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East Africa in 2017 and into 2018

After all the elections are done and dusted

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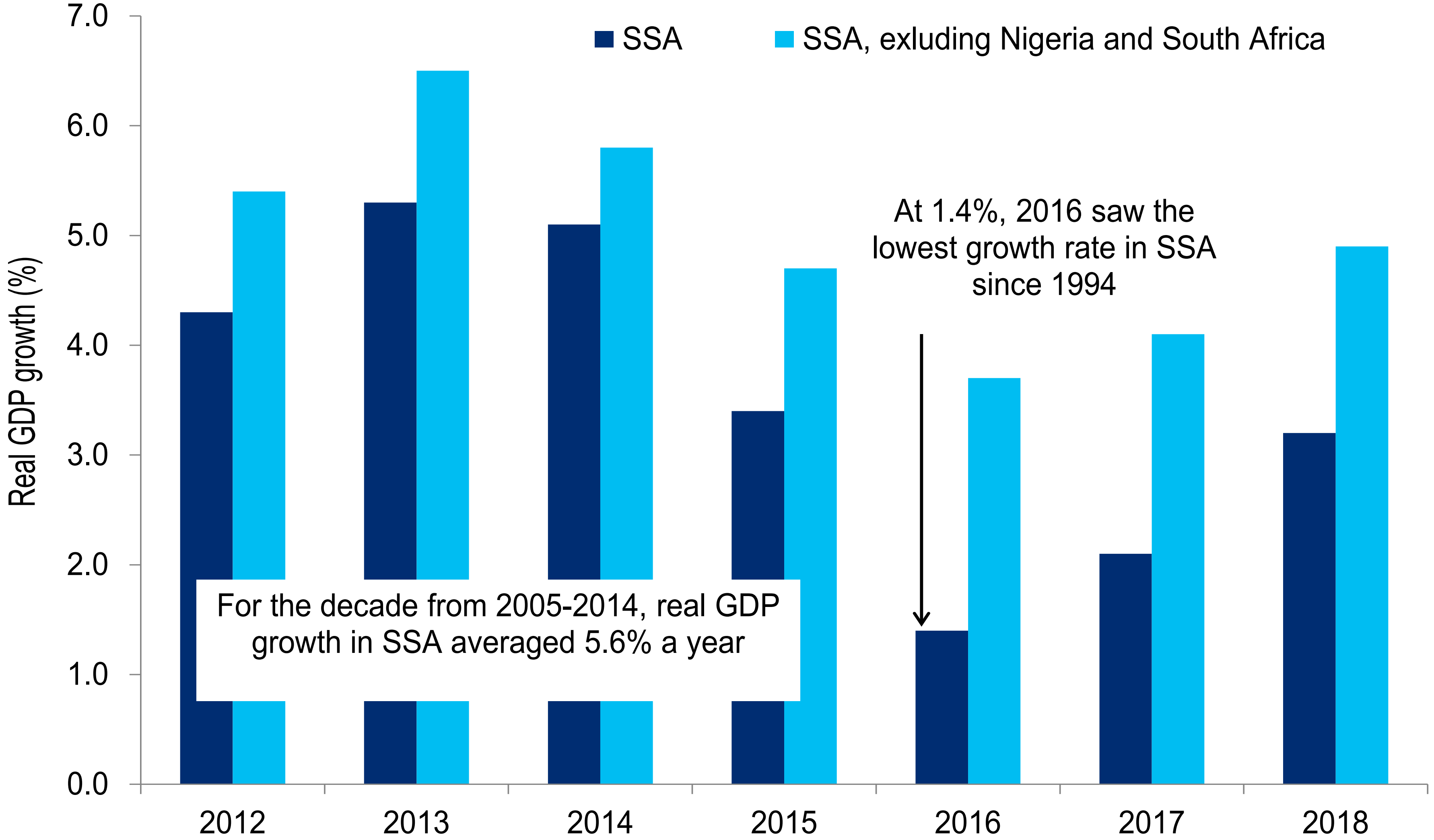
Growth in SSA slowed sharply in 2015-16

But some sub-regions continue to do well, a trend we expect to continue in 2017-18

The headline growth rate for SSA in 2016 was poor

We expect a slow recovery in 2017, which should gain modest momentum in 2018



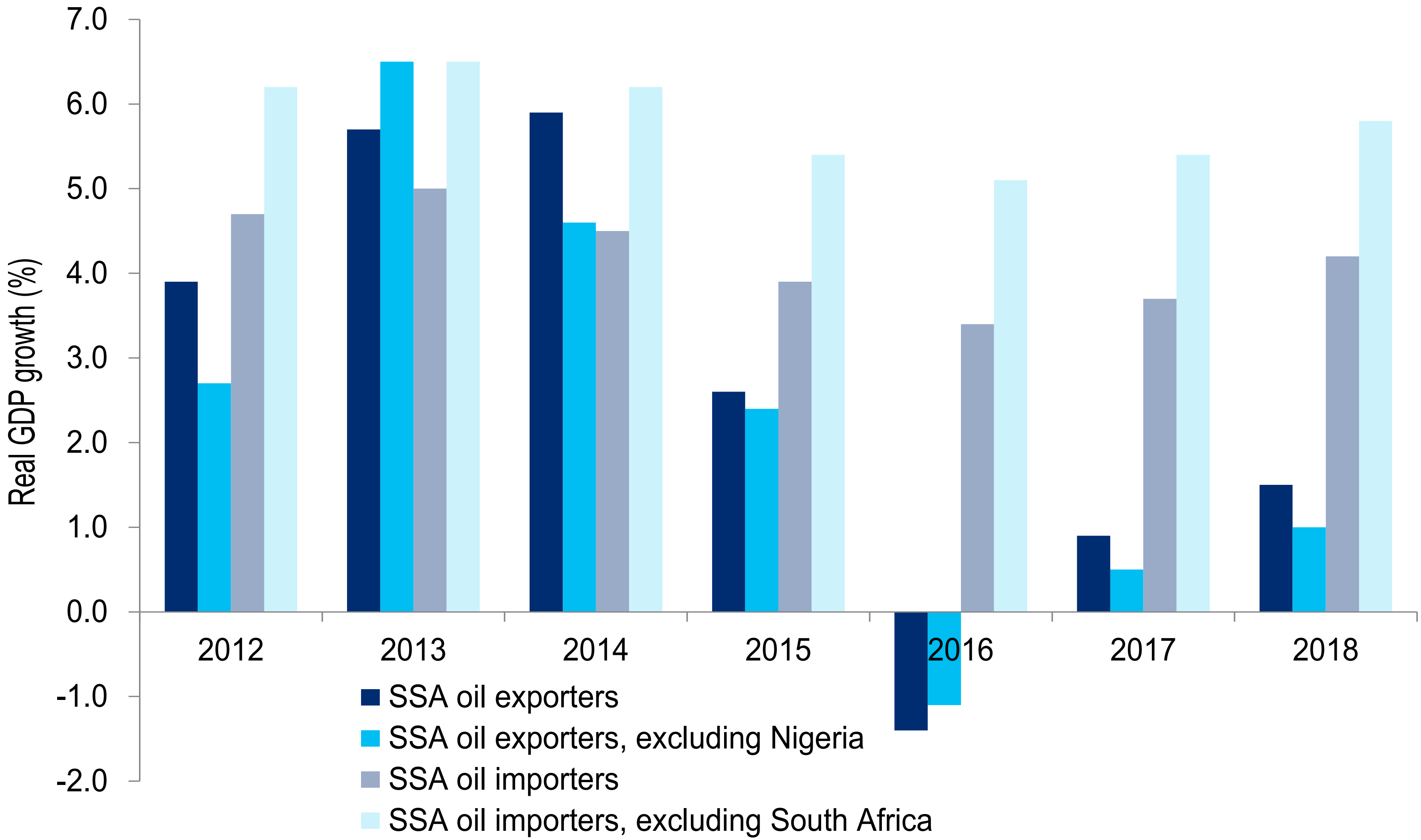
Sources: IMF and Citi Research forecasts for 2017-18

The shift in growth to oil importers

Growth in oil importers is significantly above that for commodity exporters

Nigeria and South Africa matter

As does the distinction between oil exporters and oil importers



Sources: IMF and Citi Research forecasts for 2017-18

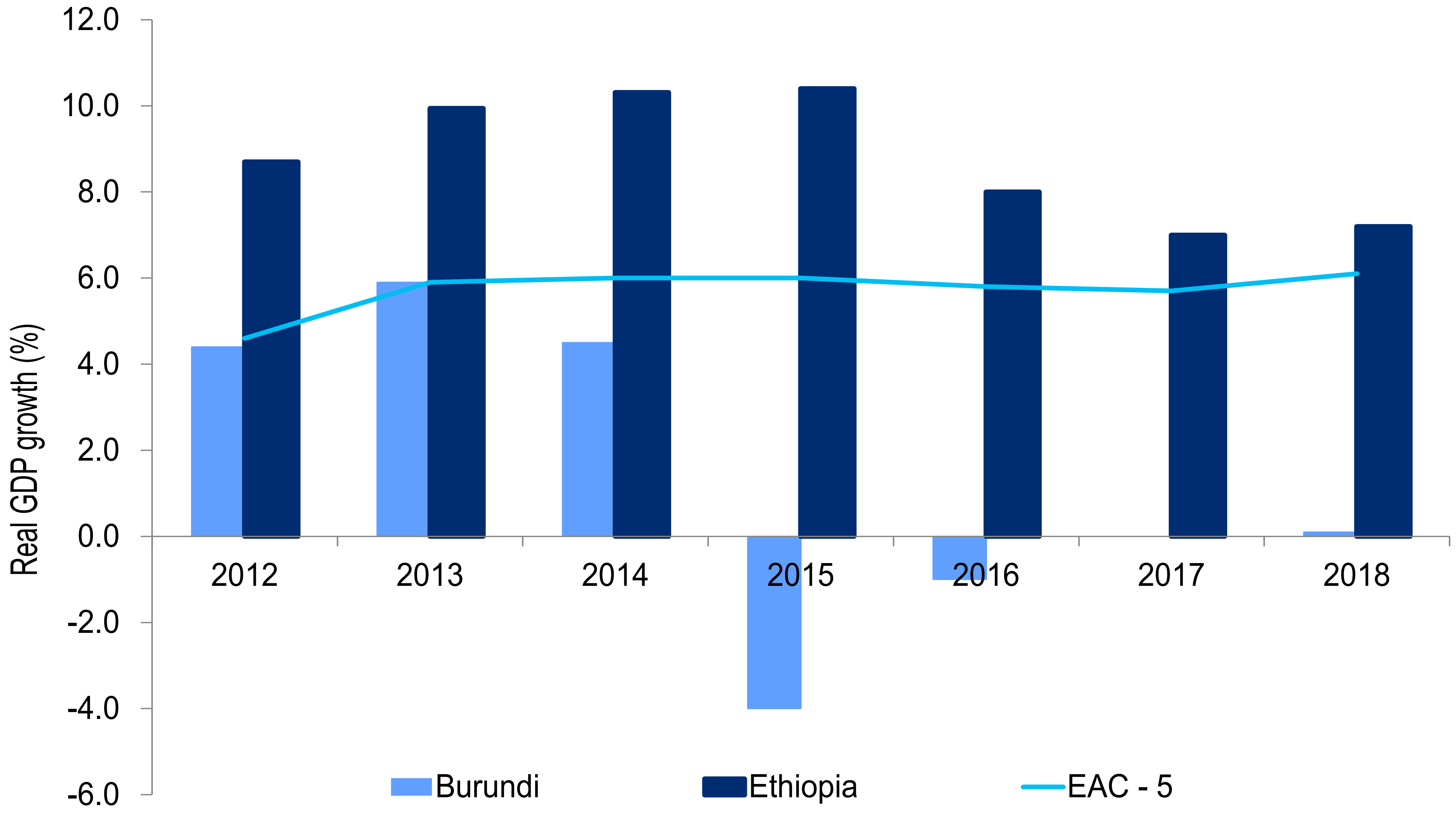
The outlook in East Africa

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

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

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

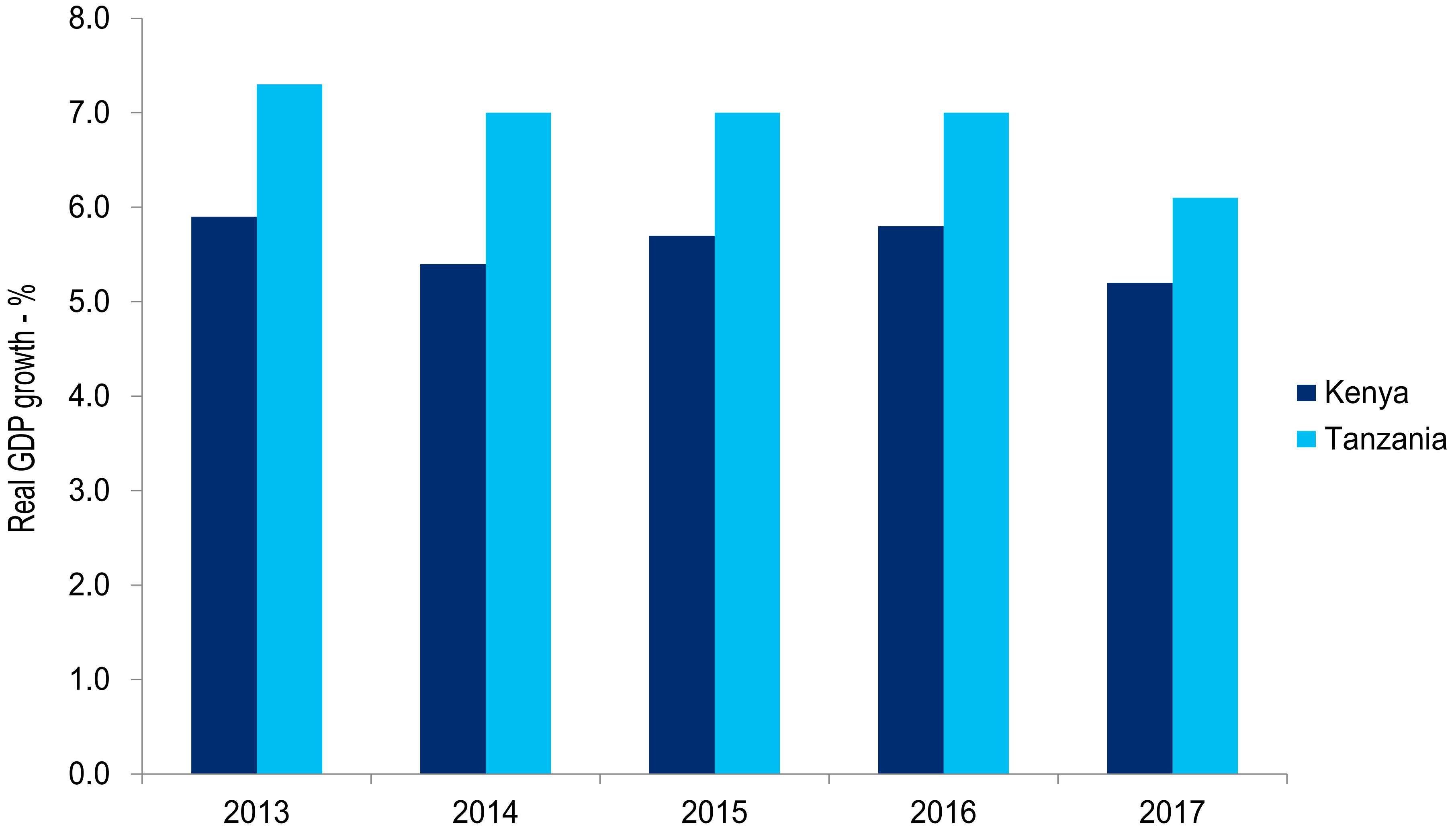
Although there have been a growth slowdown in Ethiopia and the Burundian economy remains under pressure



Sources: IMF and Citi Research forecasts for 2017-18

Tanzania and Kenya

A steady and relatively stable growth performance in both economies



Sources: IMF and Citi Research forecasts for 2017

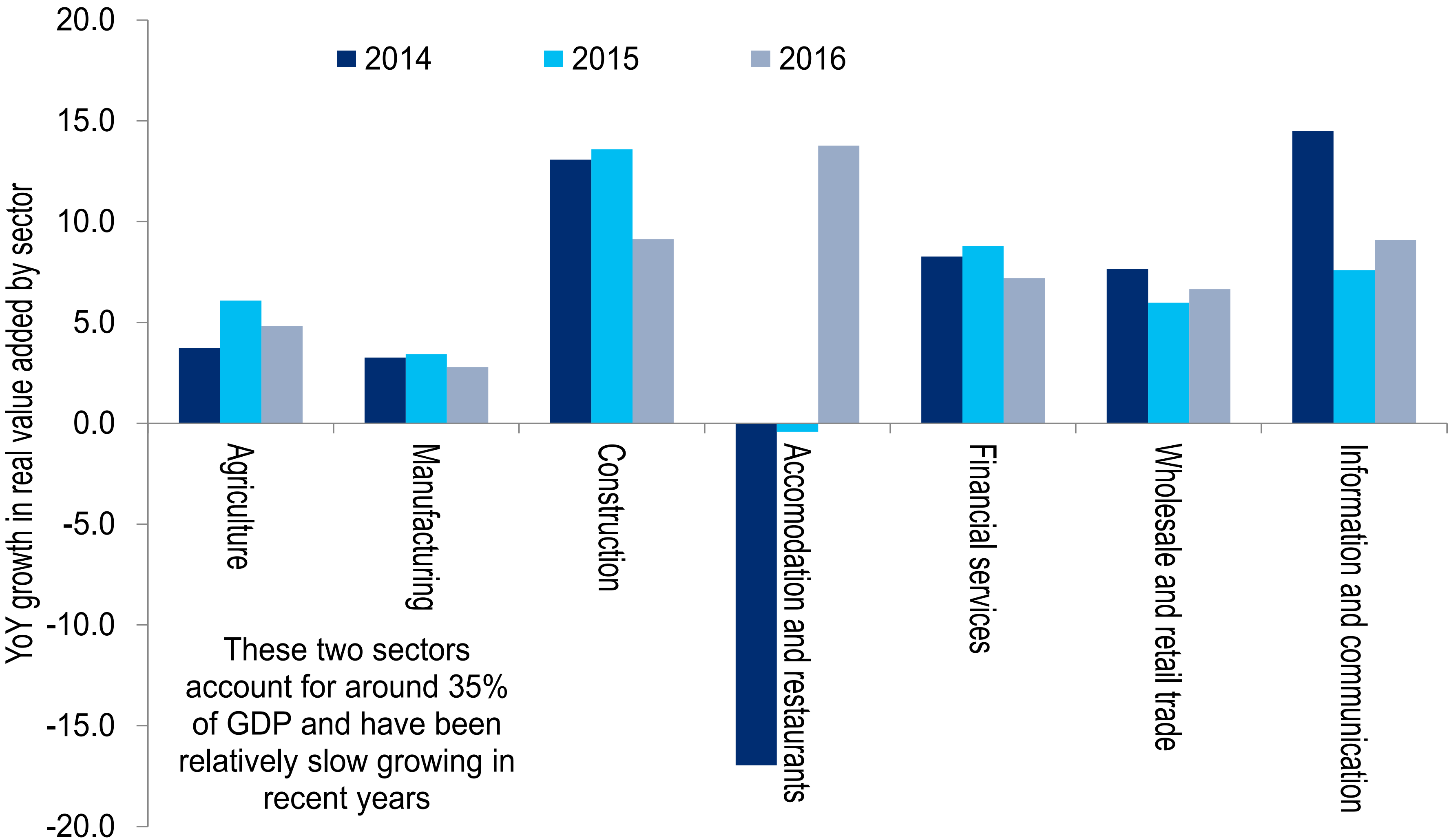
Tanzania and Kenya

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

- Growth in Kenya picked up modestly in 2015-16, Kenya, but we expect it to move sideways in 2017-18 at around 5.5%
  - Held back in part by the uncertainty around the August 2017 elections in Kenya, which will probably not have worked their way out until early 2018
    - Slow growth in the agricultural and manufacturing sectors are still an issue, coupled with the unresolved issue of Al Shabaab which makes a sustained recovery in the tourism sector complicated
  - But arguably, a growth rate of this level is insufficient to really drive up employment creation, notably in the formal sector
    - The lack of formal sector job growth remains a major issue
- Tanzania's growth rate remains "stuck" around 7%, and rather like Kenya, slow growth in the agricultural sector is an ongoing and important issue
    - 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 into 2017

Kenya: Growth by major sectors

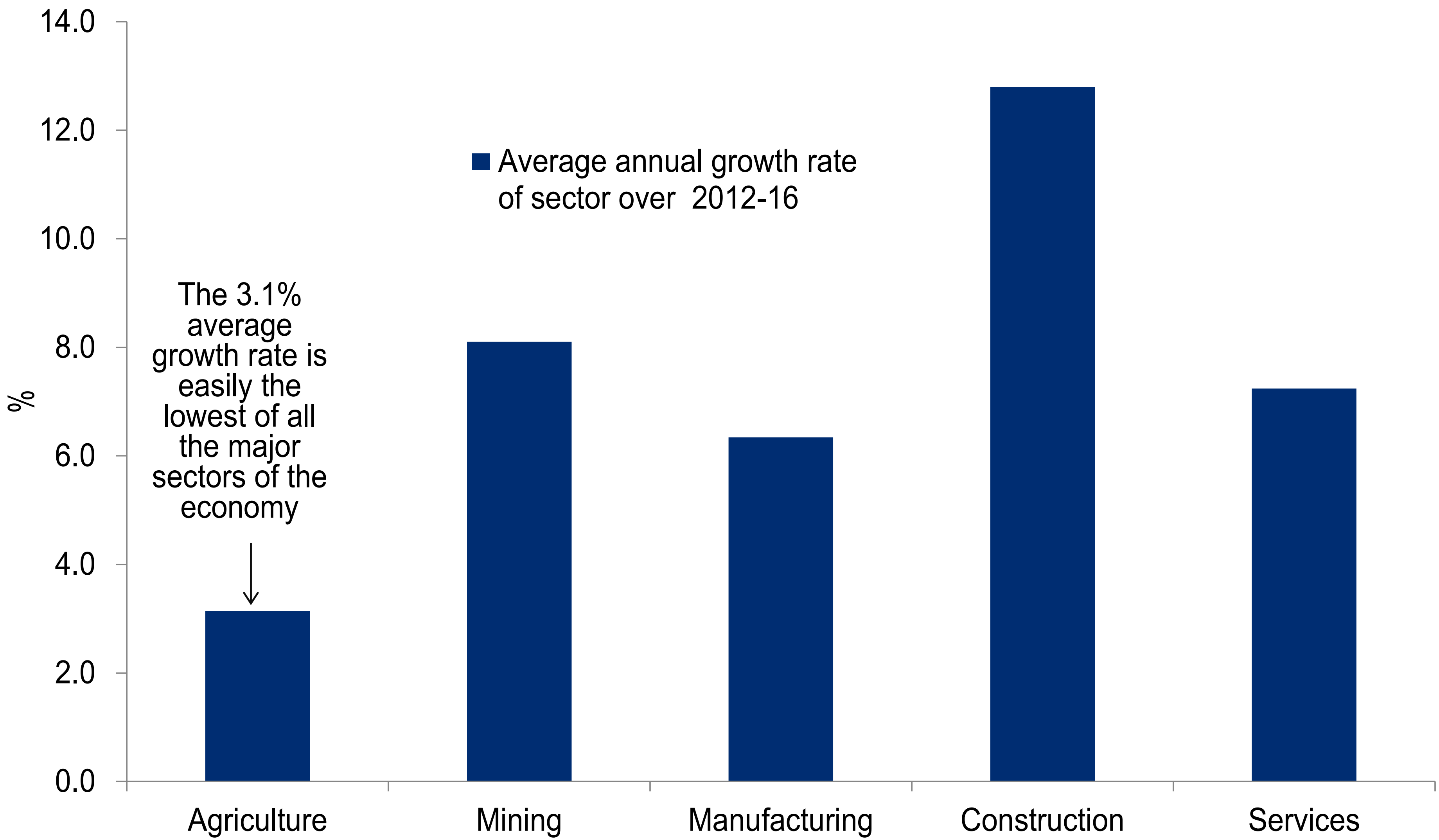
There have tended to be offsetting sectoral trends, but agricultural and manufacturing are still drags on growth



Source: Haver Analytics, Kenya National Bureau of Statistics and Citi Research for 2016 (based on data for Q1-3)

Tanzania: growth by major sectors

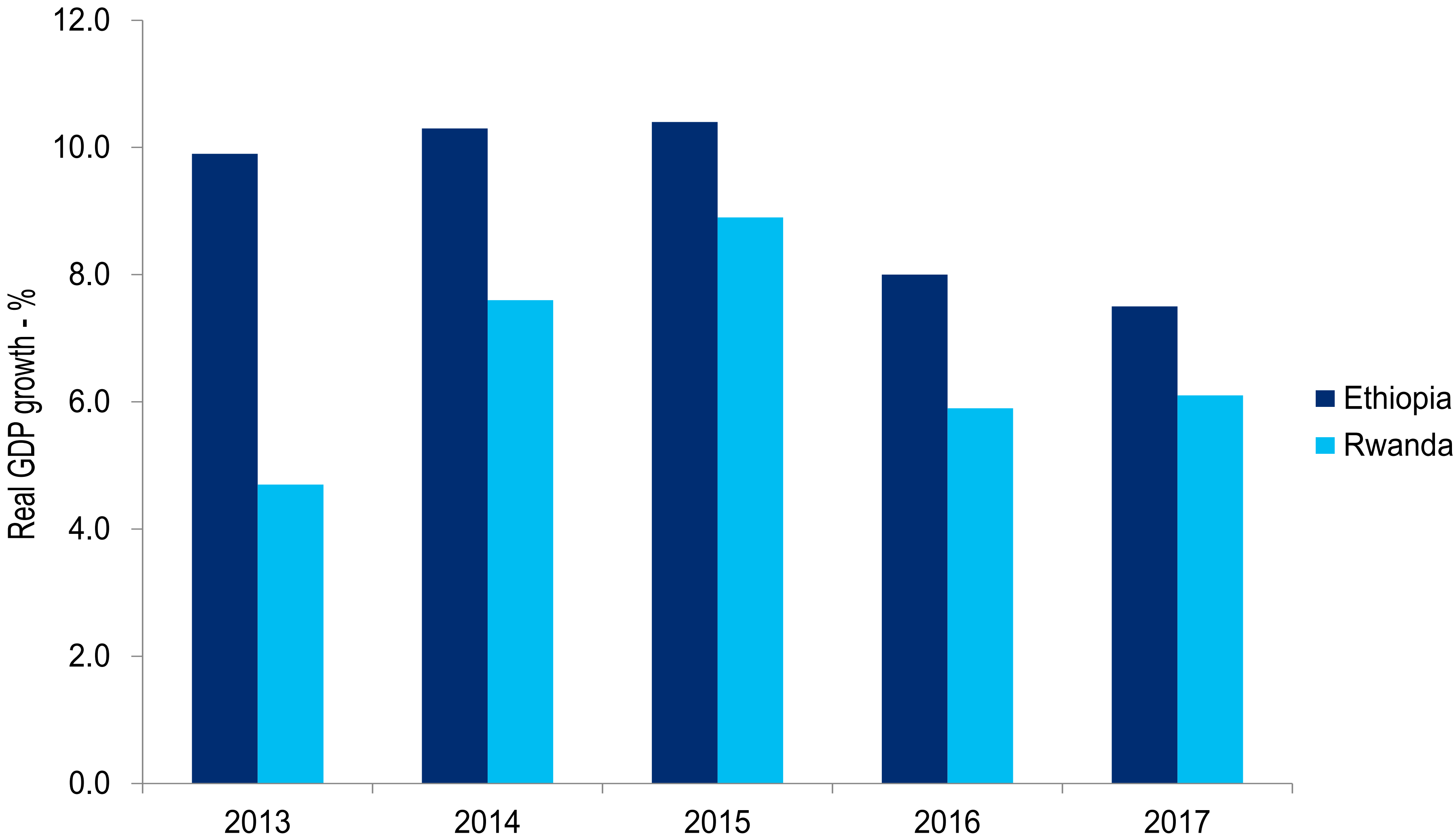
One major problem continues to be weak agricultural sector growth



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

Ethiopia and Rwanda

Growth in the star performers shows clear signs of slowing, but remains robust



Sources: IMF and Citi Research forecasts for 2017

Ethiopia and Rwanda

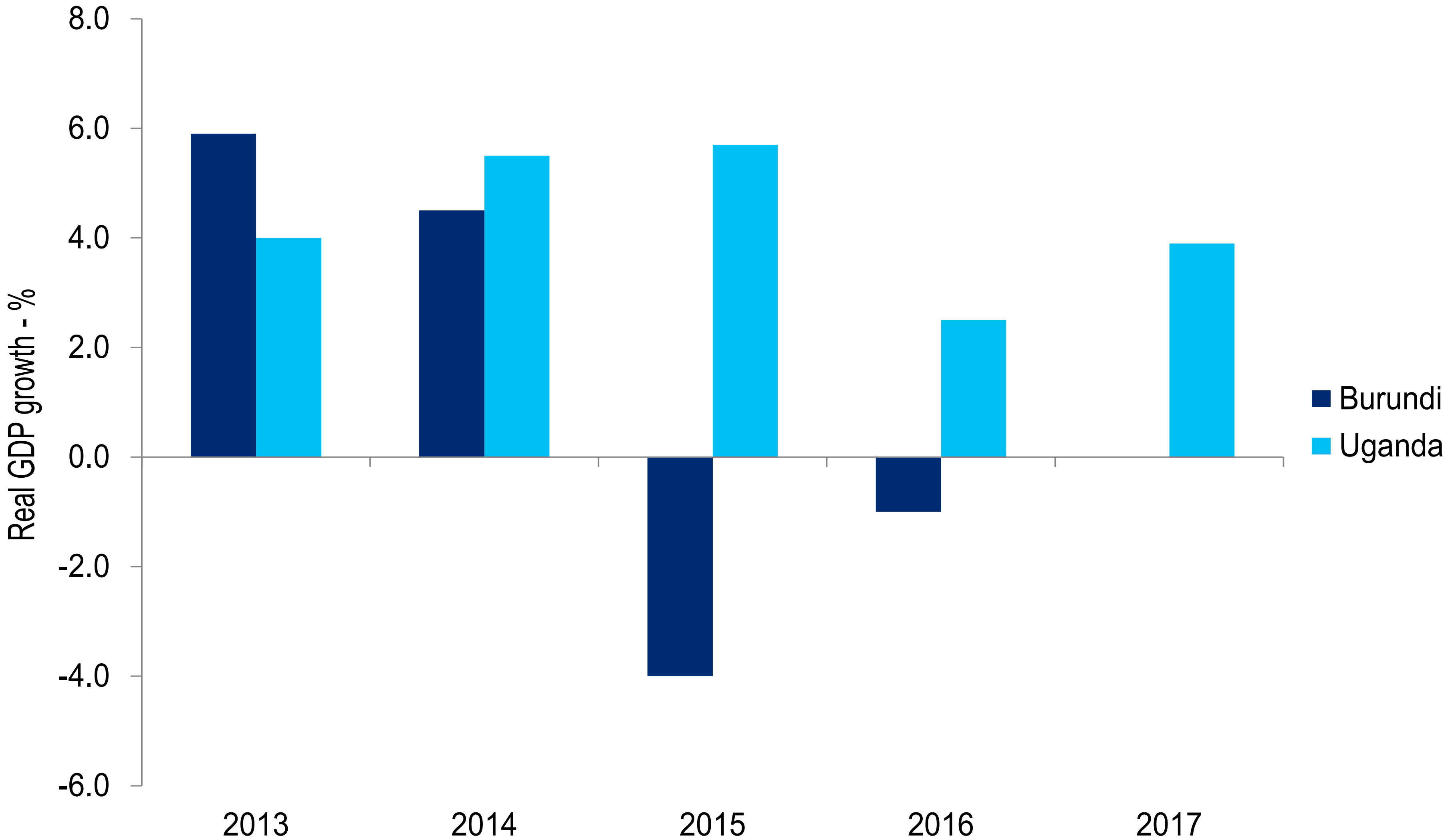
The star performers slow, but the outlook is still positive

- Until 2016 Ethiopia was one of the fastest growing economies in SSA
  - However, the negative impact of drought on the agricultural sector in 2016 continues to hold back the economy and has led to a drop off in the growth rate in 2017
    - But it is important to bear in mind that the impact of the drought has not been as great as historically and the government has made major progress in offsetting much of the worst impact
  - It has also driven a widening of the current account deficit which may prove hard to fund and continues to hang over the Ethiopian birr

- Growth in Rwanda as also slowed due to the impact of poor rains and the completion of a number of large infrastructure projects in 2016. There is also the question as to whether the economy has reached the end of its recovery phase. This was also the case in Uganda for example 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
  - Therefore, we expect growth to pick up back over 6% in 2017-18, but there is still a large double digit current account deficit which it is struggling to fund as donor support slows and this has helped to put some pressure on the Rwandan franc (RWF) until recently. But after a delayed adjustment, it may be that we see more RWF stability in 2H 2017

Burundi and Uganda

Growth under pressure in both countries, although in very different ways



Sources: IMF and Citi Research forecasts for 2017-18

Uganda and Burundi

Things are a little more complicated

- The Ugandan economy is continues to make a slow and uneven recovery from the growth slowdown which occurred in 2009-10, or after a decade long boom
  - During this time, policy mistakes – first monetary and then fiscal - have spilt over into two clear bouts of Ugandan shilling weakness, which combined with the election cycle has meant that business confidence has been under pressure and partially constrained a more sustained recovery
  - Growth slowed sharply to only 2.3% in 2012 and 2.5% in 2016 and has not picked up ery strongly in between
- 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 which is starting to divide the army as shown in ongoing "tit for tat" assassinations of soldiers and officers
  - 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 stagnate in 2017-18, while inflation picks up and remains in double digits
    - The IMF current forecasts average inflation of 12.4% in 2017 and 16.4% in 2018

Growth and sentiment in East Africa

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

- But overall, the Uganda story is instructive within the region. This is because despite this broadly positive economic performance 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 have taken their toll on confidence in Uganda, Tanzania and now Kenya
    - 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
    - However, this should improve in 2H 2017, after the Kenyan and Rwanda elections
  - Growth has still been below expectations and 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

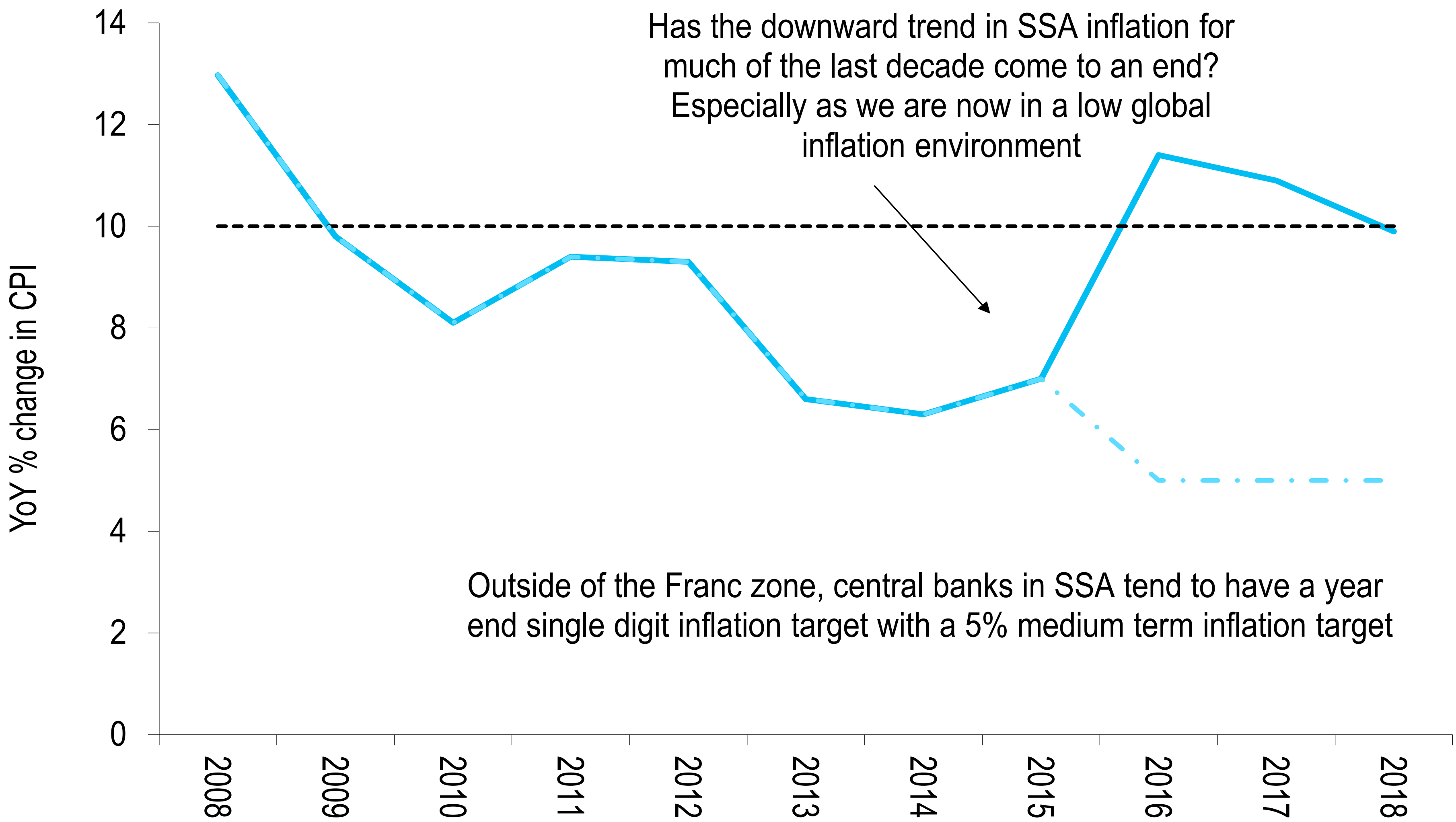
The inflation outlook

SSA inflation is 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 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 and this is not entirely offset by tight monetary policies

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

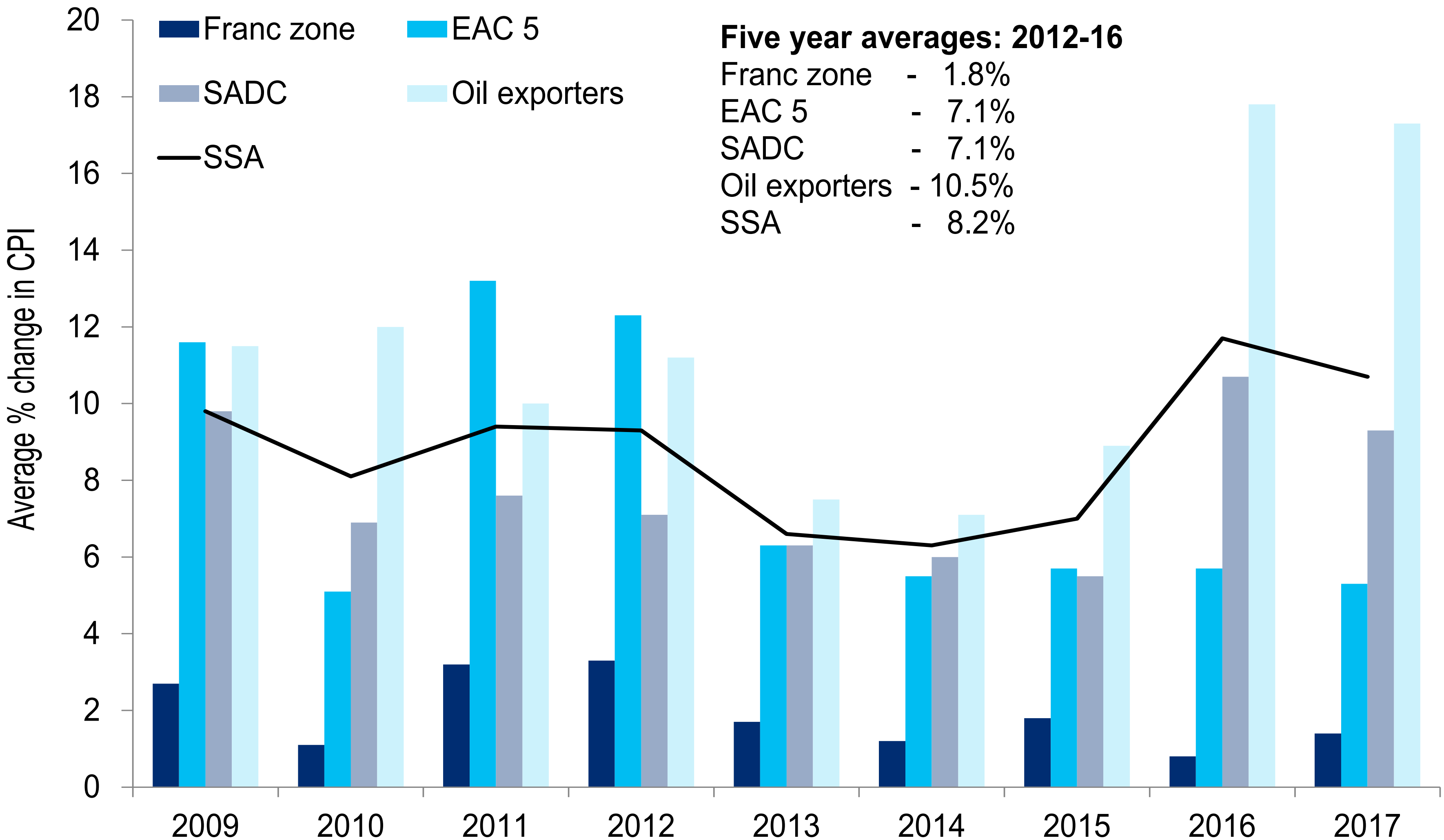
Inflation rose in 2015 and has remained elevated in 2016 and so far in 2017



Sources: IMF and Citi Research forecasts for 2017-18

Considerable inflation differentials around SSA

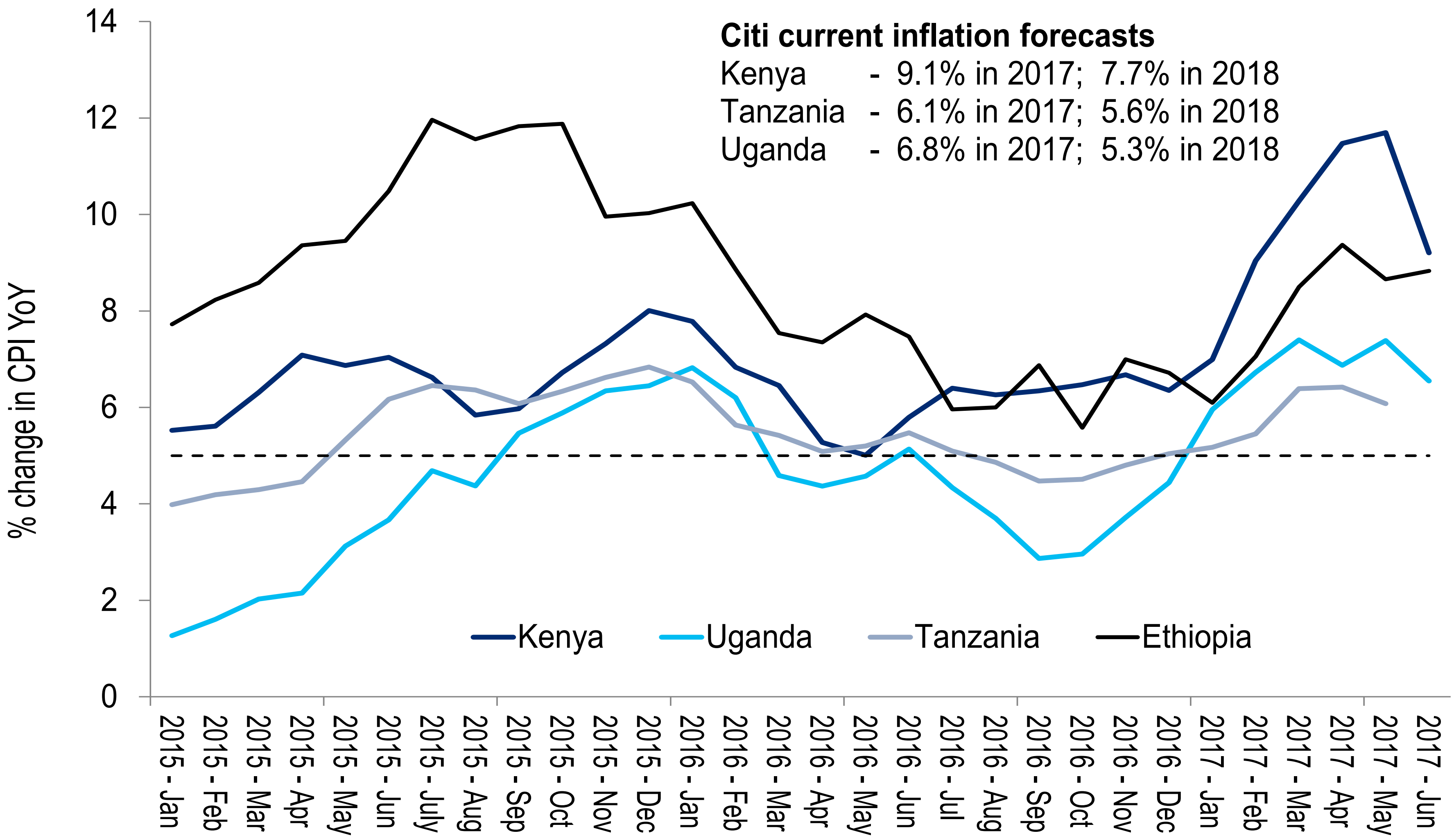
Inflation remains low in the Franc Zone, high in oil exporters and most variable in the EAC



Sources: IMF and Citi Research estimates for 2017

East African inflation

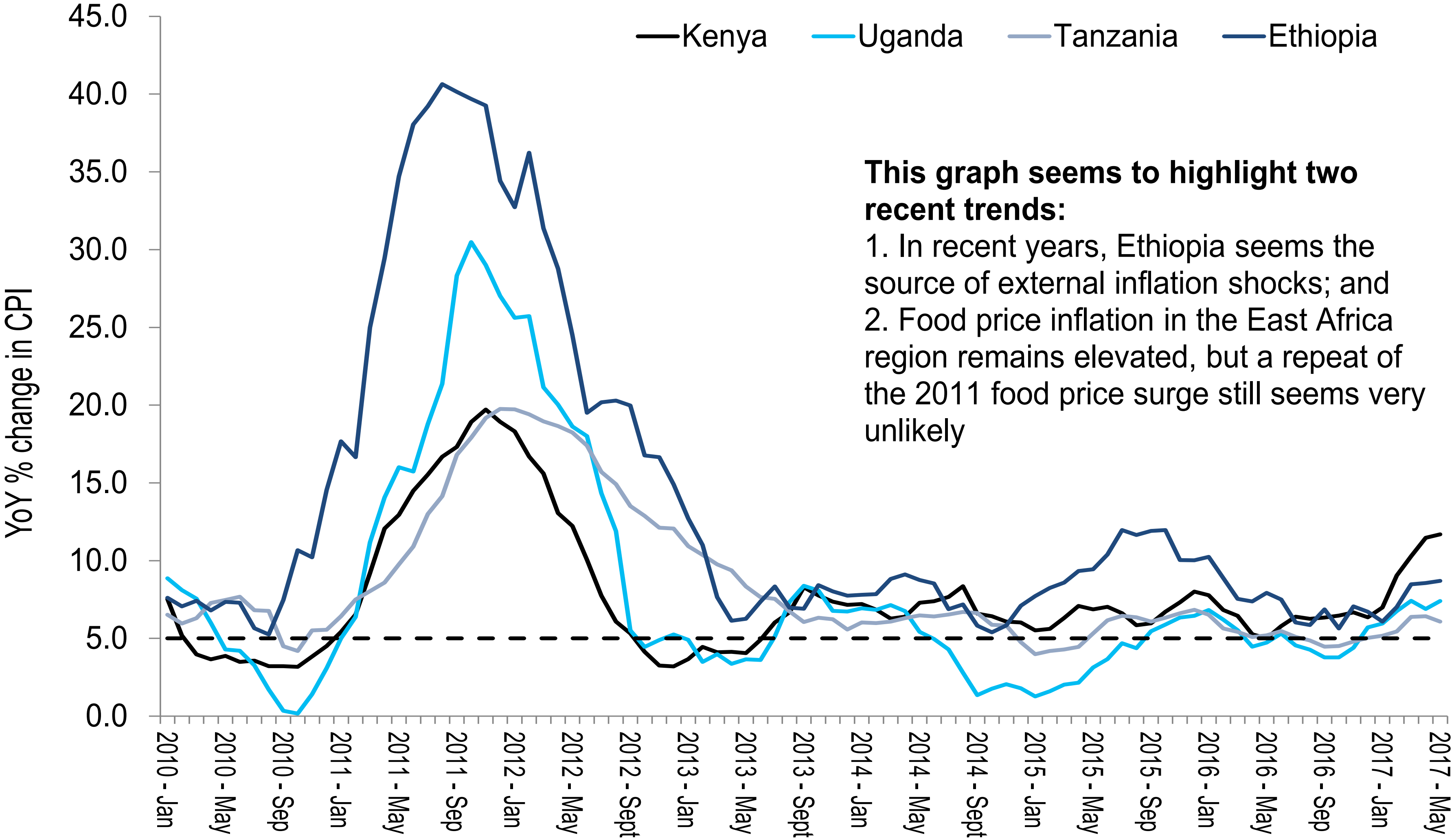
Food price inflation remains robust and an issue in East Africa in the short term



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



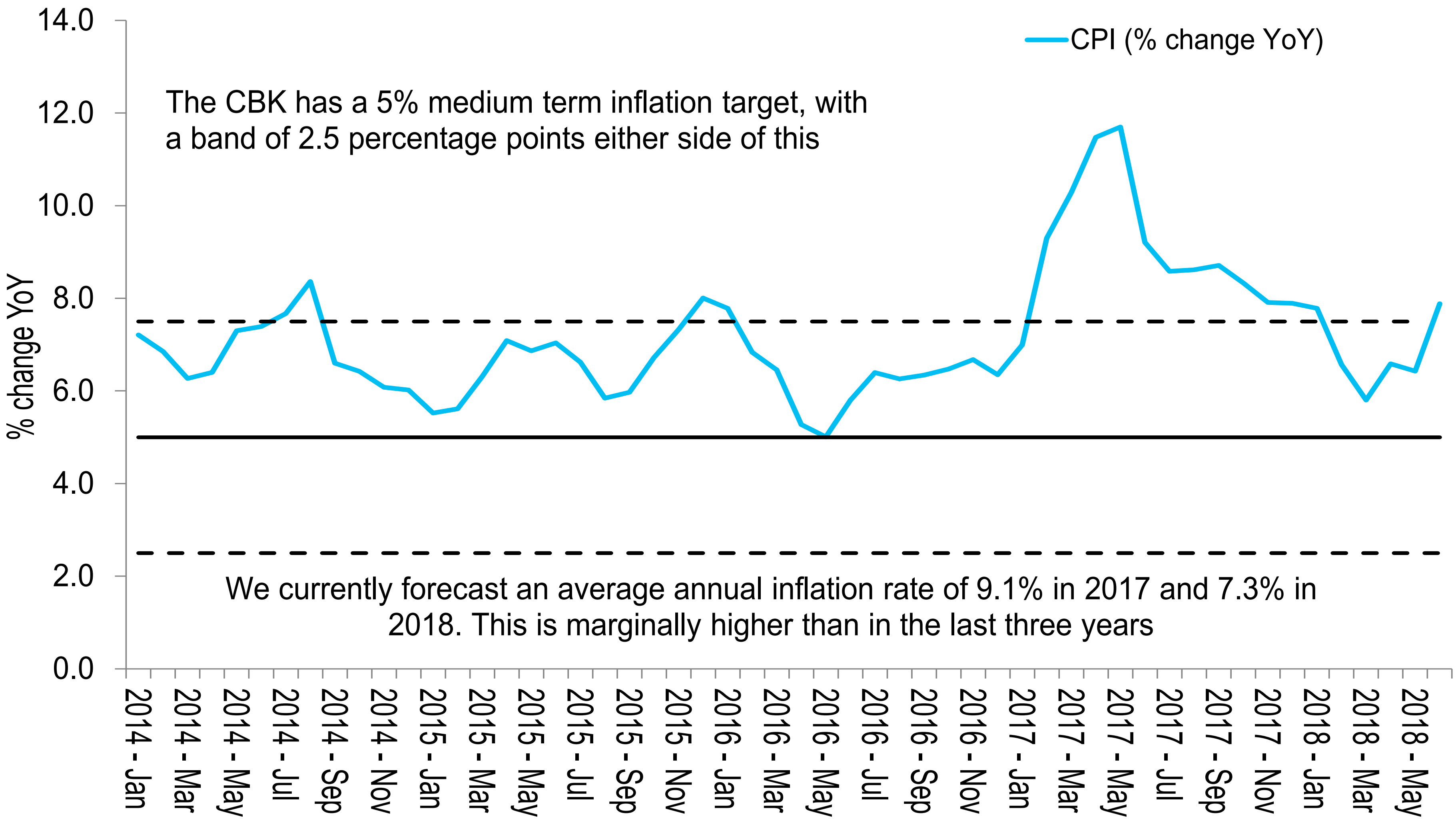
This graph seems to highlight two recent trends:

1. In recent years, Ethiopia seems the source of external inflation shocks; and
2. Food price inflation in the East Africa region remains elevated, 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

We seem to be past the peak, but inflationary pressures will decline only slowly



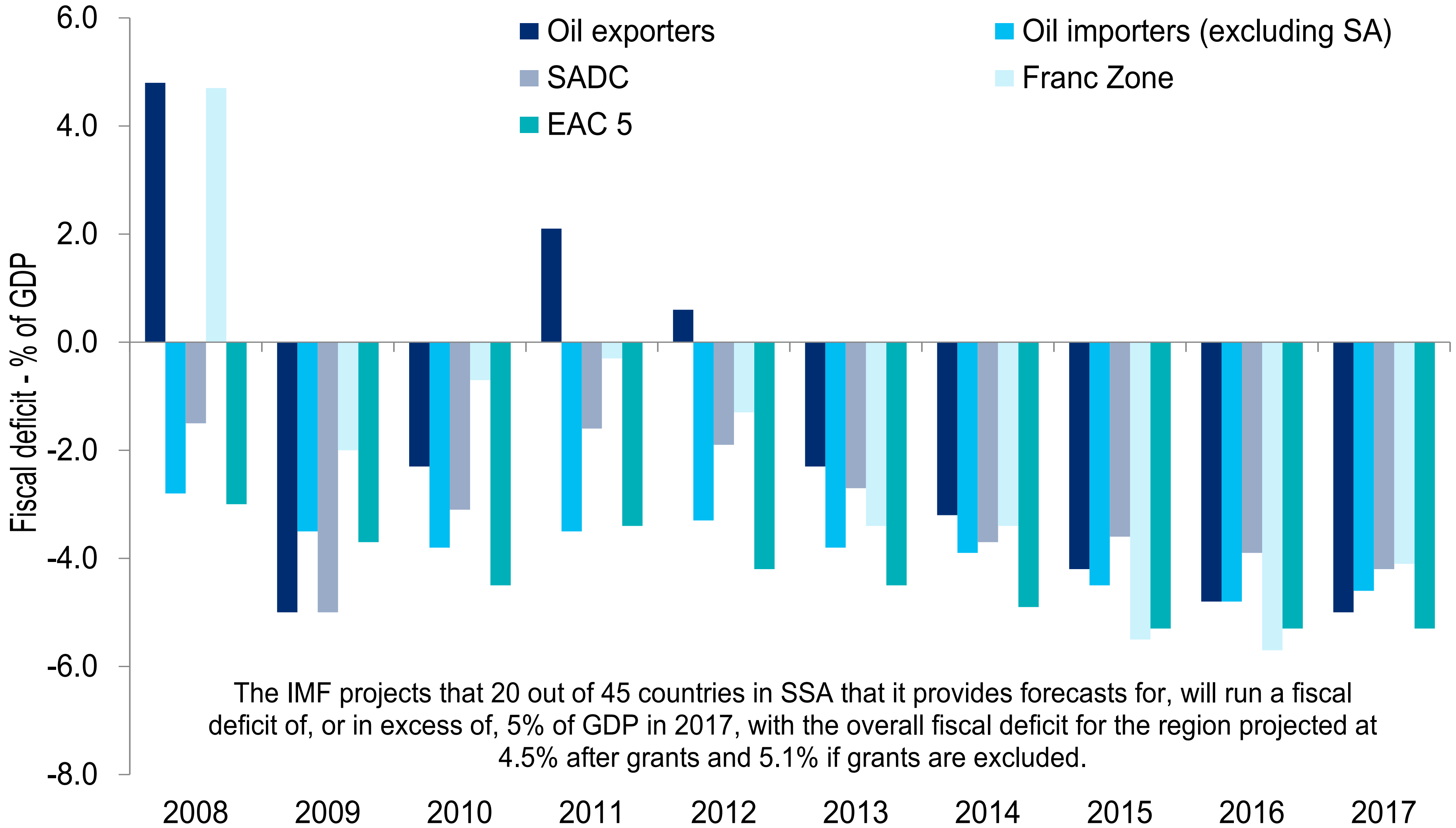
Source: Kenya National Bureau of Statistics, Haver Analytics and Citi Research

Currencies under pressure in SSA

What to make of the greater stability in 2016 and so far in 2017?

A decade of fiscal deficits in SSA begin to take their toll

Efforts at consolidation in recent years have not made significant and sustained progress



Source: IMF and Citi Research estimates for 2017

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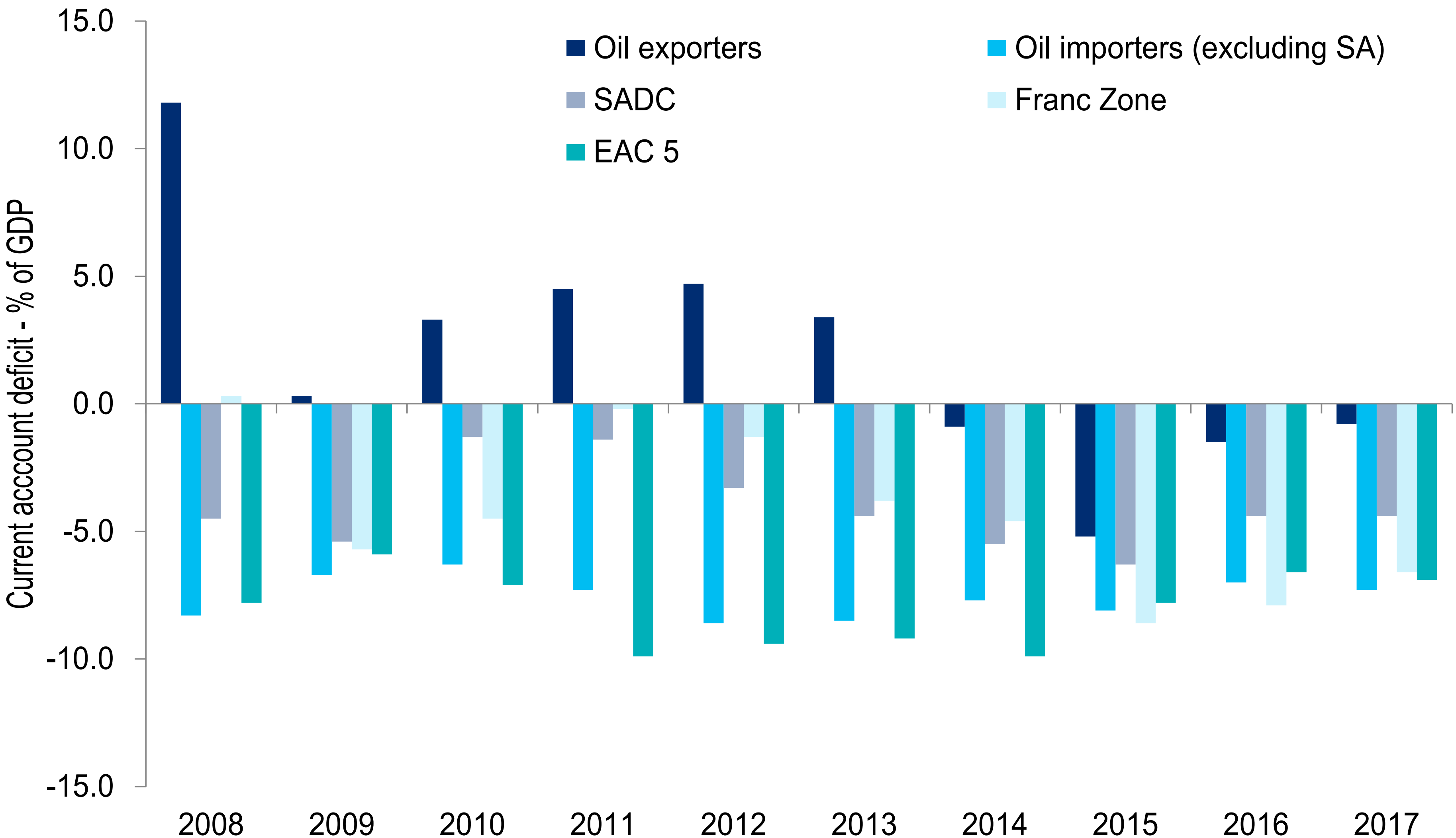
Current account deficits

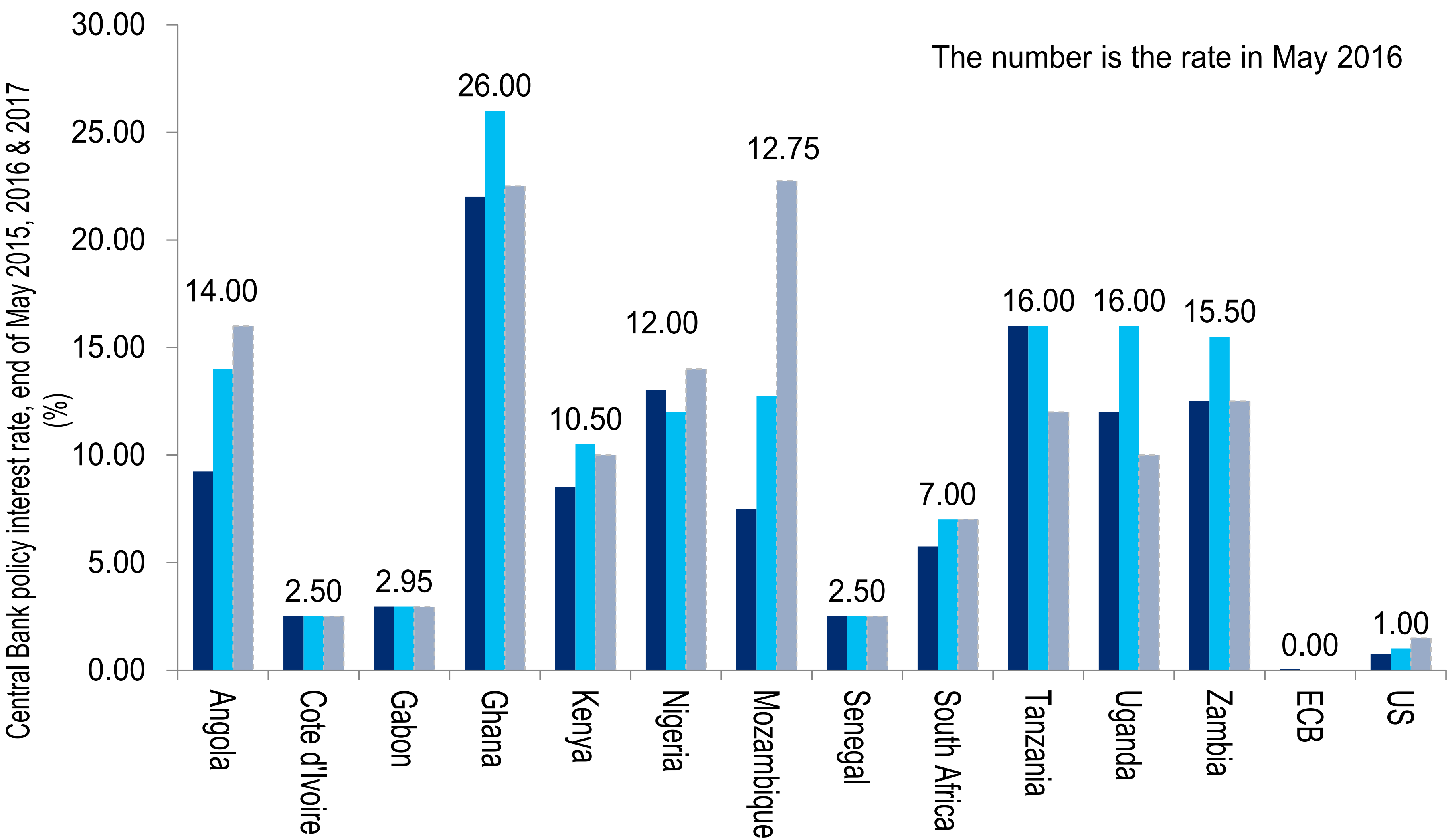
Most countries in SSA are also running large current account deficits



Source: IMF and Citi Research estimates for 2017

The strain is on monetary policy

Monetary policies were tightened in 2015 to offset fiscal laxity and weakening currencies



Source: Haver Analytics, IMF and central bank websites

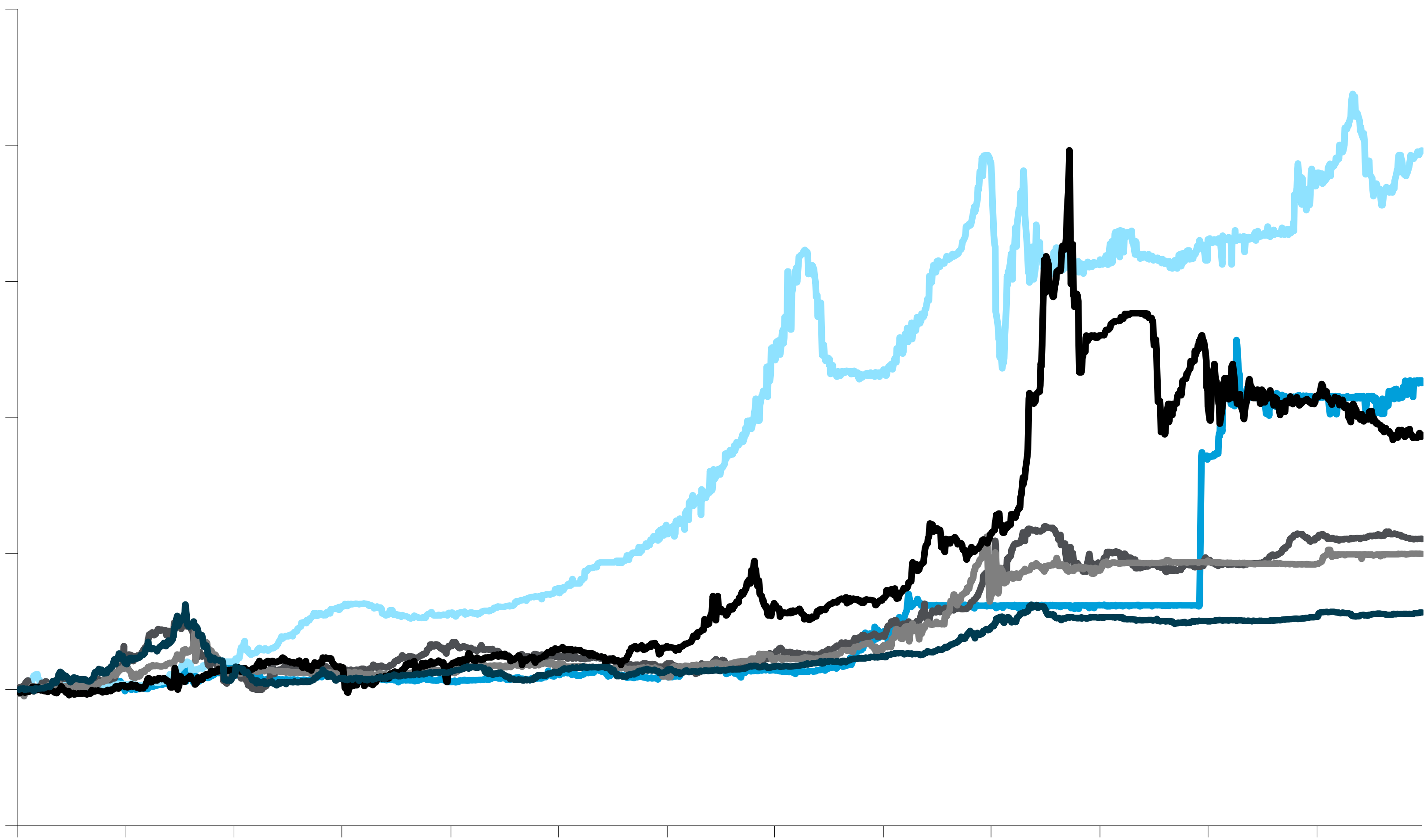
The new debt dynamics

Rising debt levels and debt service costs are becoming an issue in some countries

- If you look at the aggregate debt data, SSA does not seem to really have debt issue at present despite the deterioration in the fiscal and current account deficits. IMF data for government gross debt levels show:
  - It has risen from a recent low of 28.5% of GDP in 2012 to an estimated 42.5% in 2016
    - Although a rise of nearly 15 percentage points within five years is clearly a concern
- But the average hides some important trends. The median, not the average, has risen to 50.3% of GDP in 2016. Effectively, the average has been held down considerably by the lack of a debt build-up in a couple of large economies, led by Nigeria
  - If you look at a range of countries, and widen the measures of debt sustainability, the outlook becomes far more mixed
    - Of the 45 countries in SSA which the IMF provides data on, 13 now have government debt to GDP levels of over 60%
- And an additional concern becomes the level of government revenue and the ability to service current debt levels
  - Especially at a time of rising domestic interest rates
  - And when weaker exchange rates having pushed up external debt servicing costs

Who will follow the Ghana cedi?

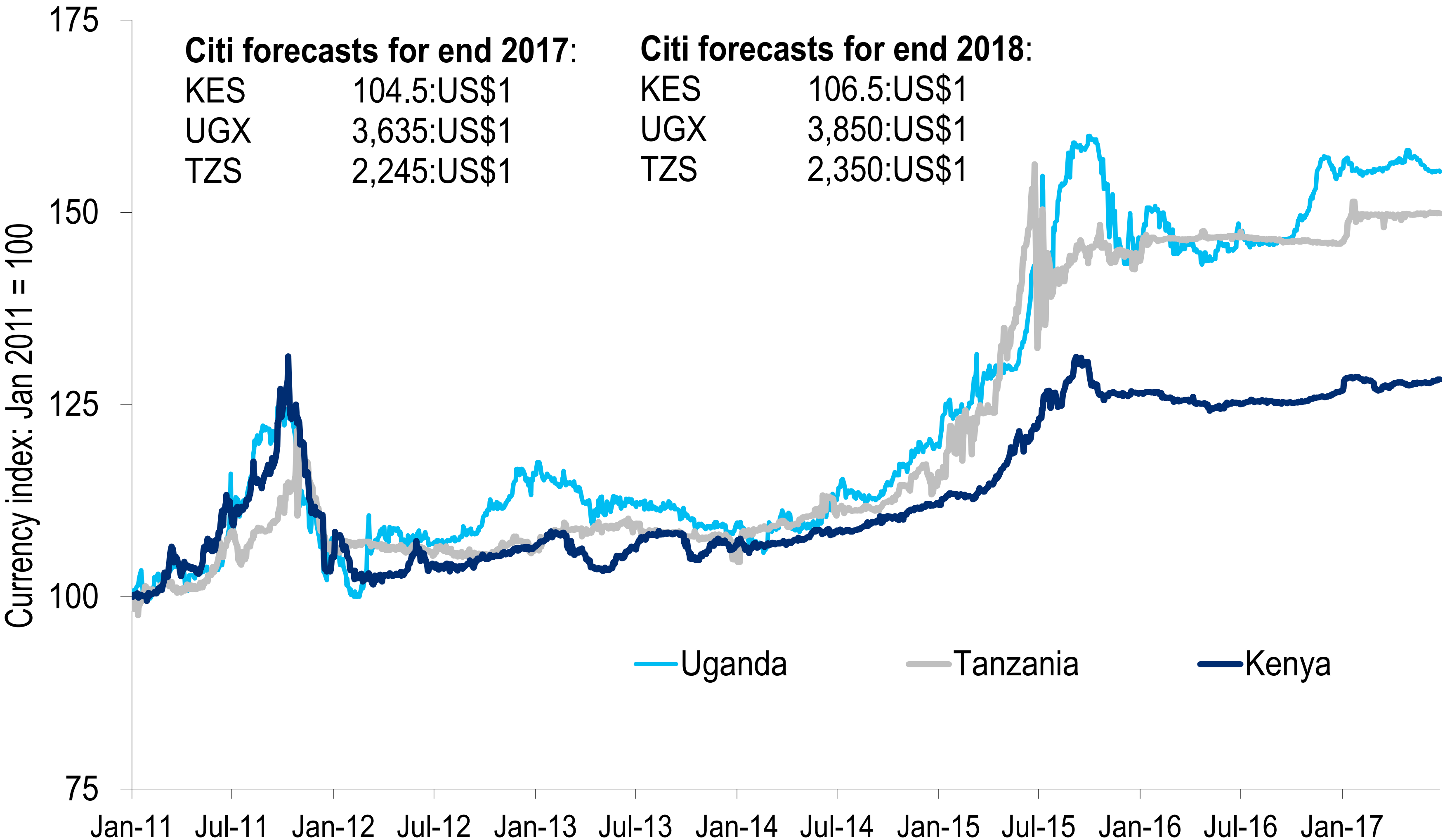
Apart from the shillings, a number of currencies have been under real pressure



Source: Bloomberg and Citi Research

The East African shillings have been stable in 2016-17

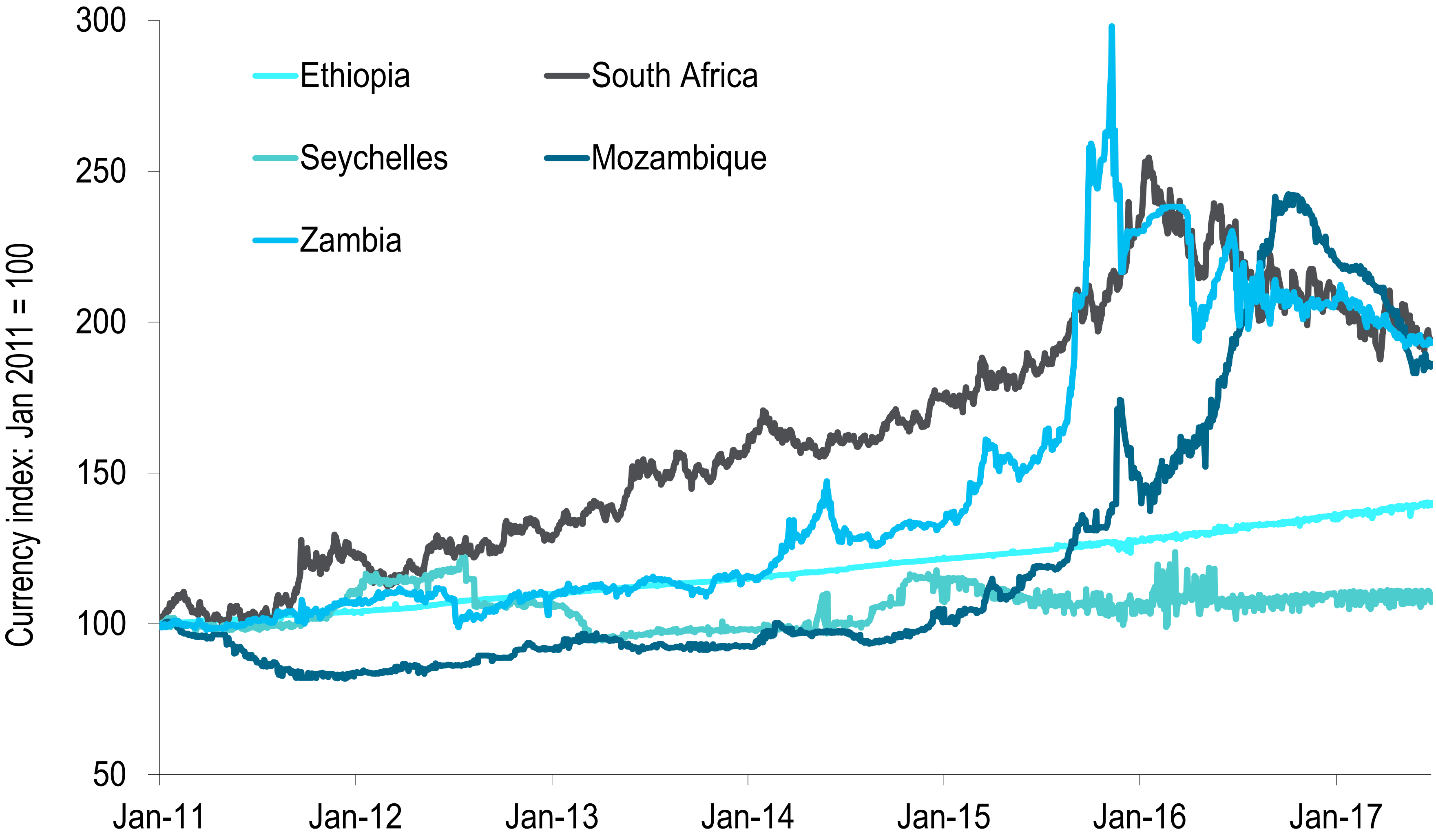
But Kenya will have to get on top of its fiscal deficit post the August 2017 elections



Source: Bloomberg and Citi Research

Currencies in Eastern and Southern Africa?

The birr adjustment is still lagging, and the metical remains vulnerable



Source: Bloomberg and Citi Research

Thinking more about Eastern and Southern African currencies

The recent appreciation of some currencies should not be taken for granted

- Of all currencies in SSA, despite its rally/stability in 1H 2017, ZAR is clearly most vulnerable to global economic sentiment and investor – risk on-risk off- sentiment
  - These global trends have to be set against the background of domestic concerns
    - And the possible loss of its investment grade rating on its domestic debt. This could drive a significant outflow of funds currently invested in South Africa via the World Government Bond Index (WGBI)
    - We forecast that the rand will weaken gradually over the year with a December 2017 forecast of ZAR13.29:US$1, with further weakness in 2018 towards ZAR13.79:US$1
- We think the currency crunch in Zimbabwe is unlikely to end soon; while the Ethiopian birr will remain under pressure. However, the scale of the recent Mozambique metical move and past Zambian kwacha weakness means that both could show much more stability in 2017. The August 2017 Focus Economics “Consensus Forecasts” are:
  - ETB 23.9:US$1 at the end of 2017 and ETB25.4:US$1 at the end of 2018
  - MZN 68.6:US$1 at the end of 2017 and MZN75.7:US$1 at the end of 2018
  - ZMW 9.73:US$1 at the end of 2017 and ZMW10.47:US$1 at the end of 2018

Some thoughts on the overall economic outlook for Kenya in 2018

What are we worrying about at present

The twin deficits in East Africa

The size of the fiscal deficits are still concerning

- We have had long standing concerns about the twin deficits in the EAC region and their long term sustainability
- On the plus side, current account deficits have fallen significantly in 2015-16. We currently estimate:
    - Kenya – from 9.8% of GDP in 2014 to 5.5% in 2016
    - Tanzania – from 10.9% of GDP in 2014 to 6.6% in 2016
    - Uganda – from 8.3% of GDP in 2014 to 5.1% in 2016
  - And they should stabilise/rise modestly from these levels in 2017
- On the fiscal front, what is clear since early 2016 is that fiscal consolidation is not really happening
  - Although Tanzania and Uganda are now both in post election periods
    - We expect the fiscal deficits to remain at current levels in both countries as both governments remain committed to boosting capital spending
  - Meanwhile, Kenya is heading into elections in 2017 and we only expect limited fiscal consolidation in the run up to the polls
- The region's government debt stock has risen from 35.4% of GDP at the end of 2013 to an estimated 45.6% of GDP at the end of 2016
  - This is a sharp rise over a limited period, although the total is still within acceptable ranges

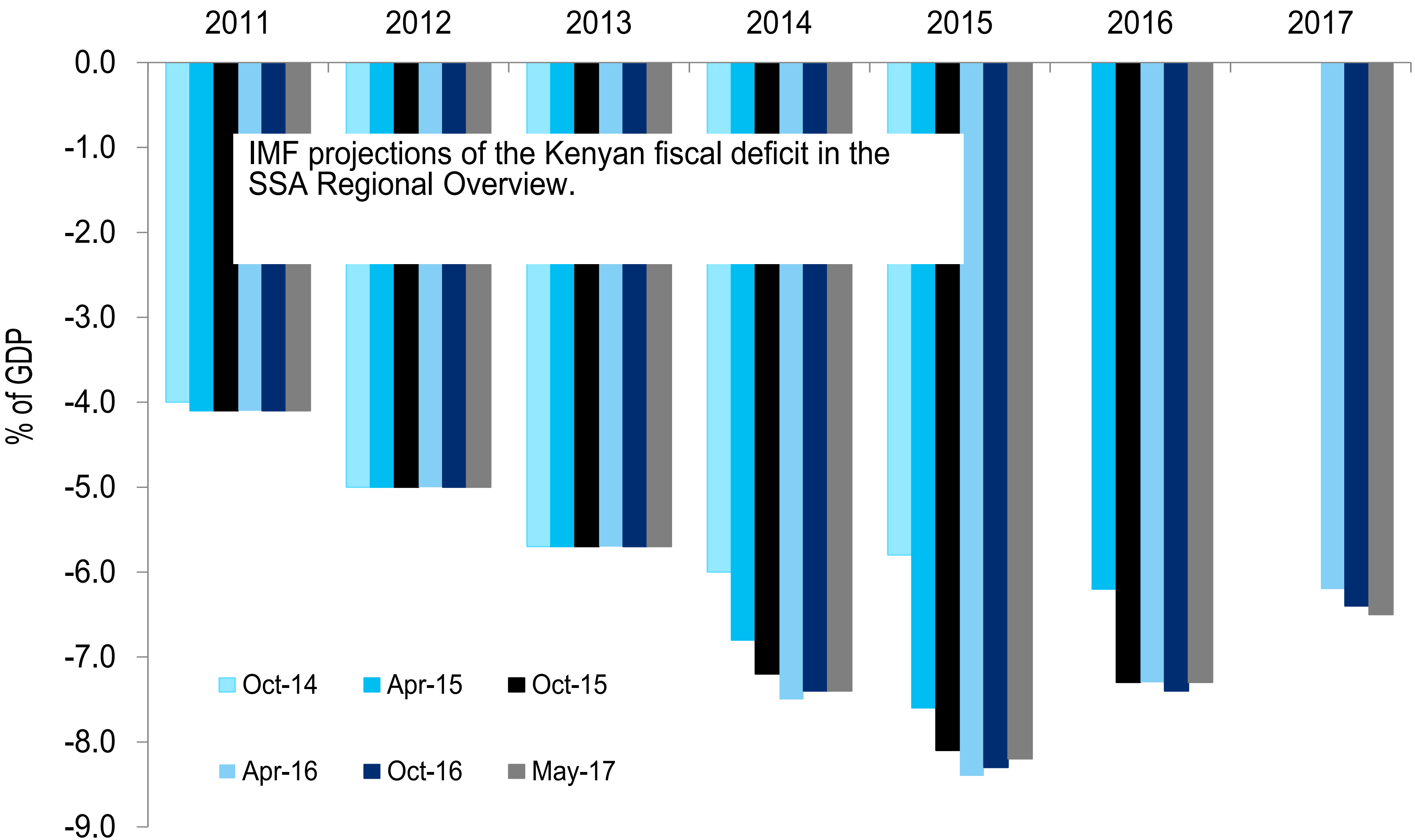
Thinking a bit more about the Kenyan economic outlook

Where do we have some concerns

- Our concerns about the Kenyan economic story continue to focus on the country's fiscal story. As the IMF notes in its May 2017 Regional Economic Outlook for SSA:
  - "prudent fiscal policies play a special role in sustaining growth spells in SSA: a better fiscal balance significantly increases the chance that a growth spell will continue, while conversely, a higher debt burden can accelerate its end"
- The inability to push ahead with fiscal consolidation in Kenya in recent years, does, therefore, remain a major source of concern to us
- Not that it will result in an imminent economic problem, but without some form of post election fiscal consolidation, we have concerns that Kenya could suddenly find itself facing a growth slowdown and a potentially more serious economic crisis, especially if the Kenyan shilling was also to come under pressure as a result of the growth slowdown
- At present our concern is that too much of the policy analysis is based on a growth pick up which means that the current path is sustainable
  - With the key question being whether devolution and the current high levels of infrastructure spending will drive Kenya to a higher growth path

Fiscal consolidation has to move centre stage

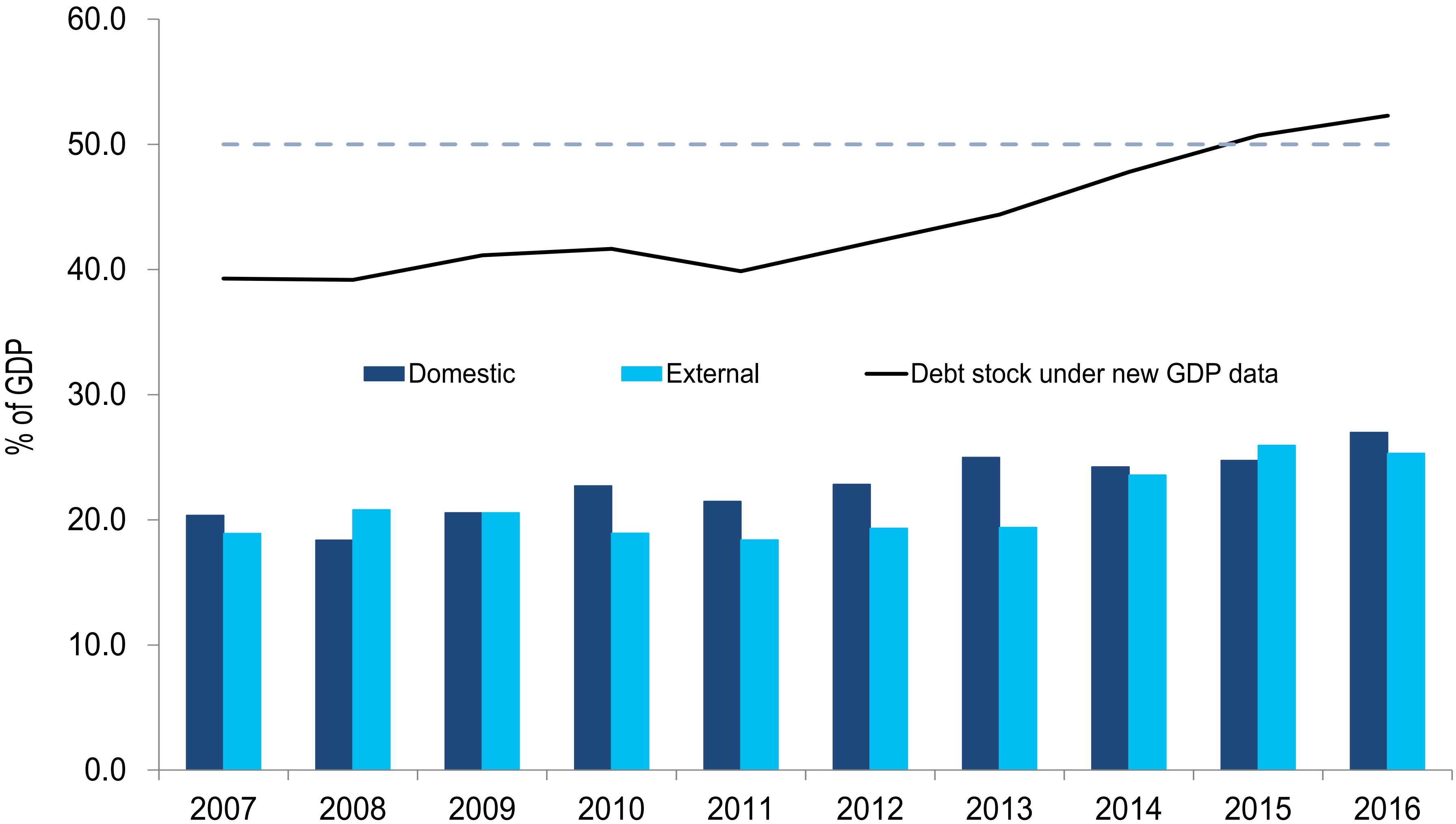
The IMF has continued to project fiscal consolidation, but it has proved illusive to date



Source: IMF and Citi Research

Kenya: The new debt dynamics

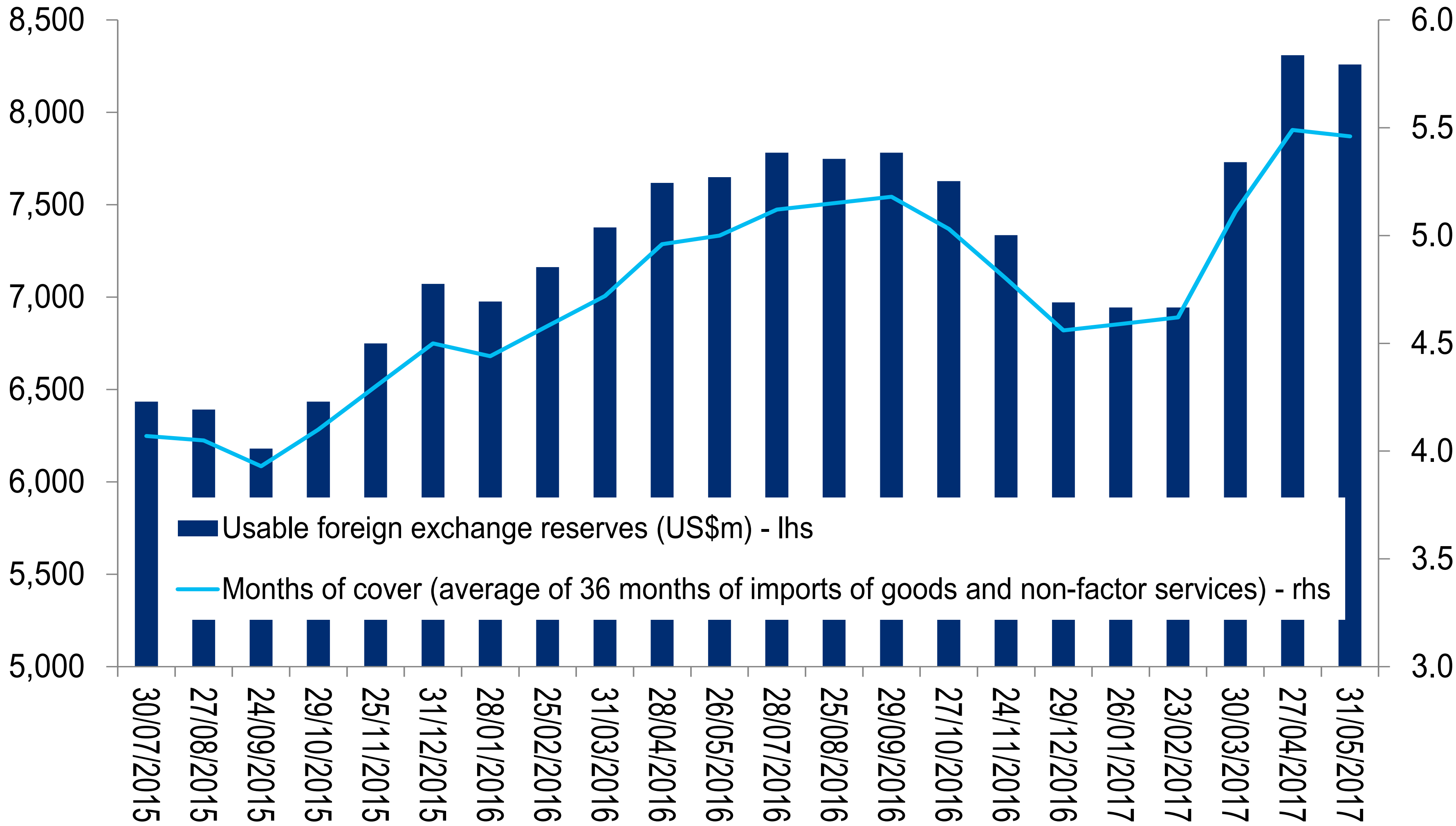
The rise in the debt ratio is most noticeable in the last three years



Source: Haver Analytics and Central Bank of Kenya

Foreign exchange reserves continue to hold up

This indicates 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

- It is instructive to look at the past Focus Economics consensus forecasts for the Kenyan shilling, or since the 2011 Kenyan shilling sell off:
  - **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
  - **January 2017** the consensus forecast for year end was KES:US$106.0
    - While in August 2017, the forecasts were KES106.3:US$1 at year end and KES109.7:US$1 at the end of 2018
- Recent history, the size of the twin deficits, PPP measures of KES value and global currency trends continue to drive forecasts of Kenyan shilling depreciation

The overall economic outlook for SSA

Things are starting to look up in 2017

But we think it will be a slow recovery

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 2016 marks the bottom of the current slowdown. We expect a modest pick up in South African growth in 2017, and assuming a final naira adjustment is made in 1H 2017, we think growth should pick up in SSA's largest economy, Nigeria, in 2H 2017
- It is also clear that there are winners and losers in this overall story in the last 18 months
  - And even for exporters of the same commodity, the impact depends very much on the policy response, especially the exchange rate policy response
  - In many ways this re-enforces the story we have already seen emerge in SSA in recent years. Not of the sub-continent rising in some uniform manner, but of increasing differences between country performance at different points in time
- We still remain confident that we will see a rebound in overall growth in SSA in 2017
  - But more generally, to break through the 5% glass ceiling we believe governments really need to push ahead with more fundamental structural reforms to push up growth rates to higher levels than are currently being witnessed

How much more currency weakness to come?

Many currencies have moved a lot in SSA and seem to be stabilising, but some still need to move

- In many parts of SSA there have been really significant moves in exchange rates in recent years, but there are still some countries which have tried to delay the required adjustment
  - In those economies that have allowed a currency adjustment, tighter monetary policies and US dollar stability against the Euro meant there has been much greater currency stability in 2016 compared to 2015. This has helped to marginally improve confidence
    - We currently expect that the US dollar will be range bound on global currency markets in 2017 and into 2018 which should help currency stability in SSA
- This has allowed central banks in East and Southern Africa to start, or to start thinking about, easing monetary policy without their currencies coming under considerable pressure
    - This has also been helped by the fact that there current account deficits have fallen, helped in significant part by lower oil prices. But the problem of large fiscal and current account deficits remains in SSA. In particular, the lack of fiscal consolidation in SSA is a major issue which could continue to raise macroeconomic and currency issues
- We think a break in the CFA franc peg is not imminent, but Plan B may still be required
- Oil exporters are still banking on a rise in the oil price to help them slowly work there way out of the current problems without having to allow a much more significant adjustment of their exchange rates. If this does not happen, there could be much larger problems brewing

Appendix A-1

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