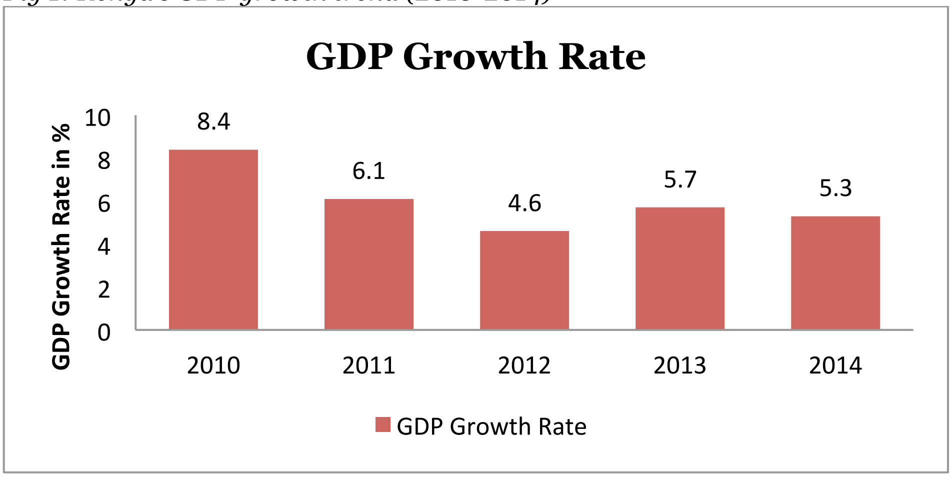
Investment and reforms in pursuit of growth and economic transformation

A conducive business environment to spur private sector growth is imperative for employment growth

Introduction

The government's fiscal strategy is premised on its development agenda of *'Enhancing Economic Transformation for a Shared Prosperity'*. The fiscal budget 2015/2016 is an increase of 25% (to KES 2.1 trillion) from the previous year's budget and articulates the government's policy stance of stimulating the economy through expansionary fiscal policy. For this to be effective, however, it is imperative that the government addresses the absorption challenges that bedevil development expenditure at both the national and county level.

Fig 1: Kenya's GDP growth trend (2010-2014)



Amidst great challenges, the economy grew by about 5.3% in 2014, which was slightly below the projected growth rate of 5.7%. The growth was underpinned by increased government and private sector consumption, lower oil prices and buoyed by a relatively strong currency. Insecurity was a significant impediment affecting the country's attractiveness to investors. Moreover, tourism earnings declined by almost 10% to KES 87 billion. Both the agriculture and manufacturing sectors recorded modest growth compared to the previous year. Construction, mining and quarrying registered remarkable growth of 13.1% and 14.2% respectively. The table below shows contribution to GDP per Sector and Sectoral Growth in percentage.

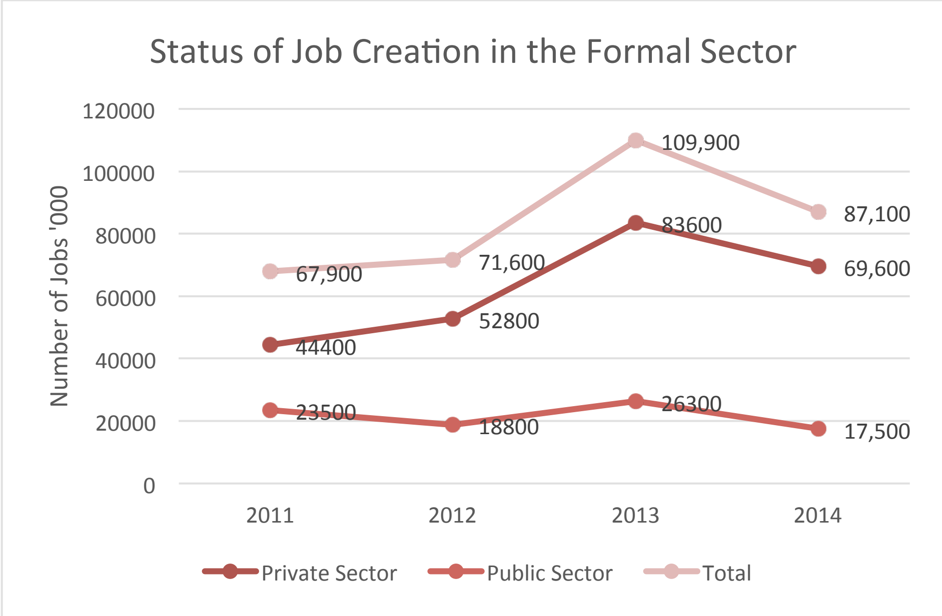
Table 1: GDP Composition and Sectoral Growth

	Contribution to GDP (%)		Sectoral Growth (%)	
	2013	2014	2013	2014
Agriculture & Forestry	26.4	27.3	5.2	3.5
Manufacturing	10.7	10	5.6	3.4
Wholesale and Retail Trade	8.1	8.1	8.5	6.9
Financial Intermediation	6.6	6.7	8.1	8.3
Construction	4.5	4.8	5.8	13.1
Mining and Quarrying	0.8	0.8	-8.9	14.2
Utilities (Electricity Supply)	1.1	1	9.8	6.8

Source: Economic Survey, 2014

Job creation remains a policy imperative for the government and yet also a key challenge. Notably, more than 85% of new jobs created are in the informal sector. The economy only added slightly over 106,00 (inclusive of self-employed) jobs in the formal sector. A solid path out of poverty is through increasing formal employment which in turn will enhance productivity and significantly raise household incomes.

Fig 2: Status of Job Creation in the Formal Sector



Macro-Economic Environment

The country's economic growth in 2014 was 5.3% compared to 2013's 5.7% growth. This growth was attributed to private consumption and a growth in capital investment on the demand side and agriculture and forestry, fishing, construction, wholesale and retail trade, finance and insurance on the supply side. Further, the GoK's rebasing of its GDP estimates based on 2010 National Accounts statistics resulted in an increase in the size of the economy by 25% compared to 2013.

Projected growth in 2015/2016 is 7% and is expected to be driven by increased agricultural production, continued investment in infrastructure, expansion in the construction sector, manufacturing, retail and wholesale and financial intermediation. This anticipated growth will however be underpinned by increased absorption of development expenditure especially for infrastructure projects as these will be key drivers of the Country's economic growth. Though there was a drop of fuel and energy prices occasioned by the drop in global fuel prices, these were outweighed by the increase in prices of food and other consumables. The successful issue of the sovereign Eurobond contributed to investor confidence in the Country's investment environment; there was however a noted decline in the shilling against the major world trading currencies which may further negate the gains made from the drop in energy prices as a result of expensive imports.

The year 2014 was characterized by a progressive easing of interest rates occasioned by the stable CBR rate at 8.5% throughout the year and downward revision of the Kenya Bank Reference rate from 9.13% in July 2013 to 8.5% in January 2015.However the increase in CBR rate to 10% by the monetary policy committee in June 2015 may impede private investments in the coming year.

Lastly, it is important to consider the sensitivity of the fiscal plan to changes in macroeconomic variables, especially in light of the recent depreciation of the shilling and significant increase in inflation. The table below shows the magnitude of changes in fiscal aggregates to shift in key macroeconomic variables.

Table 2: Fiscal Sensitivity to key Macroeconomic Variables

	Revenue	Expenditure	Budget Balance
One Percentage point reduction in Real GDP (%)	-6.0	-3.9	-2.1
One Percentage point increase in inflation rate (%)	5.7	4.1	1.6
10% depreciation in exchange rate	3.4	4.7	-1.2

Source: National Treasury, Kenya

Devolution: The promise of the counties

The devolved units have been allocated to KES 259 billion of shareable revenue along with KES 27 billion in conditional grants, amounting to KES 286 billion, representing 37% of government revenue of the last audited statements. Among the challenges experienced over the first two years of budgeting under the devolved government system is the fact that budgets are not aligned to County Integrated Development, moreover, significant number of projects in County Integrated Development are not budgeted for. Further, the unpredictability and low absorption capacity of development expenditure in the Counties may impede the attainment of the projected 7% economic growth.

The Government in partnership with some development partners have designed an incentive-based framework involving conditional grants to Counties that adhere to fiscal responsibility principles and meet minimum conditions and key delivery standards with an aim of entrenching fiscal discipline and enhancing service delivery standards in the Counties. Collaboration between the National and County Governments in implementation of the national development agenda and critical policy initiatives will encourage the generation of additional revenues for the Counties and safeguard a thriving business environment supportive of the privates sector in the Counties.

Business Climate: How competitive are we?

The private sector remains a key driver of economic growth and commendably, one of the key pillars in the government's economic development agenda in creating a conducive business environment. Insecurity has emerged as the greatest challenge affecting business sentiment and the country's ability to attract investment. The allocation of KES 214 billion (approximately 7%) to the security sector points to government's commitment to address this challenge.

The budget prominently introduced a raft of protective measures to enhance private sector development and spur job creation. Notable examples of this measure include the increase on import duty for sugar from 10 to 25%; exemption of VAT on film making equipment and the depreciation of the shilling and resultant hike of the Central Bank Rate to 10% has certainly upset the relative stable money markets and will certainly result in tightening liquidity and reduce access to credit. Notably, access to credit is one of indicators that has deteriorated according to the Doing Business Report by the World Bank. This is also attributable to the fact that domestic borrowing by government is significantly high. The plan to lower the entry barrier and enhance convenience of government paper through m-Akiba is innovative and welcome.

Business Outlook

In conclusion, the budget addressed some of the key challenges that faced the economy in 2014. Further, it also underpinned the key drivers of the economy in 2015. The allocation of 7% of the budget to national security and structural reforms will certainly enhance the business environment. Significant investment in infrastructure and measures to facilitate good governance would certainly reduce the cost of doing business in Kenya.