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Africa Economics & Strategy Weekly

Prolonged political uncertainty in Kenya and price pressures in Egypt

- **Kenya: The economic impact of prolonged political uncertainty** — Although the recent ruling by Kenya's Supreme Court that the presidential election needs to be re-run is a welcome sign of judicial independence in Africa, the prolonged political uncertainty this is creating is starting to creep into our economic forecasts, even if the impact should not be overstated.

- **Egypt: When will inflation turn?** — The sharp rise in inflation in Egypt in 2017 has been both more pronounced and prolonged than both we, and the market, initially forecast. This reflects the sharp rise in food prices. However, there are signs that the drivers of inflation are changing from the weaker currency to the removal of subsidies. Coupled with the impact of base effects, this should mean that inflation moves towards the Central Bank of Egypt's new inflation target in 2H 2018.

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The economic impact of prolonged political uncertainty

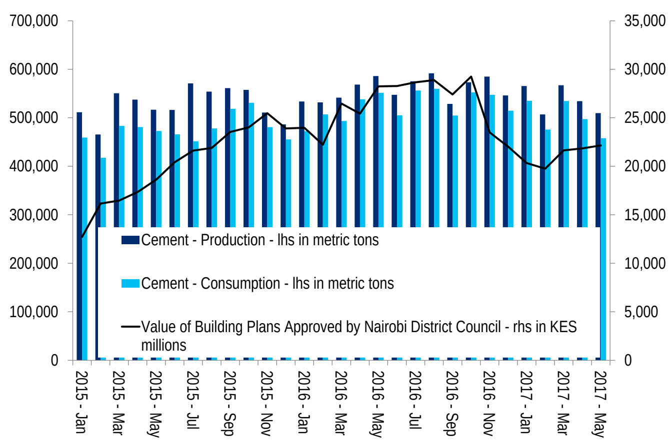
By annulling the August presidential election result, Kenya's Supreme Court gave a ruling on September 1 which showed its independence and was largely unexpected by the market, and arguably the country at large. In terms of the practicalities of the re-run, under the current constitution the election has be held within 60 days of the ruling, which provides a statutory time limit of November 1. At present, the date for the new ballot has been set for October 17, and while there could be slippage on this, we think it is unlikely to breech the November deadline. Unsurprisingly, in this environment the focus of much analysis has been on the potential political implications of re-holding the vote, whereas the potential impact on the economy has been less examined.

The first point to note is that we had expected growth to slow this year with the general uncertainty that was always likely to surround the poll, both political and business, whether it was completed in one round, there was a run-off or a re-run. As such we had pretty much stuck with the forecast that real GDP growth will ease from 5.8% in 2016 to 5.2% this year. Moreover, we had not changed this even though real GDP growth did slow more significantly than expected in Q1 2017 to 4.1%. This is because there is an argument that not too much should be read into the Q1 GDP growth number. The slowdown was largely due to the decline in the agricultural sector, where growth slipped into negative territory, rather than a more sustained and widespread economic slowdown.

But in addition to this growth data, we do now have some additional data that that indicates that after this Q1 slowdown, the economy has struggled to gain any real momentum even if there has been a very modest recovery in the agricultural sector itself. Perhaps the most significant negative data has been from the construction sector, which has been a major engine of growth in recent years. This shows that cement production and consumption data, along with the approval of new building permits, have all shown a modest decline as the August election approached.

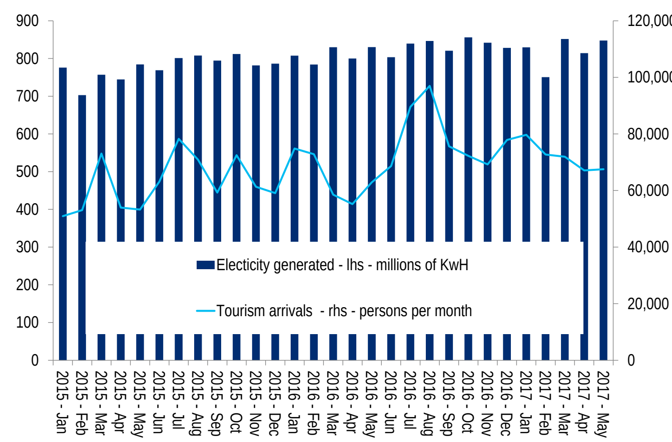
Outside of this, data has been a bit more mixed. Electricity generated has broadly been stable, although there were some problems with hydroelectric production due to the poor rains (rather like the agricultural sector) early in the year. New vehicle registrations have picked up, but domestic vehicle assembly has been stable. Tourist arrivals showed a pick-up in late 2016 and into early 2017, but have eased off since then.

Figure 1. Some construction sector indicators



Source: Haver Analytics and Citi Research

Figure 2. Electricity and tourism data



Source: Haver Analytics and Citi Research

Another and slightly more up to date indicator of the economic uncertainty is provided by the Markit Stanbic Bank Kenya Purchasing Managers' Index (PMI). This fell to 42.0 in August, from 48.1 in July, or a new low since the series began in January 2014 (a PMI below the 50.0 level reflects a negative economic outlook which has been the case since May).

But it is not just politics that has held the economy back. The poor performance of the agricultural sector has meant that inflation, driven by food price inflation, has remained elevated in Kenya in the first half of this year, which coupled with the political uncertainty has meant that consumption has generally remained under pressure. Moreover, with the passage of the Banking Amendment Act in late 2016, the Central Bank of Kenya (CBK) has been stuck in a dilemma about how to effectively respond to this.

Having highlighted these concerns, it is still worth stressing that we think the overall economic slowdown has remained moderate to date. We would now not be surprised if growth fell below 5% for the year, which would be the lowest level since 2012 when it was only 4.6%. Moreover, in the case of inflation, although we think that the CBK will struggle to bring it back within its inflation target – 5% plus or minus 2.5 percentage points – in 2H 2017, it should creep back into the target range in early 2018 assuming that the rains are normal.

Moreover, with robust foreign exchange reserves and a slow moving market, the overall political uncertainty and the lack of monetary policy direction, has had little overall impact on the Kenyan shilling. Generally, the worst sort of economic crisis occur in Africa when political uncertainty spills over into currency weakness, which then means that overall confidence can quickly evaporate. In many ways, the converse remains the case in Kenya, with provisional balance of payments data up to March continuing to show robust capital inflows into Kenya continuing to finance the current account deficit as the country continues to attract regional capital inflows, at least in part because of its greater political stability than many of its neighbours.

In addition, the main weakness in the Kenyan economy, the fiscal deficit remains fundable. We still have significant long term concerns about the potential impact of fiscal deficits of the size recorded in recently years on the overall economic outlook for Kenya if it is not brought under control after the elections. But it seems unlikely that the deficit will run out of control around the elections, even given the cost of holding the presidential re-run[1]. Although revenue will now be under pressure for a more prolonged period than expected, and as growth slows, the reality is that new government spending, notably capital spending, will be severely constrained by the prolonged political uncertainty.

But while we now expect that the economy is likely to move on a modest downward trajectory in 2017, the real question about where the economy goes into 2018 is unresolved given that the new political uncertainty will now cast its shadow over much 2H 2017. There are considerable differences amongst political forecasters about the outcome of the election re-run between Uhuru Kenyatta the incumbent president, and Raila Odinga, his main challenger. Given the potentially closer nature of the contest over the coming months, it will be interesting to see whether this means that economic policy takes more of a role in the political spotlight than seemed the case the first time around.

The lack of economic policy debate the first time around probably reflects the reality that there is not a huge difference in terms of economic policy for the electorate to choose from. Effectively both candidates are broadly centrist in terms of economic policy, with Uhuru Kenyatta probably right of centre and Railia Odinga, left of centre. But there are still some identifiable differences.

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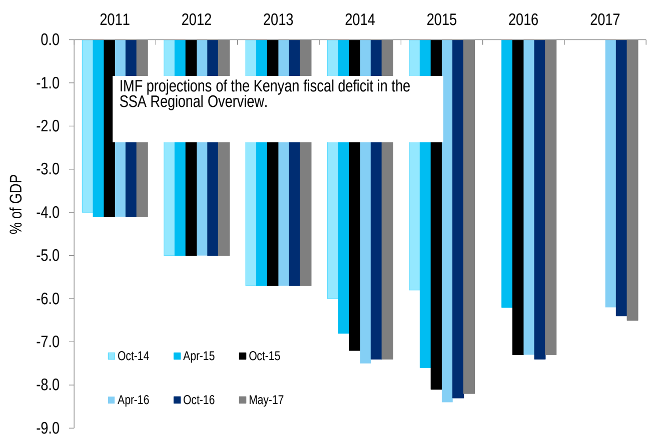
[1] It is estimated that the multiple August elections cost around US$500m to conduct. However, as the re-run is just a two candidate presidential poll, its cost should be much lower.

- We would expect a second term Kenyatta administration would be able to get its policy programme quickly up and running. While there will be some degree of cabinet reshuffling, the thrust of policy will be the same as recent years, which has seen the government pushing ahead with infrastructure investment led growth. However, in a second term there is likely to be more focus on the need to bring the fiscal deficit down to more acceptable levels. To achieve this, revenue collection will move centre stage with perhaps less emphasis on super large infrastructure projects and more on smaller projects.

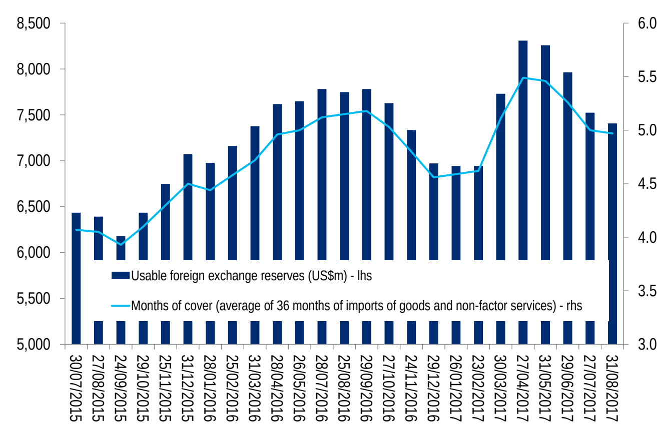
- In the case of an Odinga administration, there is the potential for a considerable delay in getting ministers appointed, as there is likely to be much more political bargaining within a larger and more unwieldly coalition over ministerial postings. This could also be complicated as we would also expect the administration to show a greater commitment to the fiscal decentralization and the transfer of spending to county governments. Whether this slows the potential pace of fiscal consolidation is not clear, but it is plausible that fiscal consolidation will move ahead more slowly.

Figure 3. Illusive fiscal consolidation in Kenya



Source: IMF and Citi Research

Figure 4. Foreign exchange reserves



Source: Central Bank of Kenya, Weekly Statistical Bulletin and Citi Research

If fiscal consolidation is the main economic issue facing whoever wins the elections, what will also be important for the economic team of whoever wins the election is their relationship with the IMF. Although the IMF has consistently projected that Kenya will move onto a path of fiscal consolidation in recent years, the deficit has largely moved in the opposite direction into high single digits as a percentage of GDP.

This is at least in part because of the approaching elections, but also partially because Kenya only has a stand-by facility with the Fund. This is useful as a back-up if the economy was to hit a crisis, as it provides a substantial fallback financing option for the government. But until the facility is drawn down, it does mean that the Fund's has less influence on policy than if Kenya was on a more active IMF programme. The current programme is due to expire in March 13, 2018 and so with the election delay, the approach taken over negotiations with the Fund for any potential new programme will be one of the key indicators of commitment to fiscal reform in Q1 2018.

And how do we think the presidential re-run will play out? While the Supreme Court ruling has clearly given the Odinga campaign a new momentum, its preliminary statement noted that the decision was based on irregularities and illegalities in the way the vote count was conducted, rather than any evidence of serious misconduct as has been alleged by Mr Odinga. If this is the case, we still think it will hard for the Odinga campaign to overturn the margin of nine percentage point victory which Mr Kenyatta won the August vote especially as finance will be more constrained for the opposition alliance in the coming months.

Egypt

When will inflation turn?

The path of Egyptian inflation has surprised us in two major ways since the devaluation of the Egyptian pound in November 2016.

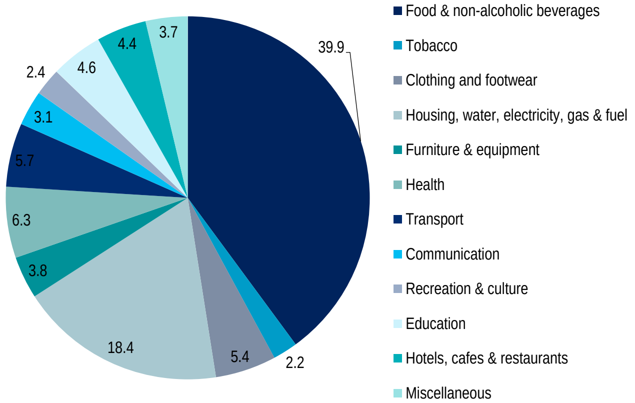
- First, it has risen to a higher peak than we initially expected. In the January forecast round for Emerging Markets Economic Outlook and Strategy (EMEOS) we forecast that inflation would average 21.4% this year. However, we now estimate it to average 30% in 2017[2].
- Second, the typical "camel's hump" path of inflation that often occurs in Africa following a devaluation similar to that experienced in Egypt, now seems a little more illusive. While it had seemed that inflation had peaked in April, with the urban headline inflation rate reaching 31.5% YoY, and then falling in the following two months to under 30%, the pick-up in the rate to 33% YoY in July has clearly complicated the expected trend.

These trends raise two questions in our mind. First, what has driven inflation to these higher than expected levels, and second do we still think that a peak in Egyptian inflation is near?

The first thing to note is that a major factor behind the rise in inflation has been very high food price inflation. Egypt still has a large weighting for food in the consumer price index (CPI) basket: food and non-alcoholic beverages account for 39.9% of the basket of the urban inflation index. This sub-index quickly shot up to over 40% by February 2017 and has stayed above 40% since then. But having peaked at 43.6% in April we had expected it to ease after Ramadan. This initially seemed the case, but instead it picked up again to 42.4% in July.

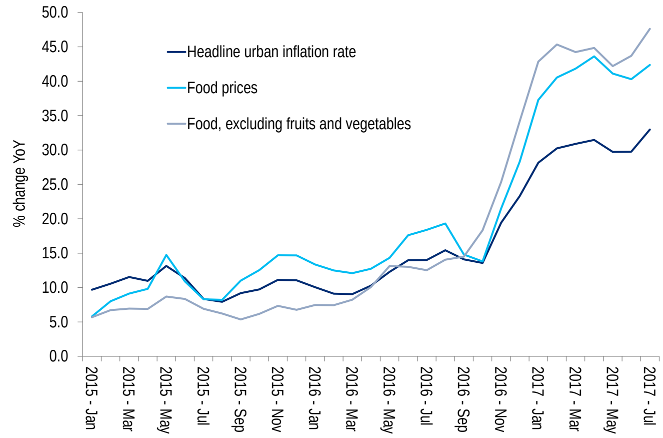
[2] The Focus Economics, Consensus Forecast published in January 2017, for average inflation in 2017, was 18.9%. Interestingly, the consensus still does not seem to be not capturing the more prolonged rise in inflation seen in the last few months, as in the September 2017 edition the average for 2017 was 25.4%.

Figure 5. Urban inflation – Percent weights in the basket



Source: Haver Analytics and Citi Research

Figure 6. Headline and food price inflation



Source: Haver Analytics and Citi Research

Part of the problem with food price inflation in Egypt compared to most other African countries, including North Africa, is twofold. First, a larger portion of food products are imported and second, a wider range of food products are subsidised. The importance of this first trend can partially be seen in the index provided by the statistical authorities which shows food price inflation, excluding vegetables and fruit. A much greater portion of fruit and vegetables are grown locally, and not surprisingly the overall food index has risen faster than the index excluding fruit and vegetables reflecting the exchange rate impact on the price of imported food.

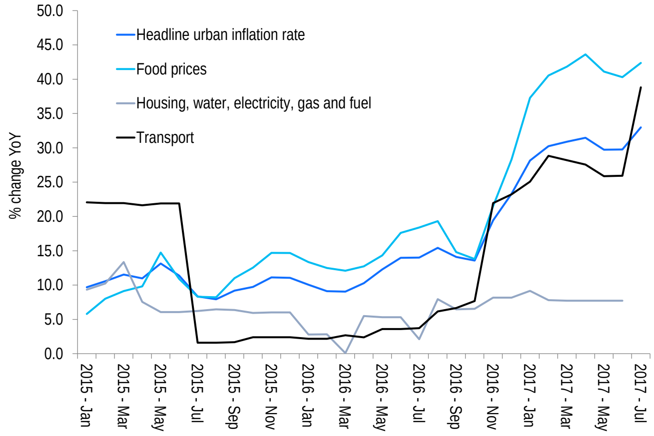
In addition, the government has probably been more willing to raise the price of subsidised food products than we expected. We had expected the food price subsidies would be removed more gradually than others. However, there have been significant price rises for a wide range of food products from bread, to olive oil and sugar, all of which have pushed up food price inflation.

Another important factor to consider about food prices in Egypt is that most products are transported by road. In fact, this is a common issue in Africa, in that rises in petrol prices, and even public transport fares, also have a knock on effect in terms of food price inflation. So although transport only accounts for 5.7% of the CPI basket, the sharp acceleration of this category, the sub-index rose from 25.9% in June to 38.8% in July, due to a combination of rising public transport fares and a sharp rise in the petrol price, may help explain the pick-up in food price inflation. In late June, the government increased the price of normal petrol and diesel by just over 50% to EGP3.65/litre.

But these trends also highlight an important issue. One way to think of the current inflation path in Egypt as a two-step process. First the impact of the devaluation pushes up prices generally, notably of imported products. Then second, this has been followed by adjustments to various regulated prices, to reduce the level of subsidy. So while the impact of the devaluation initially drove the sharp rise in inflation, as this has faded the impact of changing regulated prices has now increased as a significant driver of inflation.

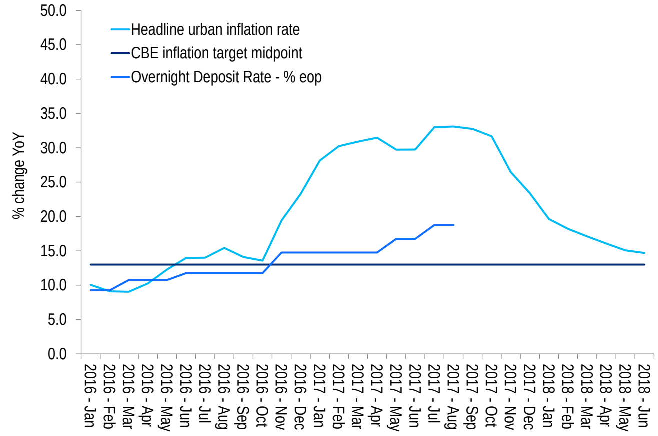
Going forward, there are arguably two main ways in which subsidized prices impact on inflation. In addition to further cuts in food subsidies, the sub-category of the CPI – housing, water, electricity, gas and water – accounts for a substantial 18.4% of the CPI. In addition, as already noted, transport accounts for an additional 5.7%. And the reality is that are going to have to be major price rises in all these areas, which will continue to impact on inflation.

Figure 7. Headline and key administered price inflation



Source: Haver Analytics and Citi Research

Figure 8. Our projected inflation path in Egypt into 2018



Source: Haver Analytics and Citi Research from August 2016

For example, even with the recently announced increase in the petrol price, it is still very low by international standards and some way off a break-even price. When announcing the recent price change, the minister of petroleum, Tarek El Molla, indicated that the change would mean that total subsidies for petroleum products in 2017-18 would fall to EGP110bn billion from EGP145bn this fiscal year. Meanwhile, the petrol price at around US$0.20/litre is still very low by international standards. Global Petrol Prices estimates that the average price around the world is US$1.08/litre. We estimate that the price in Egypt would have to rise to over US$0.60 to eliminate the subsidy. To this, there will be additional increases in subsidised prices. For example, in 2017-18 fiscal year electricity prices are set to rise between 18-42%.

We had expected Egyptian inflation to fall back quite sharply in Q4 2017. However, the path seen so far this year, means that we now expect a slower fall back in the inflation rate in the final quarter of this year and into 2018. Moreover, we also have more uncertainty over the rate of decline than we did earlier this year. However, we still remain broadly confident that even with rises in subsidized prices, the Central Bank of Egypt (CBE) can meet its inflation target of 13% (+/- 3%) by Q4 of 2018 and that inflation could then trend down into single digits into 2019. In fact, even with the projected price increases, we still think that the positive base effects that kick in from Q4 2017 mean that inflation could fall below 13% in Q3 of the 2018.

Appendix A-1

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