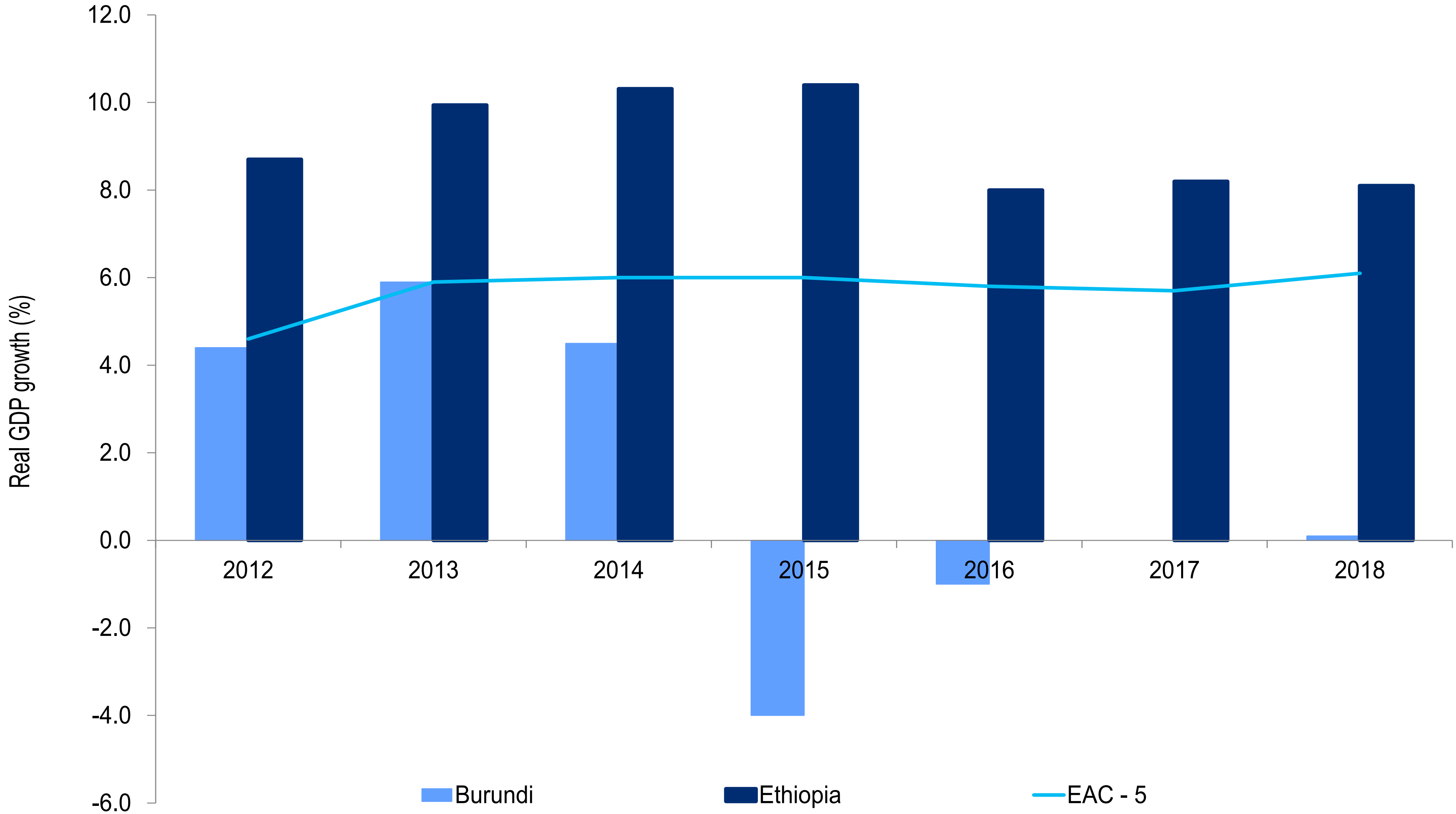
The growth outlook in East Africa

The macro data is broadly positive, if nuanced, but sentiment less so

East Africa is dominated by the five member states of the East African Community (EAC-5) Burundi, Kenya, Rwanda, Tanzania and Uganda. The EAC 3 is Kenya, Tanzania and Uganda. We also include Ethiopia in the sub-region. Eritrea and South Sudan are excluded due to lack of reliable data.

EAC-5 growth has been quite stable at the 5-6% level

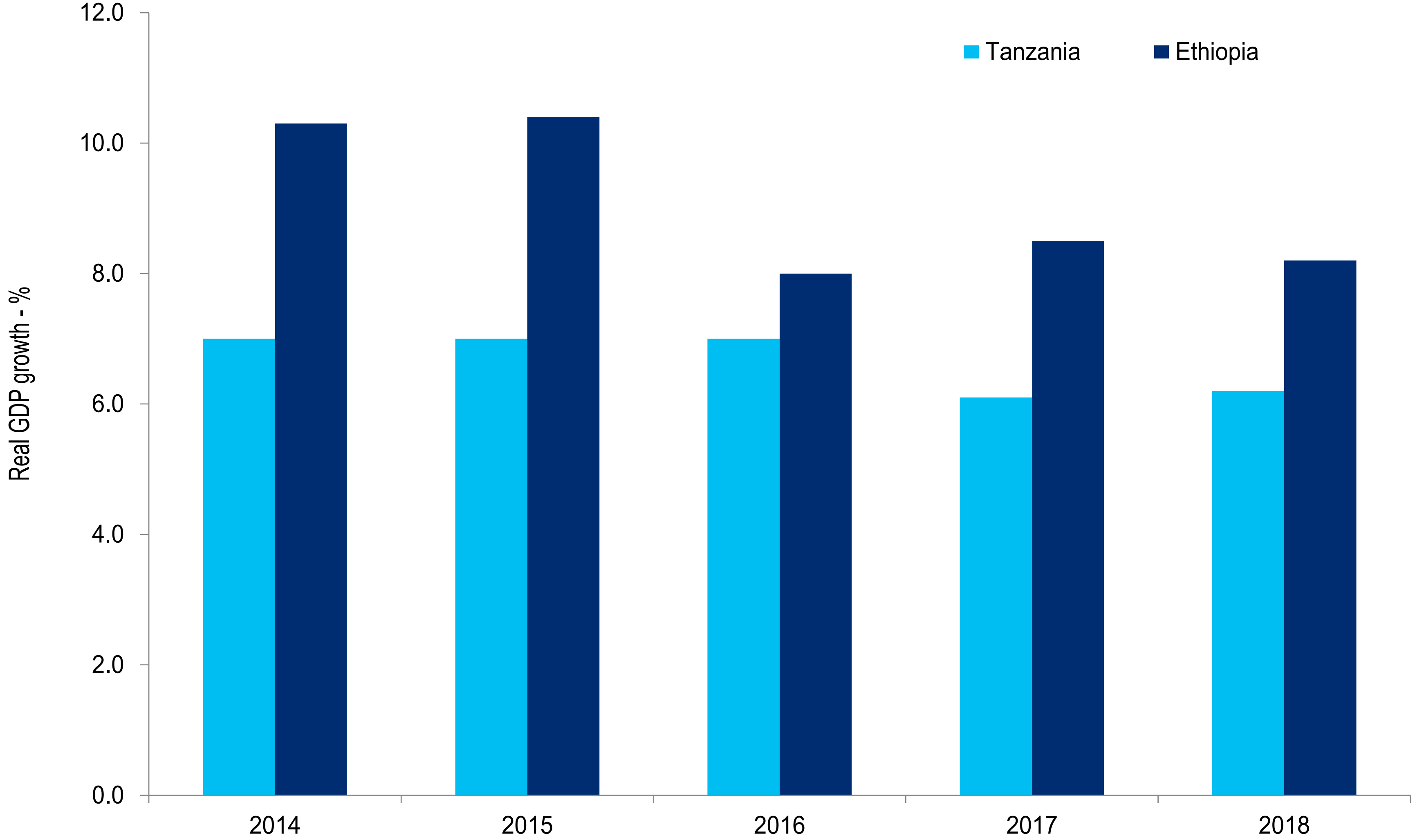
Although there have been a growth slowdown in Ethiopia and the Burundian economy remains under pressure



Sources: IMF and Citi Research estimates/forecasts for 2017-18

Ethiopia and Tanzania

There are signs of strain on the growth story in both countries, but this is still limited



Sources: IMF and Citi Research estimates/forecasts for 2017-18

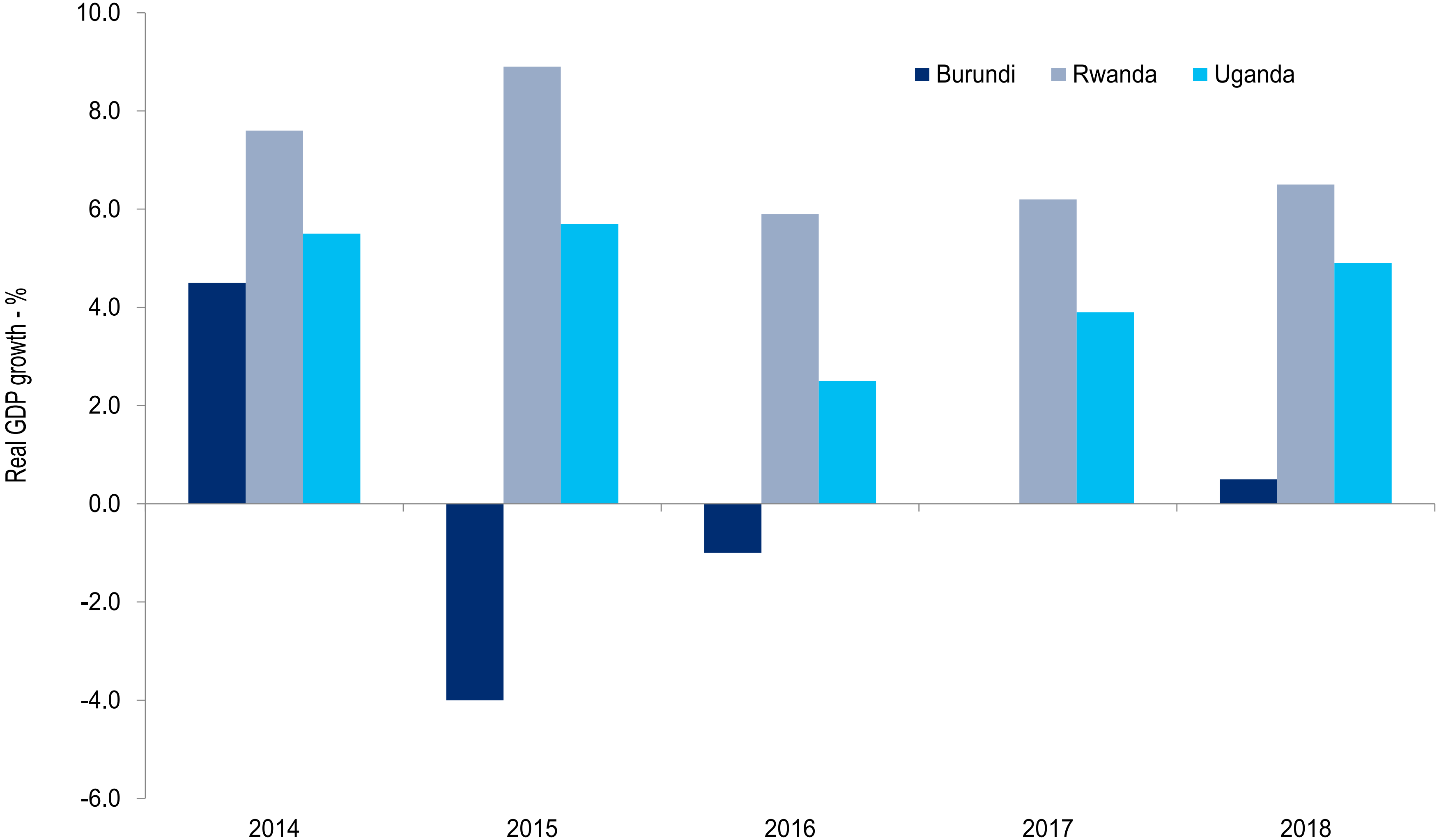
Ethiopia and Tanzania

Good numbers, but some concerns about the data and what it is telling us

- Tanzania's growth rate remains "stuck" around 7%, but we think will have slowed towards 6% in 2017 and growth will remain under some pressure in 2018
- There are two major questions over Tanzanian growth which remain unresolved
  - Why growth remains so slow in the agricultural sector is an ongoing and important issue and not quite fully reconcilable with food price inflation data
  - And we also have some important concerns about the accuracy of the growth data, notably in light of some of the other macroeconomic data which indicates a possible slowdown in the growth rate in 2016 and 2017
- Ethiopia's growth rate has clearly slowed from the rates of over 10% recorded in the decade from 2005-14. But at around 8-9% a year it clearly remains robust by the standards of SSA
  - There is some concern that it should have slowed more given the problems in the agricultural sector in recent years
  - Against the background of the ongoing political unrest in the country
- But at present these problems do not really seem to be showing up in the data. Instead, the main problem remains the large current account deficit, low foreign exchange reserves and the potential impact of this on the Ethiopian birr (ETB)

Burundi, Rwanda and Uganda

Diverging growth trends in the Great Lakes region



Sources: IMF and Citi Research estimates/forecasts for 2017-18

Burundi, Rwanda and Uganda

Things are a little more complicated in Burundi and Uganda compared to Rwanda

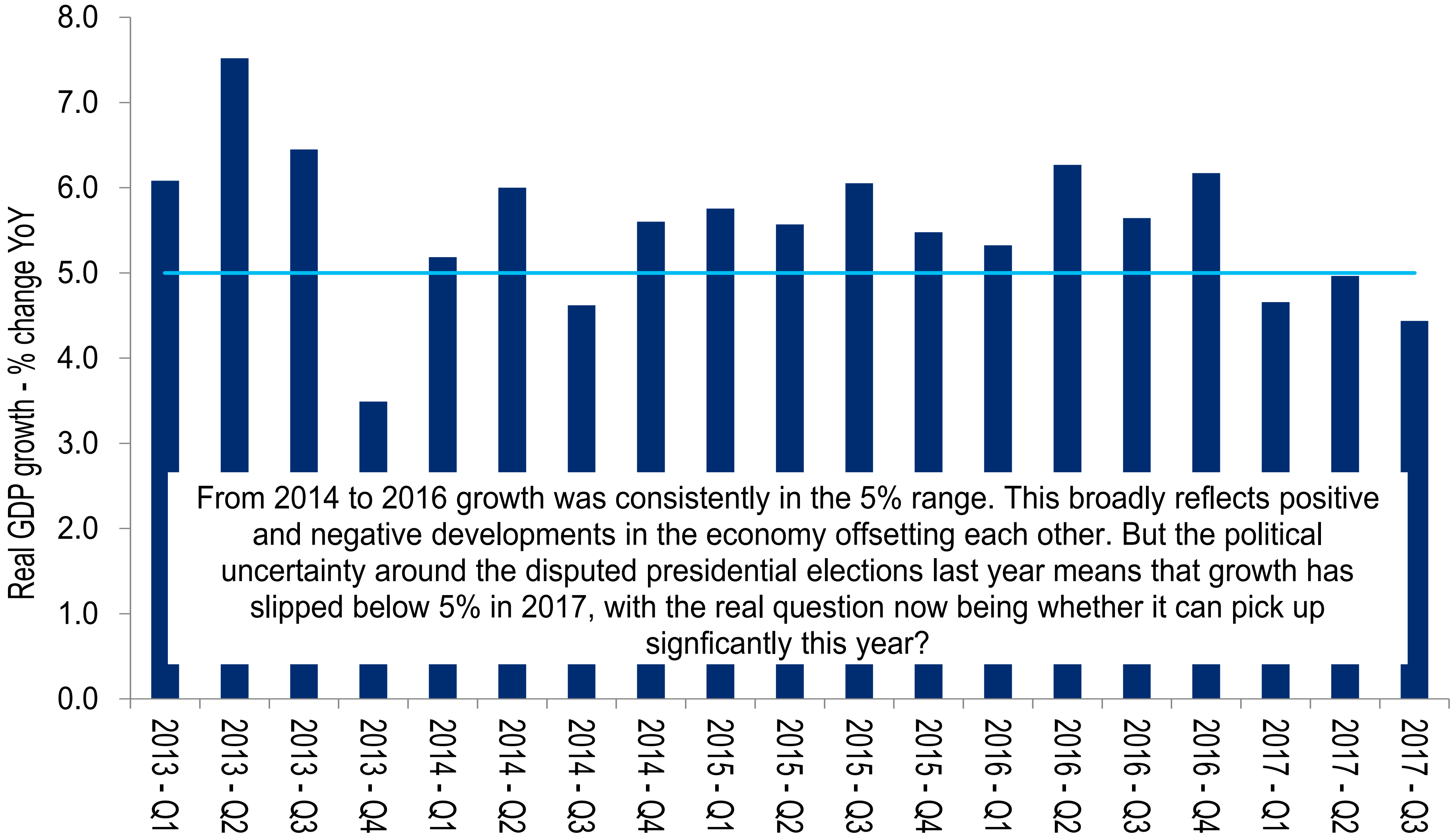
- The Ugandan economy continues to make an uneven recovery from the growth slowdown which occurred in 2009-10 after a decade long boom. Growth slowed sharply to 2.5% in 2016, but there are some signs of recovery in 2017 which should continue into 2018
  - During this time, policy mistakes – first monetary and then fiscal - have spilt over into periodic bouts of Ugandan shilling (UGX) weakness, which combined with the election cycle has meant that business confidence has been under pressure

- The problem in Burundi can be summed up in one word – politics. Following the attempted military coup in May 2015 and then the re-election of President Pierre Nkurunziza in July 2015, the crisis is perhaps best seen as a low intensity conflict
  - Donor support continues to limit some of the potentially worse economic damage, but how long this situation can continue continues to remain highly uncertain. Growth is expected to continue to stagnate in 2018, while inflation remains in double digits

- Growth in Rwanda slowed since 2015 due to the impact of poor rains and the completion of a number of large infrastructure projects.
  - There is also the question as to whether the economy has reached the end of its recovery phase, as was also the case in Uganda around the 2009-10 period. But there is an argument that Rwanda remains a better managed economy than Uganda and the slowdown may prove less problematic given this is one of the most development focussed governments in SSA

Kenyan growth is somewhere in between

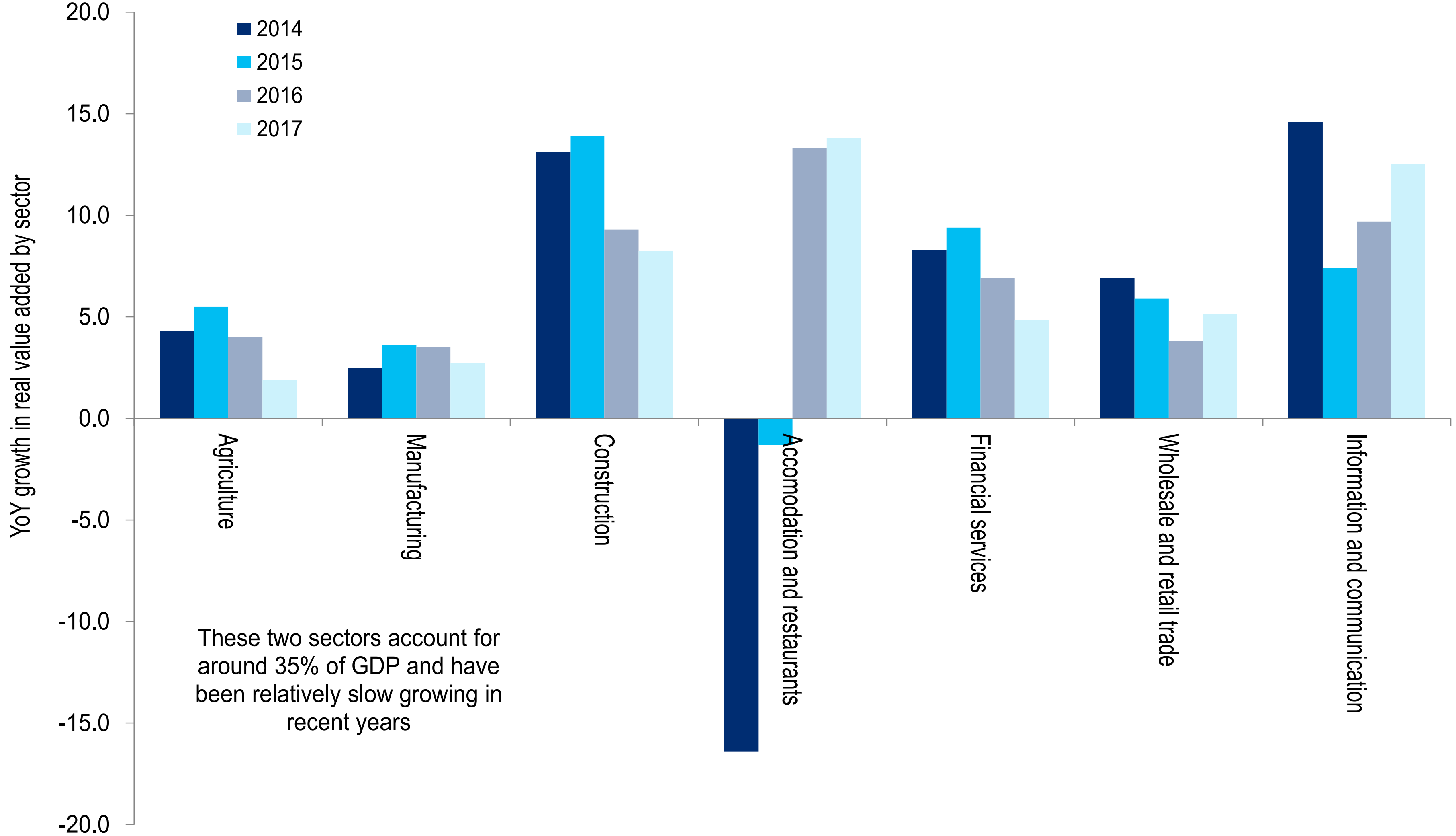
But growth has clearly come under some pressure in 2017



Sources: Haver Analytics, Kenya National Bureau of Statistics and Citi Research

Growth by major sectors in Kenya

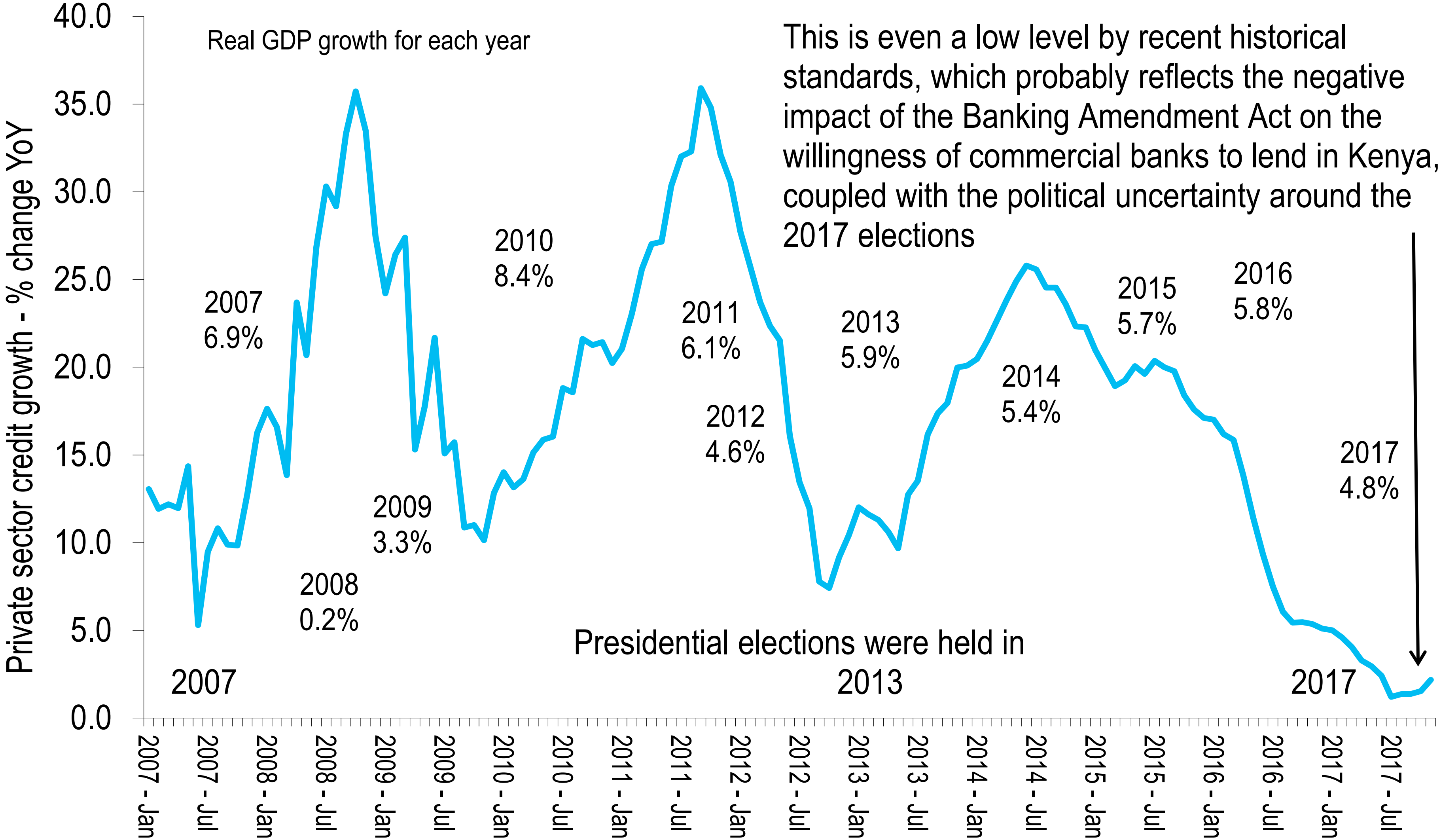
There have tended to be offsetting sectoral trends, but agricultural and manufacturing are still drags on growth



Source: Haver Analytics, Kenya National Bureau of Statistics and Citi Research for 2017 (based on data for Q1-3)

The problem of private sector credit growth in Kenya

Historically volatile, and not closely linked to growth, but this time it seems under real pressure



Source: Haver Analytics, Central Bank of Kenya and Citi Research

Some additional thoughts on Kenyan growth in 2018

The outlook is positive, but there is quite a lot of uncertainty around it

- Clearly there is some optimism that growth could potentially re-bound quite strongly in 2018. The IMF currently forecasts growth of 5.5% in 2018 and in January the CBK governor, Patrick Njoroge, told reporters in Nairobi that the economy would grow by 6.2% this year. These are not over-optimistic forecasts but there is an argument that they depend on the direction of
  - Monetary policy: notably the ongoing impact of the Banking Amendment Act and the interest rate cap
  - Fiscal policy: the extent to which the government does start to move ahead with fiscal consolidation
  - Agriculture sector growth: whether there will be normal rainfall trends in the coming year
  - Business sentiment: the IHS Markit/ Standard Bank Purchasing Manager Index rose to 53.0 in December, from a recent low of 34.4 in October, which is the first time back in positive territory for eight months
  - And crucially, how political events play out in the coming months
- In the light of this, a more cautious growth forecast may be a better approach. The Focus Economics, Consensus Forecast is for 5.3% growth this year
  - Citi is currently forecasting a growth rate of 5.6% for the year

Growth and sentiment in East Africa

Some ideas as to why GDP growth and sentiment may not be fully aligned

- But overall we still have a view that while there has been a broadly positive economic performance in east Africa in recent years, we still find that business sentiment in the region is somewhat constrained. This raises the question of why?
- There are a range of possible factors to take into account:
  - Two years of elections in 2016-17 in all the main economies, coupled with political unrest in Ethiopia have taken their toll on confidence
    - Especially when coupled with ongoing regional political uncertainty, notably due to the civil war in South Sudan and the terrorism threat from the Horn of Africa
  - Growth has robust and it also seems that competition seems more intense
    - And there are still ongoing concerns about the weather and food price inflation
      - High food price inflation has impacted on low income households and consumption
  - The low implementation pace of government infrastructure projects
  - The are concerns about the health of the banking sector across the EAC which has already forced central banks in the region to take action
  - The lack of an oil/gas sector kicker to the growth story: counter intuitively, could higher oil prices be positive to confidence in an oil importing region?
  - Concerns about the EU-EPA agreement

Inflation trends in SSA

Inflation has generally been on an upward path since 2015 and food price inflation is an issue, especially in East Africa

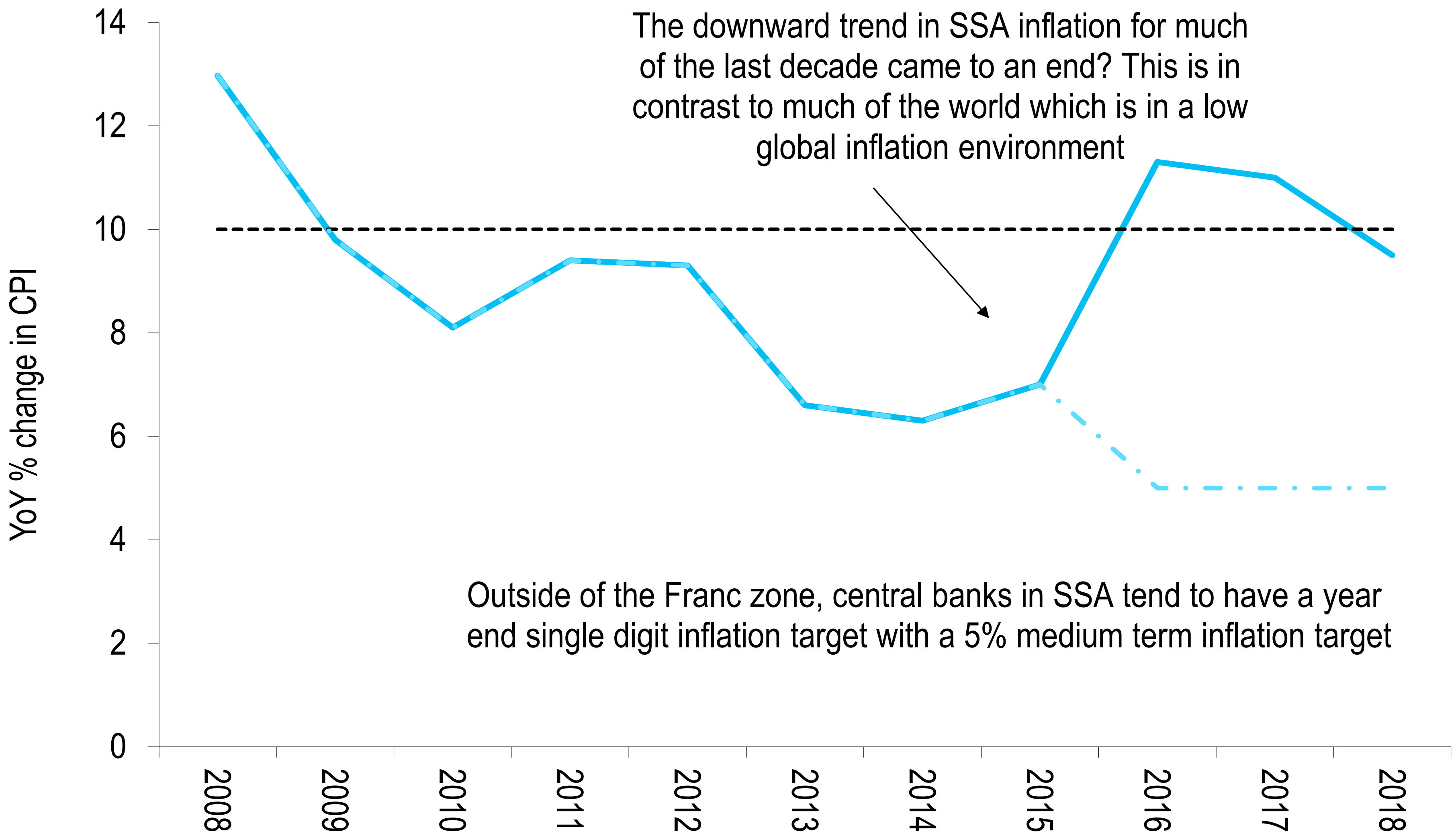
The inflation outlook in SSA

Inflation is generally going in a different direction to global trends

- Generally, the global economy is now in a period of “low inflation”. In fact, the concern until recently, notably in developed markets, was more about disinflation
  - But the inflation outlook for SSA is more complicated
    - Inflation in the CFA Franc Zone remains very low and stable
    - While elsewhere, since 2015 inflation has risen, sometimes significantly
- There seem to be three major factors behind this:
  - Harvests in a range of countries have been negatively impacted by droughts or floods and long standing structural issues about cross country trade and storage. On average food price inflation in SSA from 2009-16 was 1.4 percentage points higher than non-food price inflation and driven by “fresh food” price inflation
  - Weaker currencies, or foreign currency shortages, in recent years have meant imported inflationary pressure have built up
    - A general rule is that a 10% currency depreciation pushes the inflation rate up by 1 to 1.5 percentage points
      - But there is considerable variability across countries
  - Significant fiscal deficits have been an underlying factor driving inflationary pressures which have not been entirely offset by tight monetary policies

Has the downward trend in inflation in SSA come to an end?

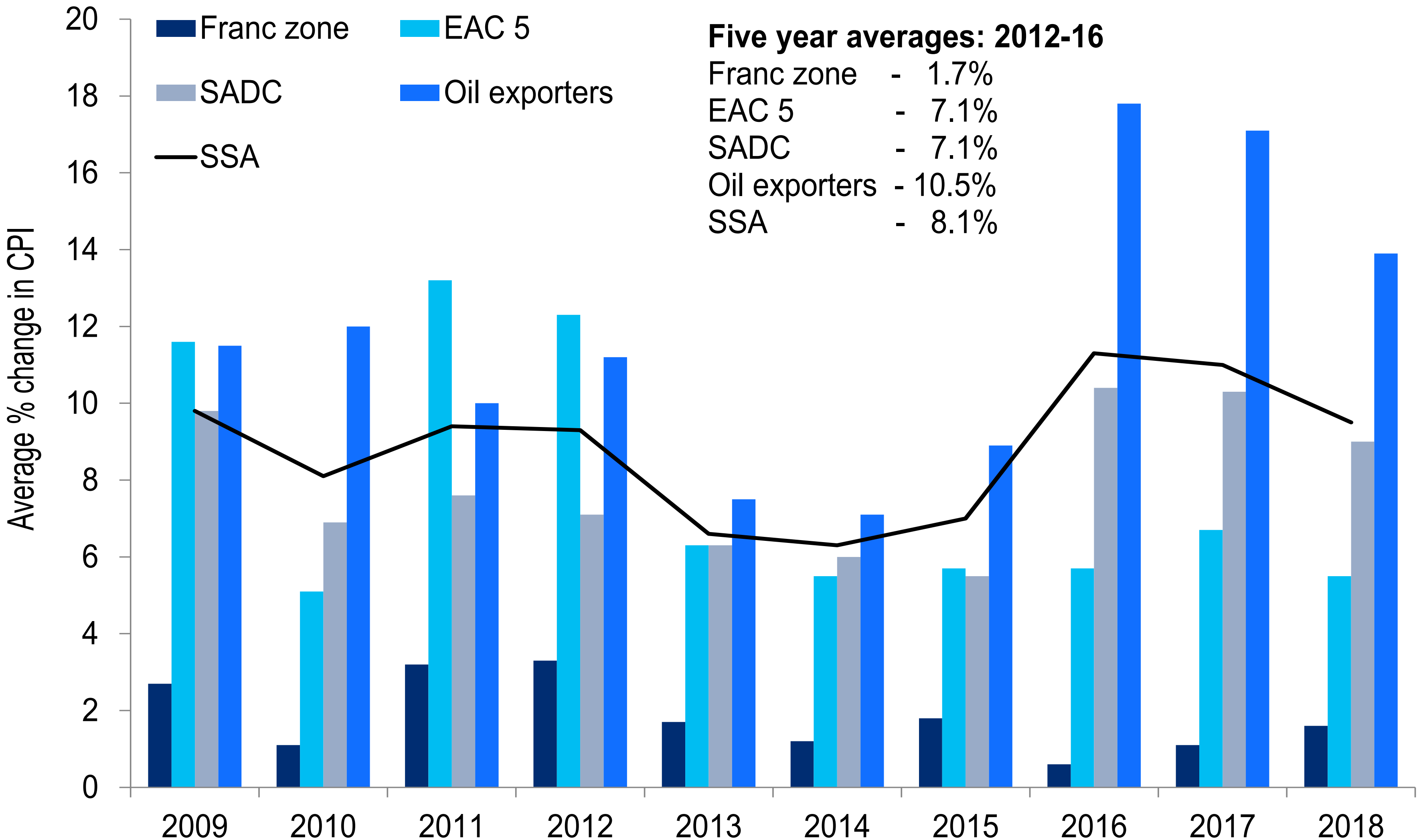
Inflation rose in 2015, has remained elevated since, and will only ease gradually into 2018



Sources: IMF and Citi Research forecasts for 2017-18

Considerable inflation differentials around SSA

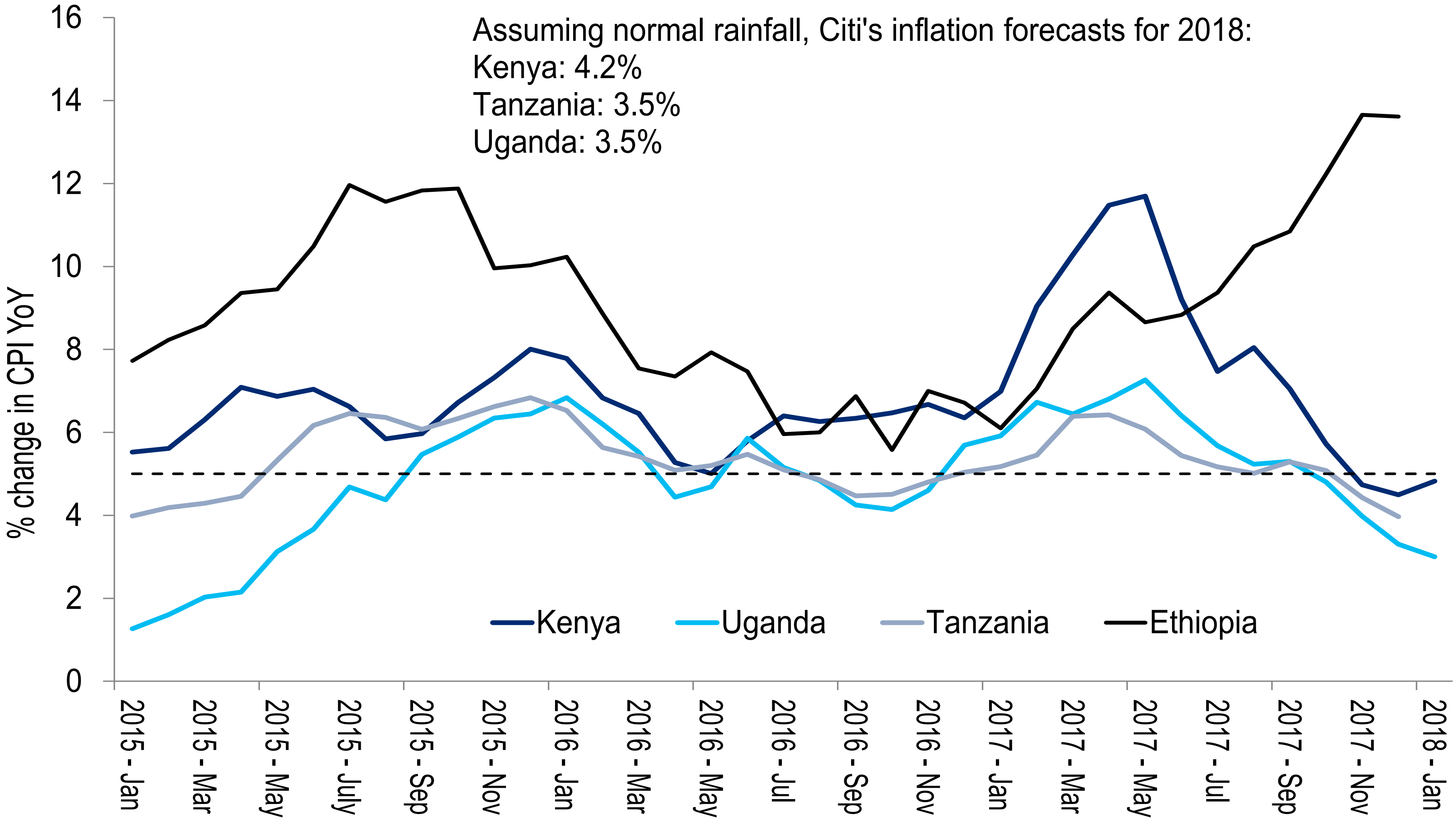
Inflation remains low in the Franc Zone, high in oil exporters and most variable in the EAC



Sources: IMF and Citi Research forecasts for 2017-18

East African inflation

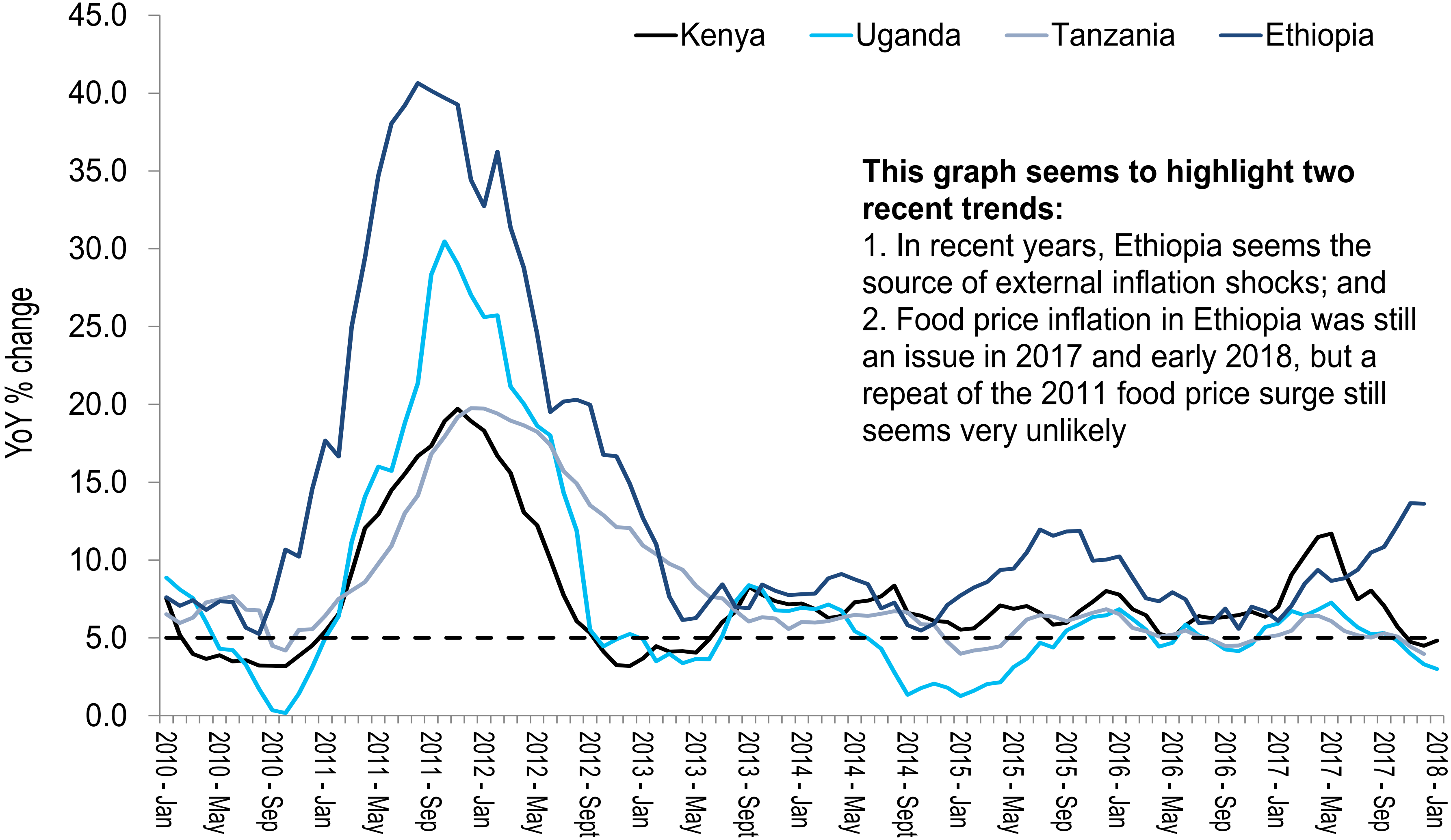
Inflation could well prove to be very low in Tanzania and Uganda in 2018



Sources: National Statistical Agencies and Citi Research.

A repeat of the 2011-12 inflation hump seems unlikely

Although the food price problem still seems to originate in the Horn of Africa

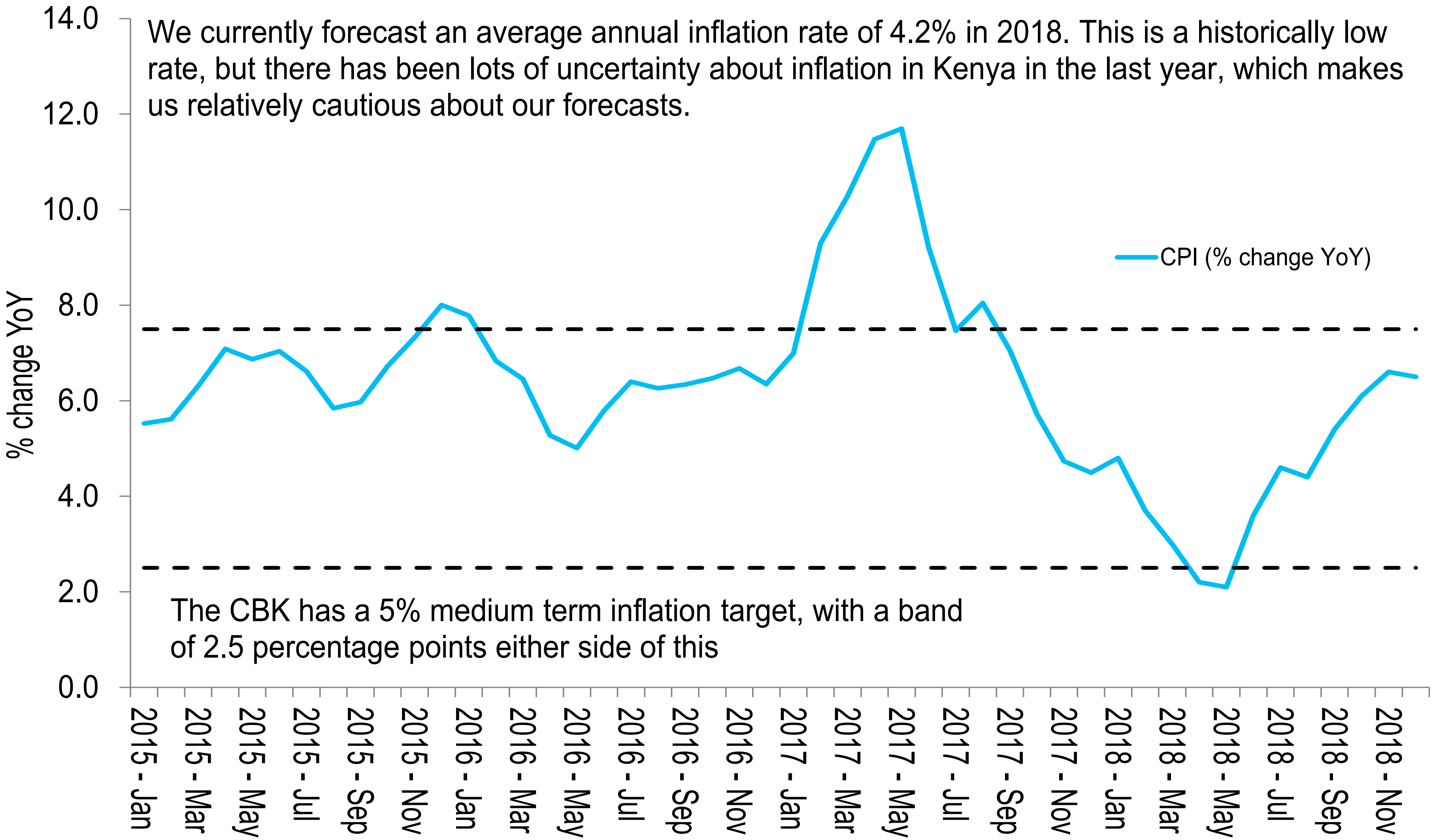


This graph seems to highlight two recent trends:
1. In recent years, Ethiopia seems the source of external inflation shocks; and
2. Food price inflation in Ethiopia was still an issue in 2017 and early 2018, but a repeat of the 2011 food price surge still seems very unlikely

Source: National Statistical Agencies, Haver Analytics and Citi Research

Our current Kenyan inflation forecast

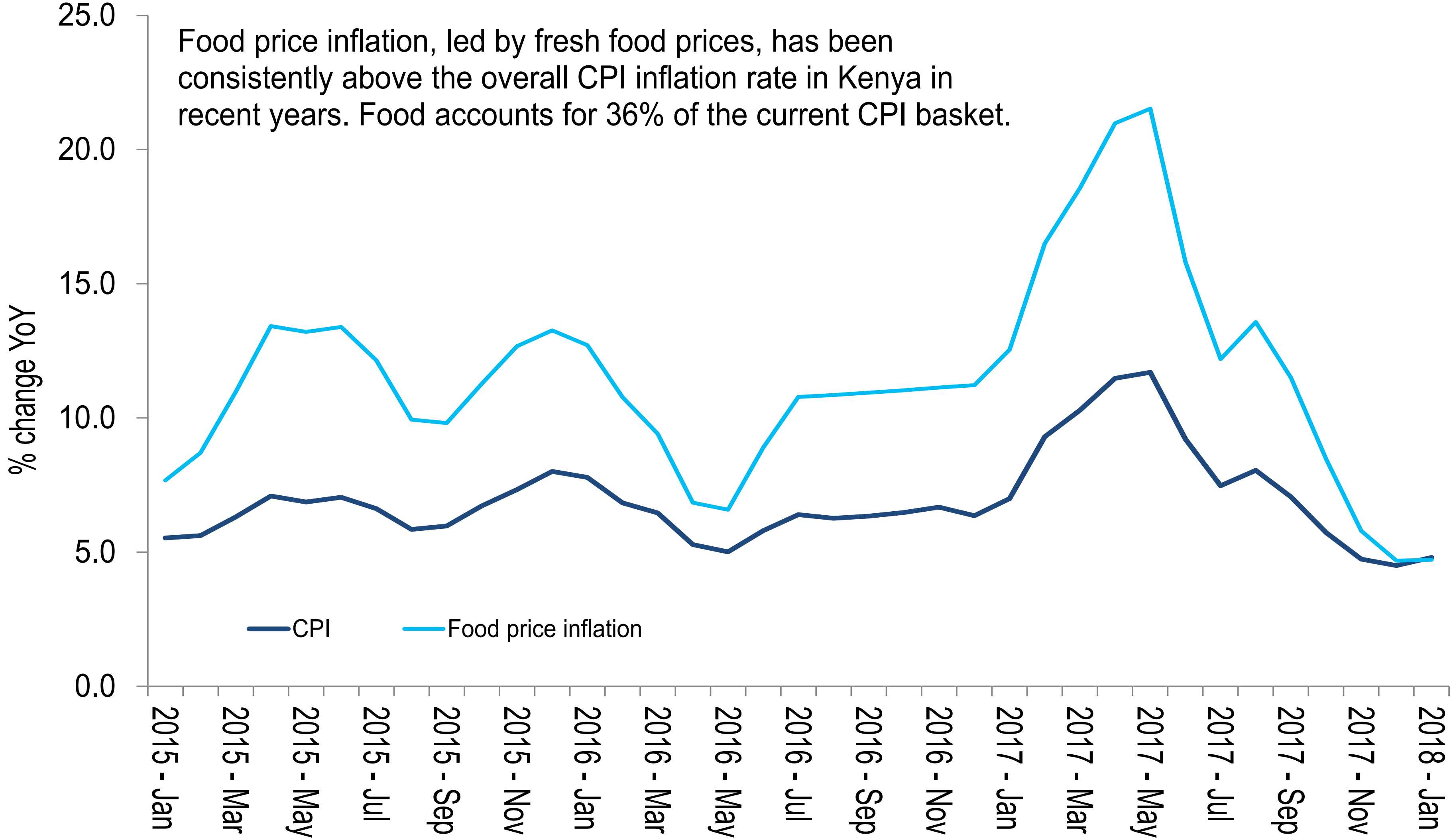
Inflation has been very volatile in Kenya in the last year, creating considerable uncertainty



Source: Kenya National Bureau of Statistics, Haver Analytics and Citi Research for 2018

Kenyan inflation trends

One of the main problems has been forecasting food price inflation



Source: Kenya National Bureau of Statistics, Haver Analytics and Citi Research

The twin deficits in East Africa

Where to now?

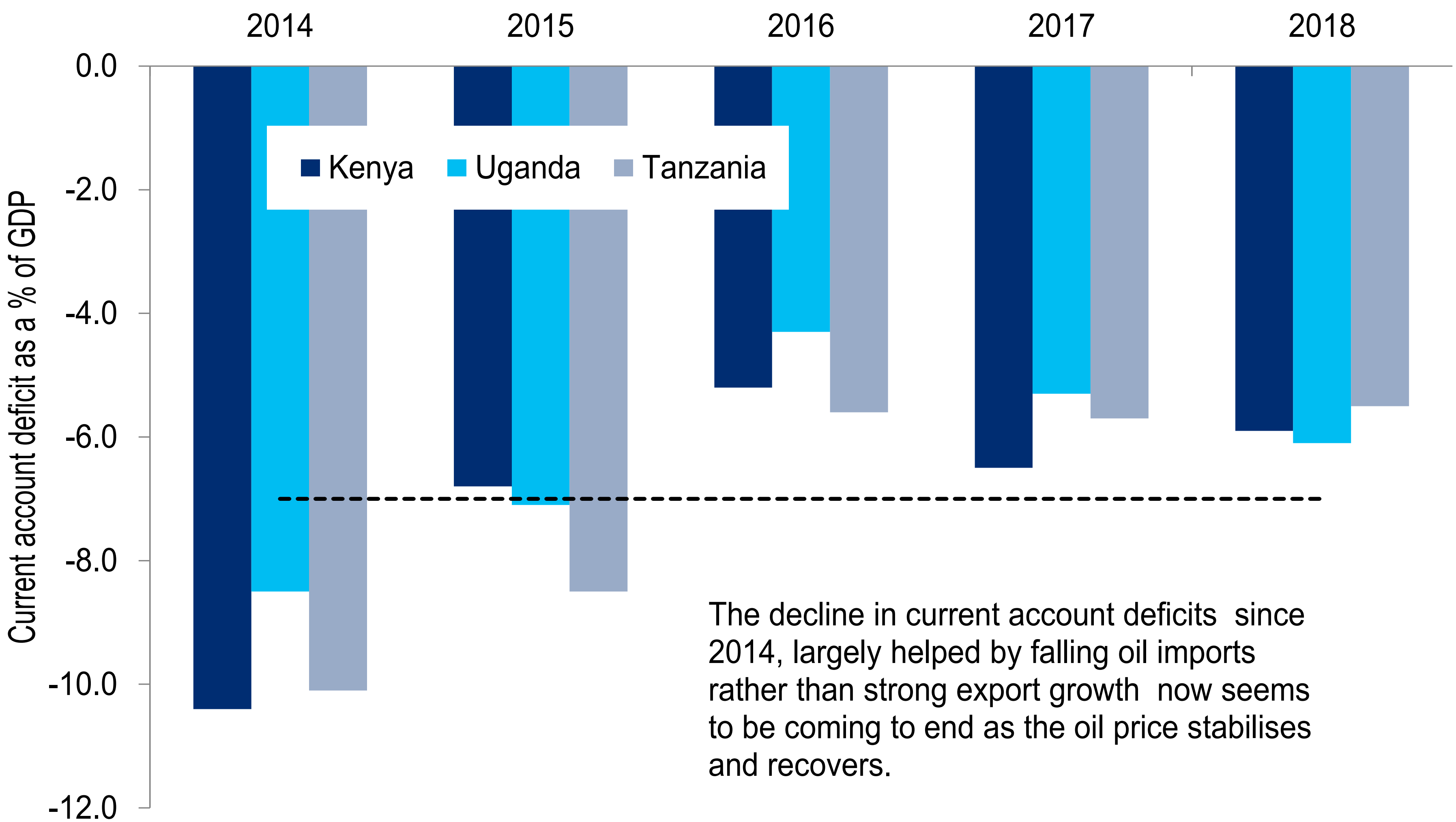
The twin deficits in East Africa

The size of the fiscal deficits are still concerning

- From 2012-14 we had increasing concerns about the size of twin – fiscal and current - deficits in the East Africa sub-region and their long term sustainability. In particular, current account deficits were in double digits. However, they fell significantly in 2015-16:
    - Kenya – from 10.4% of GDP in 2014 to 5.2% in 2016
    - Tanzania – from 11.2% of GDP in 2014 to 4.2% in 2016
    - Uganda – from 8.3% of GDP in 2014 to 4.7% in 2016
  - However, they have stabilised at these levels in 2017 and may even pick up again in 2018
- On the fiscal front, what is clear since early 2016 is that fiscal consolidation is not really happening
  - However, Tanzania and Uganda are both in post election periods and while their fiscal deficits are significant, they are not "excessive"
    - We expect the fiscal deficits to remain at current levels in both countries as both governments remain committed to boosting capital spending
  - In Kenya, the process of fiscal consolidation has made no progress and the deficit has remained significant in recent years
- Overall, the government debt stock for the EAC-5 has risen from 35.4% of GDP at the end of 2013 to an estimated 46.9% of GDP at the end of 2017
  - This is a sharp rise of over 10 percentage points over a limited period, although the total is still within acceptable ranges

Current account deficits have fallen

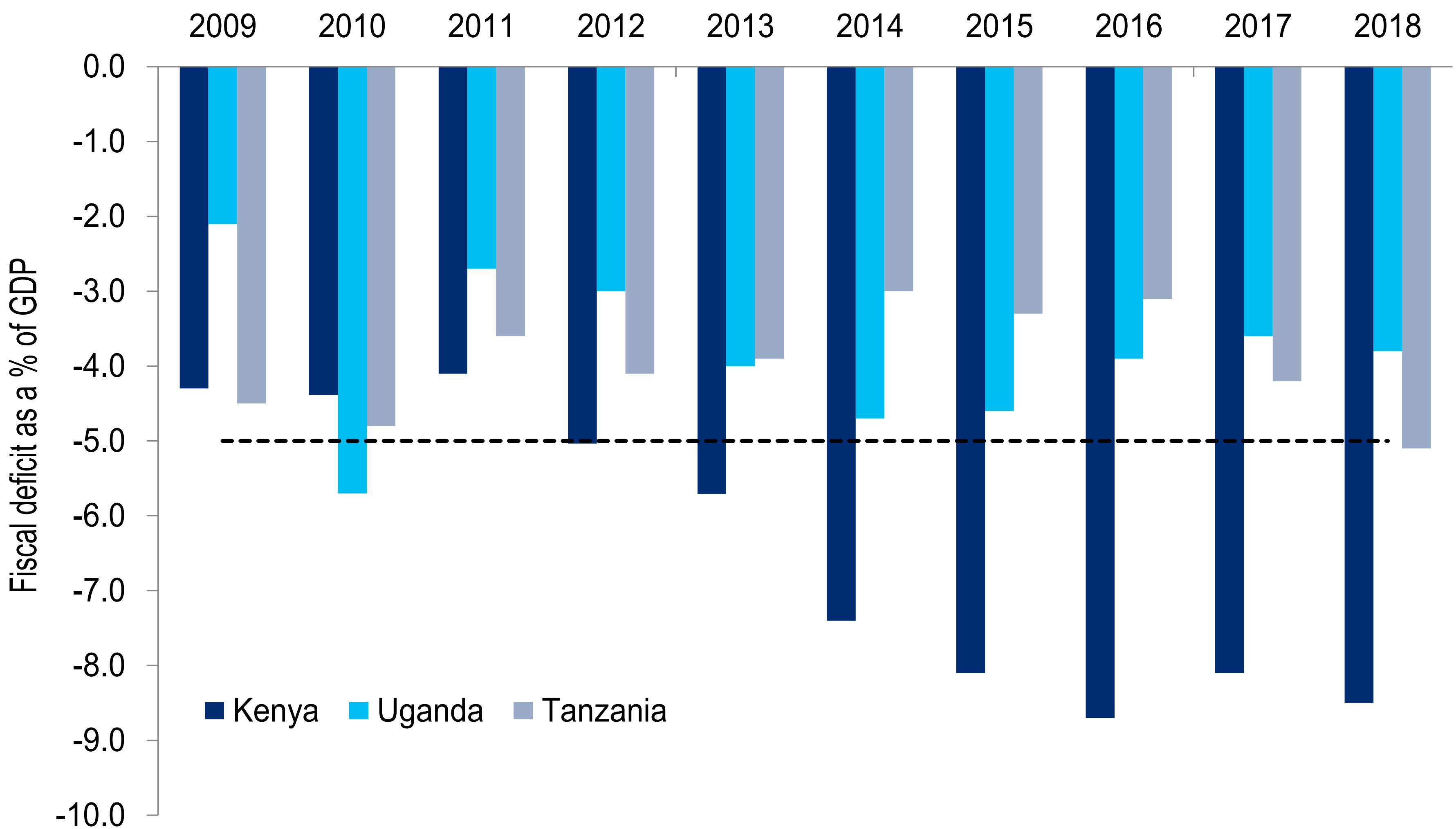
But this trend has now slowed down and even reversed as the oil price has recovered



Source: IMF and Citi Research estimates for 2017-18

Fiscal deficits in East Africa

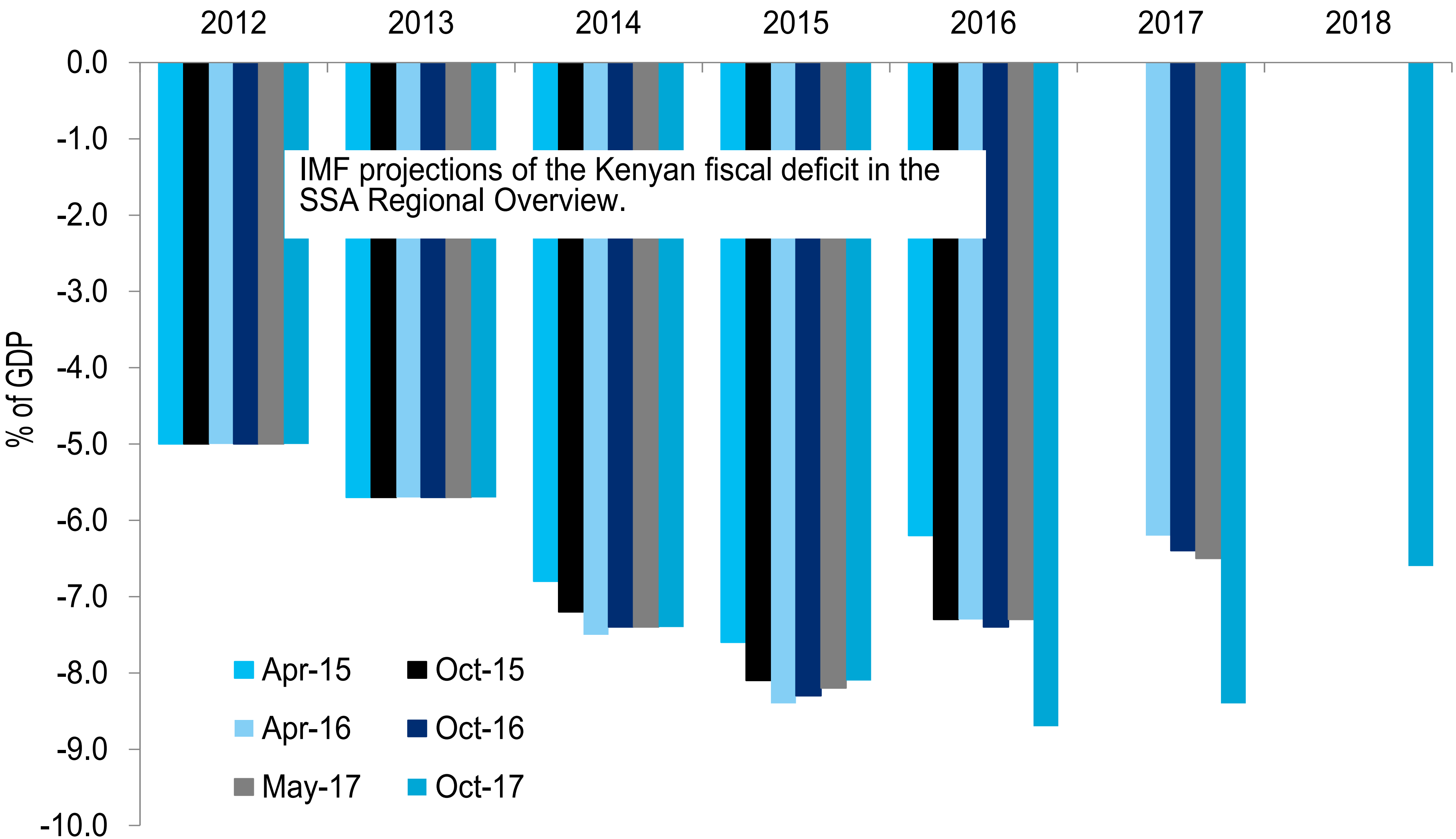
Kenya's fiscal deficit is now looking very much more concerning than for Tanzania or Uganda



Source: IMF and Citi Research estimates for 2017-18

Illusive fiscal consolidation in Kenya

Despite the IMF constantly forecasting fiscal consolidation, the deficit has remained wide



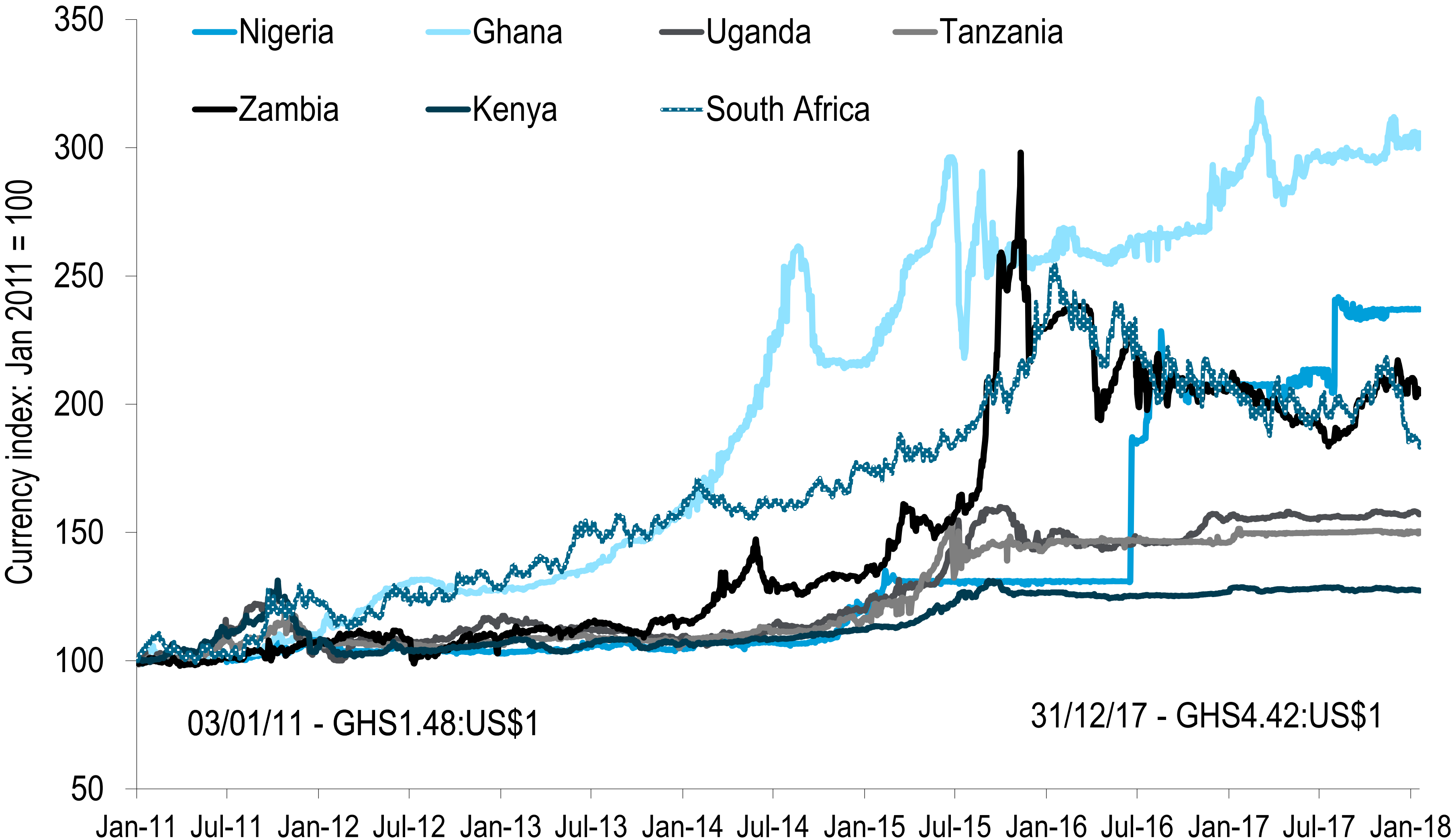
Source: IMF

What does all this mean for the shillings?

Or why has KES been so stable?

Who will follow the Ghana cedi?

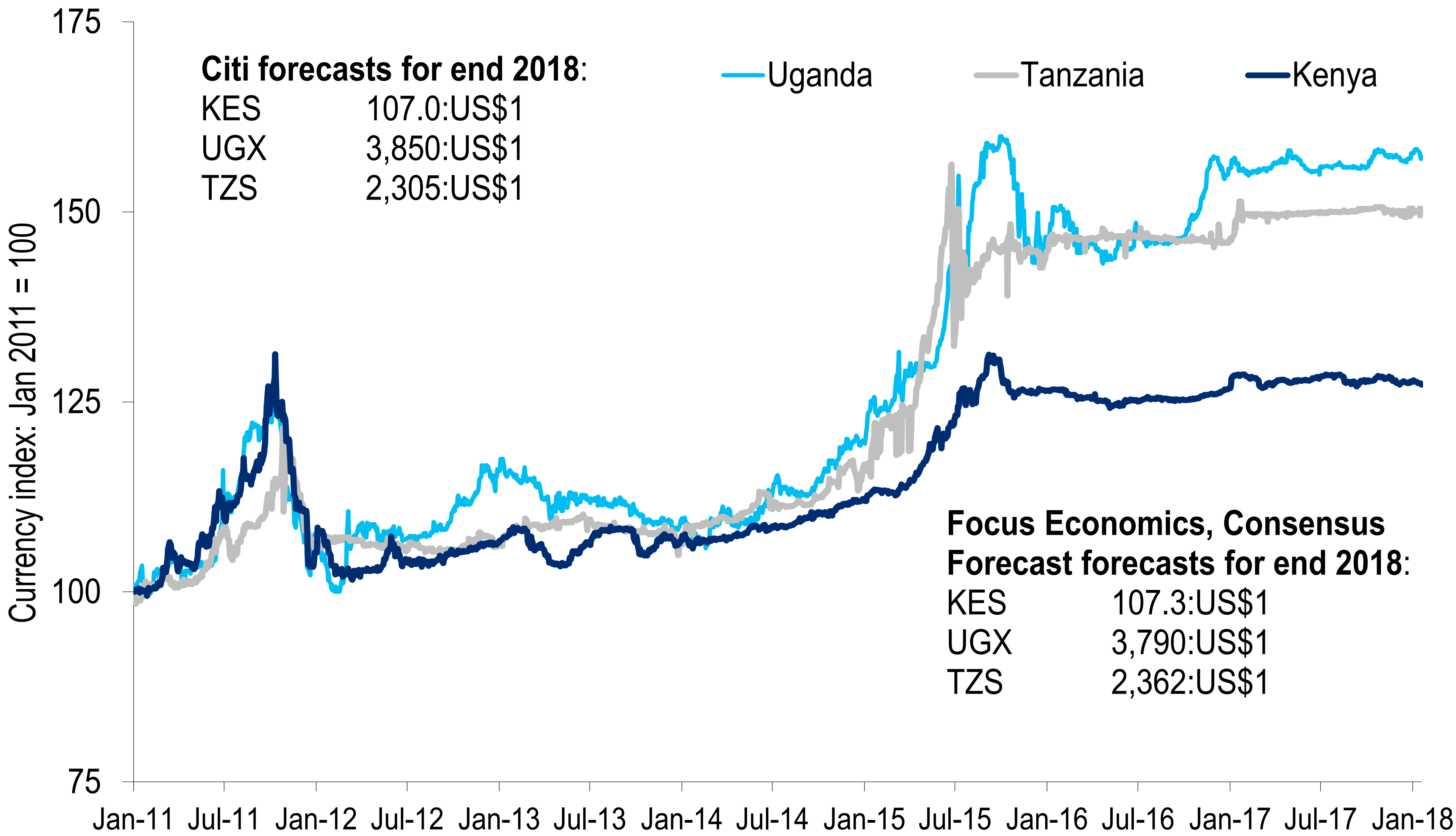
Apart from the shillings, a number of currencies have been under real pressure



Source: Bloomberg and Citi Research

The East African shillings have been stable in 2016-17

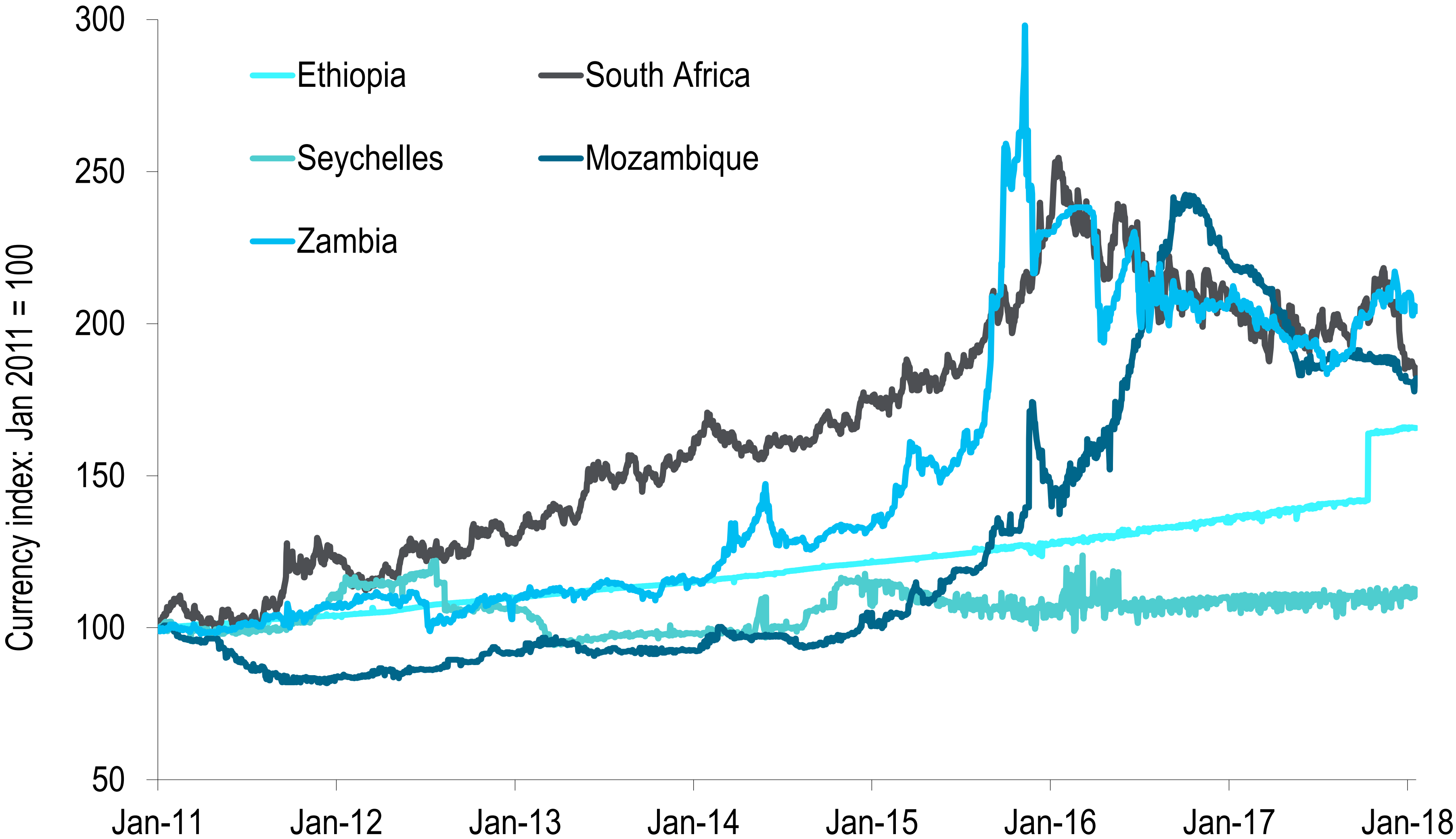
At present there are no signs of immediate pressure in the coming year



Source: Bloomberg and Citi Research

The Ethiopian birr is the other source of concern

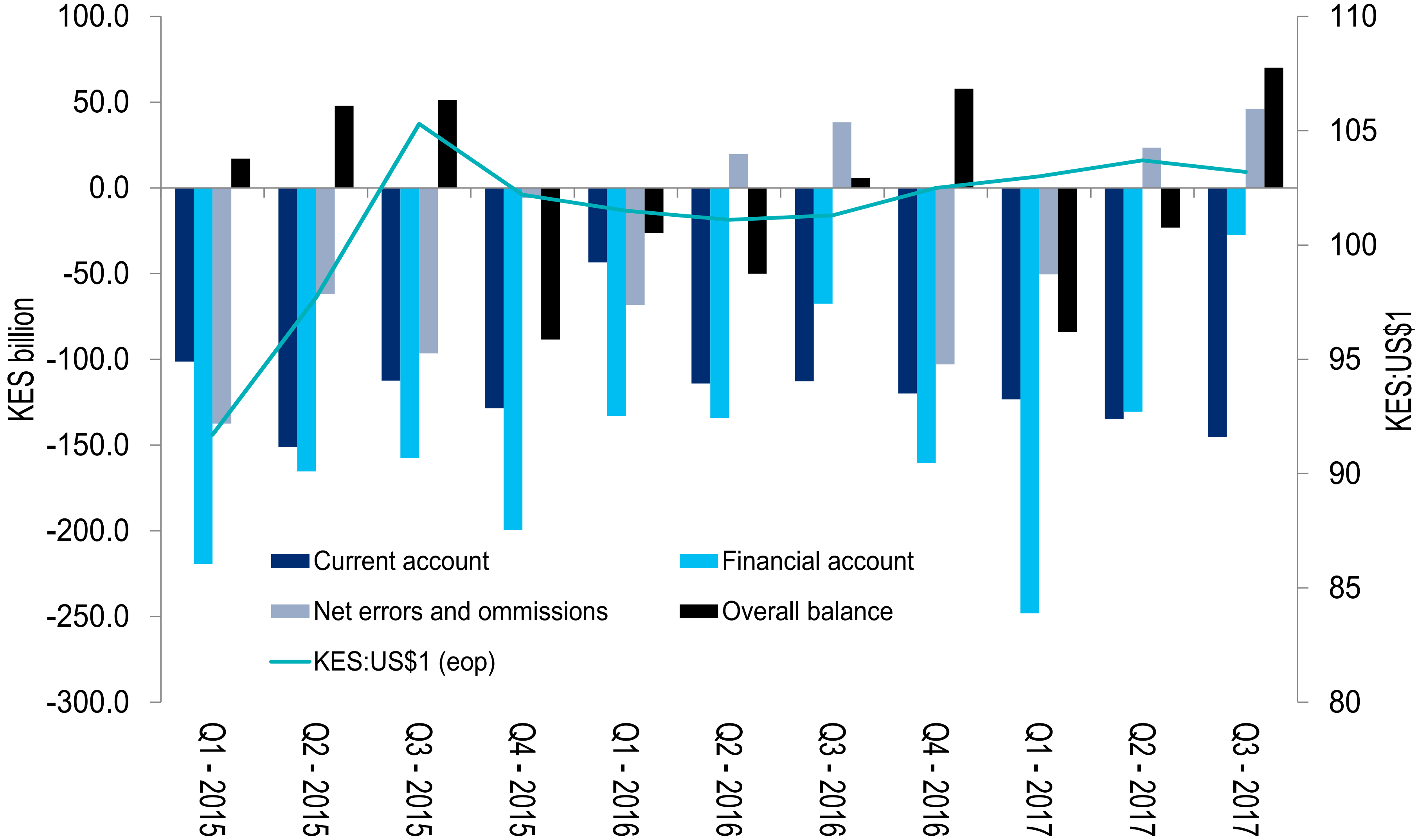
It seems unlikely that the recent devaluation of around 20% is sufficient



Source: Bloomberg and Citi Research

Funding the current account deficit in Kenya

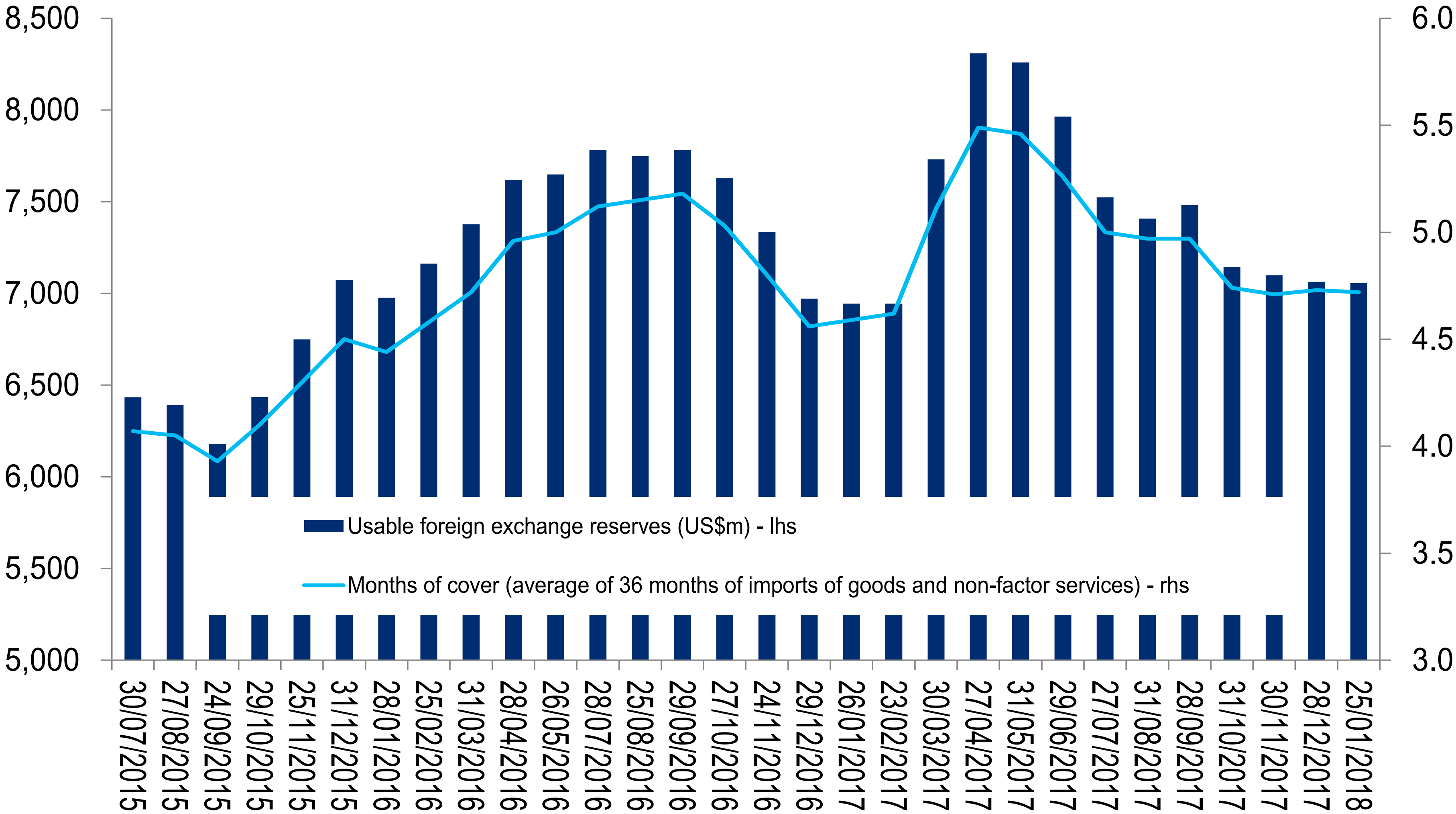
The data continues to indicate that capital flows remain robust



Source: Haver Analytics, Central Bank of Kenya and Citi Research

Foreign exchange reserves continue to hold up into early 2018

This may indicate that pressure on KES is not imminent



Source: Central Bank of Kenya and Citi Research

The market generally forecasts too much KES depreciation

But it may have broadly got the forecast correct in 2017

- The market seems to consistently overstate the expected depreciation of KES in recent years. Focus Economics, Consensus Economics forecasts for the KES:US$1 show:
  - **January 2012** the consensus forecast for year-end was KES96.5:US$1. The outturn at the end of December 2012 was KES86.0:US$1;
  - **January 2013** the consensus forecast for year-end was KES90.8:US$1. The outturn at the end of December 2013 was KES86.3:US$1;
  - **January 2014** the consensus forecast for year-end was KES91.6:US$1. The outturn at the end of December 2014 was KES90.6:US$1;
  - **January 2015** the consensus forecast for year-end was KES93.8:US$1. The outturn at the end of December 2015 was KES102.3:US$1;
  - **January 2016** the consensus forecast for year-end was KES108.6:US$1. The outturn at the end of December 2016 was KES102.5:US$1; and
  - **January 2017** the consensus forecast for year-end was KES106.0:US$1. The outturn at the end of December 2017 was KES103.2:US$1.
- This seems to highlight two things. First, from 2012-14 the market continued to expect considerable KES weakness. As this did not materialize, it expectations adjusted down to expect less weakness. But this adjustment process was disrupted in 2015 so the market went back to forecasting more depreciation than materialized in 2016. Since then it seems that the market has continued to forecast depreciation, but has scaled back its expectations of it

The overall economic outlook for East Africa and Kenya in 2018

Can a more sustained pick up in growth occur?

What to make of all this?

A more complicated growth story than is commonly percieved

- 2015 and 2016 were difficult years for SSA in macroeconomic terms and for investors
  - Weak or sharply falling growth in the larger economies and oil exporters, rising inflation and weakening exchange rates in many countries have impacted on confidence
    - But we think this is an important reality check with respect to the African growth story
  - But it does seem that 2017 marked the bottom of the current slowdown with a slow recovery now underway in both Nigeria and South Africa, which should push up the overall growth rate

- In East Africa, the overall macroeconomic outlook has been positive
  - Growth has held up in the 5% range, although clearly it is under some pressure and maybe lower than expectations and against the background of strong competition
  - Inflation has been volatile, driven by food prices, but "not excessively so", and maybe heading into a quite low period in 2018
  - There has been a considerable degree of exchange rate stability, notably with respect to the Kenyan shilling
    - Although the other two shillings, Tanzania and Uganda have been a bit more volatile
  - And even some consolidation of the twin deficits, although this is more limited in Kenya, especially with respect to the fiscal deficit

The Kenya outlook in a little more detail

Many to move

- The fiscal deficit does remain a major concern for us and especially if the current account deficit were to widen out more than we currently think in the coming years (however, on a positive note Citi Research does expect the oil price to slip back significantly in 2H 2018)
  - Moreover, as long as capital flows into Kenya remain robust, we do not expect the Kenyan shilling to come under significant pressure this year
    - The biggest macroeconomic cloud on the horizon remains the fiscal deficit. We are looking very closely for signs of real moves towards fiscal consolidation in 2018, notably in the June 2018 budget
- We think that inflation will remain low and within the Central Bank of Kenya (CBK) target in 1H 2018, but that it could pick up towards the top end of the range in 2H 2018. We have it picking up to around 6.5% YoY by the end of this year
  - How the CBK responds to this fall and rise in inflation over the course of the year will depend considerably on whether revisions to the Banking Amendment Act are possible
- Growth should bounce back this year. We still think this will be a relatively modest pick up, but are some indications that this could be more significant than we are currently forecasting

But a lot will depend how politics plays out

Sometimes there is too much focus on elections

- Although we have had a major focus on politics in East Africa as we have moved from one election to another in 2016-17, in some ways elections are just set piece political events which a story can be hung around
  - But in reality, often in Africa the real political crises do not occur around elections
- This seems most obvious in Kenya, where there needs to be some form of political resolution to the disputed presidential election of 2017
  - But it is also the case that political issues remain in both Uganda and Tanzania after the elections
  - And maybe in Ethiopia around the May local/municipal elections
  - While the Burundi political crisis currently remains unresolved
  - And all this plays out against ongoing regional issues, notably in the Horn of Africa and the civil war in South Sudan

Appendix A-1

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