

Growing tomorrow's economy

Economic analysis

National Budget 2012/2013

Development Projects – The Key to Real Growth

Government expenditure should spur economic growth. The low budget execution of development expenditure does not support this

60% of development expenditure was not spent in 2011

Economic growth needs to have impact

Economic performance against last year's proposals

Against a budget of more than Shs 1 trillion and the impetus of Vision 2030 flagship projects, GDP grew by a mere 4.4% compared to 5.8% in the prior year. Key reasons for this low growth were:

- Erratic weather conditions
- Escalating oil prices
- Weakening of the Kenya shilling which led to widening of the current account deficit

However, the nature of our economic development, more so within the context of investments under Vision 2030, is that it is supply driven. Hence economic growth is mainly driven by government expenditure. Did the government spend 1 trillion KES in the year and did the economy feel the impact? We are sceptical. Close to 60% of the development expenditure was not spent and this raises questions about the government's ability, if not willingness, to fully implement development projects.

Key challenges that need to be addressed include:

- Low implementation capacity
- 'No Objection' donor bureaucracies

- Overly optimistic projections

This has led to a low budget execution ratio with respect to development projects which should spur economic growth.

This year's budget is no different. Of the 1.46 trillion KES budget, 451 billion KES has been set aside for development projects with 59% targeting physical infrastructure.

It makes good business sense for the government to invest in infrastructure. We should applaud the large allocations to road allocation, energy, an urban commuter rail system, transport, irrigation infrastructure and the ICT sector. We have to spend money to make money and it is impossible to grow a healthy economy if we have shoddy infrastructure.

However, challenges still remain regarding whether the government can spend the allocated funds. There are options to enhance the absorption capacity of development funds, such as:

- Procurement planning for development estimates and
- Enlisting the services of professional private sector project managers to implement some of the development projects.

Failure to enhance development expenditure absorption will lead the

desired fiscal multiplier being driven by recurrent expenditure which is not sustainable.

How did the other sectors of the economy perform?

Agriculture continued to contribute significantly to the economy (24%). However, agriculture expanded by a paltry 1.5% compared to 6.4% in 2010. The same story of erratic weather conditions despite investments in irrigation continues to be told. Although there was 8 billion KES allocation to irrigation and an additional 1 billion KES to the Agribusiness Fund, little was said about extension services to bolster information and technology transfer at the rural smallholder agriculture level.

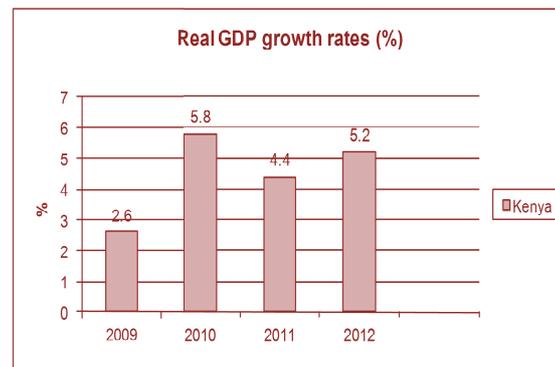
In addition, a major challenge is to design meaningful integrated solutions to the real problems faced by farmers. Provision of irrigation water should be coupled with strengthening markets, encouraging crop diversification, addressing public demand for produce, tackling the issue of soil nutrient management, carrying out soil conservation measures and improving physical access to markets.

As a result of high inflation and interest rates, manufacturing sector growth slowed to a mere 3.3% as compared to 4.4% in 2010 due to high costs of fuel and inputs and the depreciation of the Kenya Shilling.

The financial services sector continued to perform impressively expanding by 7.8% through the year as compared to 9% in 2010. Persistent high inflation, high interest rates which affect the cost of borrowing and large interest rate spreads between lending and savings/deposits rates were a challenge during the year.

To curtail the spiralling inflation, the Central Bank of Kenya tightened the monetary policy by increasing interest rates leading to deceleration of growth. Further, weakening of the Kenya Shilling in the latter half of the year further fuelled the import prices of necessary items.

Agriculture – the backbone of our economy – has not been comprehensively addressed



The Employment Question

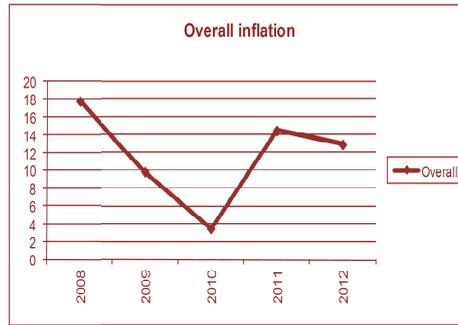
In 2011 520,000 new jobs were created with only 74,200 being in the modern sector. This trend is worrying since for the past four years there has not been any significant change in the number of jobs created by the economy. As such the increase in the aggregate demand for goods and services could not sustain projected growths.

Kenya's edge in the region with respect to human capital is seen with the continued investment and growth in the education sector. The sector grew by 4.9% in 2011. The right skills and readiness for the job market will be an important factor for real economic growth.

Macroeconomic stability

One of the key constraints to private consumption has been high inflation as a result of the high cost of food and fuel.

The Minister, while aiming to bring inflation down to 5% did not provide any significant measures to address this. The overall average annual inflation rate was 14.5% in 2011 (2010:3.5%). This was due to high fuel and electricity prices which affected the cost of production and distribution of goods and services. This year's budget struggled to provide direction to stem high inflation other than the hope of low crude and favourable rainfall.



Even with a stable and predictable interest rate the investors could not finance expansion with high costs of production. However it is anticipated that with a reduction in inflation, costs of production will reduce and aggregate demand for goods and services will increase in the coming year.

It is anticipated that the debt to GDP ratio will decline from 46% in June 2012 to 42% in two years. This is still above the 40% prescribed for developing countries by the IMF.

It is however important to focus on not just the debt to GDP ratio but in achieving faster economic growth. Thus development projects should be accelerated to spur economic growth and expand the economy to facilitate a lower debt to GDP ratio.

On the Social Front

Education and the health sectors continue to receive keen attention. The government has allocated 233.1 billion KES to the education sector and 85 billion KES to the health sector to address key aspects of the Millennium Development Goals. This will enhance consumer spending for households with increased disposable incomes due to government-led health and education interventions.

Both education and health spending have a positive and significant direct impact on the accumulation of education and health capital, and a positive and significant indirect impact on growth.

The positive effects of both education and health spending are strongly influenced by the quality of governance. As such the funds allocated to judicial reforms, the elections and the implementation of the constitution should provide

investors with the confidence they need in the economy.

What do the Budget proposals mean for businesses?

There were no shifts in the government's policy direction. This is important for businesses to continue operating within a predictable, consistent and stable policy environment.

However, external factors such as the global economic downturn fueled by the Euro zone crisis will weigh heavily on new or expanded investments locally.

The government's capacity to spend, equitable distribution of resources, fast tracking of the proposed infrastructural developments and the ability of the coalition government to see through a stable electioneering period will be important to the success of the budget execution. How effective and sincere the government is will be seen in the levels of aggregate demand for goods and services within the year.

On the other hand, businesses have to be smart. Prudent investments, robust cost control measures including a review and streamlining of business process will be important for benefits to be realised. Diversification into new markets, products, sources of credit and investment options will be important to staying afloat.

Conclusion

The budget is consistent with the Vision 2030 pillar of achieving economic and social equity. The political pillar will continue to be tested as we wade through the implementation of the constitution. This should provide new opportunities for businesses. Business should call the government to account on spending on development projects. The challenge is to ensure that, for once, the budget is executed fully.

Focus should be on sustained economic growth – not just the preoccupation with the debt to GDP ratio.