April 2017

Aktia

East Africa: Zambia, Kenya and Ethiopia

Trip Notes

We visited three East African countries, Zambia, Kenya and Ethiopia during the end of March. We met representatives from governments, embassies, financial institutions, politicians and independent experts. A clear picture of the countries and the state of their economies was built in three capitals, six days, ten flights and 28 meetings.

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- East African countries are on average less commodity dependent than other Sub-Saharan African countries and thus they have managed to maintain strong economic growth even during the past two years.
- Broad inflation pressures have eased close to the central banks' targets. However, inflation may temporarily rise due to higher food prices as drought have had a negative impact on harvests.
- Zambia, Kenya and Ethiopia have idiosyncratic short-term challenges, but they still have plenty of potential to maintain strong GDP growth.

Zambia

The main theme in our discussions was the IMF's simultaneous visit and the related loan package and support programme. The loan, expected to amount to over 1 billion USD, is important for Zambia as it would ease the government's short-term budget constraints and also provide an access to bilateral loans, and other concessional loans below market rates.

The government's indebtedness is a current issue and domestic and foreign investors would therefore like to see the IMF-supported programme anchoring fiscal policy to more sustainable level. The current government does fortunately seem to have an understanding that the IMF programme is needed.

Zambia's publicly funded support programs are a key reason for the large budget deficits, and a challenge for implementing the IMF-supported programme. However, progress is underway as removal of fuel subsidies has commenced.

The electricity subsidies for the mining sector considerably increase public spending, as the country is forced to import expensive electricity from abroad. The amount of these subsidies has been difficult to estimate due to problems in measuring true domestic electricity production prices, but an independent research commissioned from a neutral source will hopefully provide a solution satisfying both the government and the mining sector.

Load shedding has been common in Zambia because of low electricity generation capacity. However, load shedding has more than halved from eight hours per day last year.

The farming subsidy programs are a political hot potato, as they partly support the poorest people in Zambia by maintaining the corn price below market. Mealie-meal, made from corn, is the most important source of nutrition for the majority of country's population and strong price increases are difficult politically. The government has even increased the number of people covered by the programs since last year.

With copper accounting for around 75% of the total value of exports, Zambia's economy is the most heavily dependent on commodities among our three travel destinations. The positive

”Load shedding has halved since last year”

Agricultural Subsidies in Zambia

The Farmer Input Support Program distributes subsidised seeds and fertilizers to small scale farmers. The purpose of the program is to increase the productivity of the farms, improve food security and the standard of living in rural areas. The program has failed to be completely successful, since the governmental purchase-organisation has had difficulties in understanding the farmers' needs. Moreover, the program is unfortunately mired with corruption. The government is, however, moving towards an E-voucher system, where the farmers are given cash grants.

The **Food Reserve Agency's** mission is to secure strategic food reserves and stabilise the price of essential crops. The maize is procured from small scale producers at a premium price through intermediaries and sold to millers below market price, in order to keep the price of maize flour low. Also this program has fallen victim to corruption and inefficiencies. Moreover, it entices the small scale farmers to focus solely on maize, even if e.g. soybeans could be more profitable.

The structure of the programs underline the importance of maize for Zambian farmers and its political importance. Maize is, as a result, three times more expensive in Zambia compared to neighbouring Congo and Malawi.

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news is that copper production, which has a key role in the economy, has already picked up and hit a new record in 2016. Copper production is expected to expand further in 2017. Stronger export volumes and higher copper prices will improve Zambia's current account.

Copper mining has dominated the economy over a hundred years, and the value of diversification has been understood after the volatility of the previous two years. Agriculture is seen as a potentially even bigger sector than copper mining: ground water is abundant, there are two harvests per year and Zambia has more arable land than any other African country; almost 60% of Zambia's land area is suitable for agriculture. However, the subsidies for maize distort the market and difficulties with land ownership between English law and tribal law impede further commercialization of the agricultural industry.

We continue to view Zambian government bonds as favourable investments, as inflation is decreasing, economic growth is picking up and the public economy is improving. The Eurobonds are further supported as the deficit is planned to be financed by focusing more on domestic markets.

Kenya

Kenya's economy is the most developed of the three countries, and growth has been buoyed by consumption and the service sector. Light manufacturing, construction and mining make up 16 % of the economy, whereas the service sector is almost half.

The autumn rainfall was scarce and the ensuing drought led to elevated food inflation to 16 % momentarily in February and had a negative impact on agriculture, an important export industry (coffee, tea and horticulture constitute 37 % of exports). Core inflation is still decreasing, and the central bank did not see it prudent to raise rates in their previous meeting. They will, however, continue to monitor the second round effects of the food inflation.

The rate cap on lending by banks complicates the central bank's monetary policy though. Banks are allowed to charge only 4 percentage points above the policy rate (currently 10 %). The alternative cost for banks is to invest in government bonds, currently at a similar yield, without credit risk. Hence, a decrease in the policy rate could potentially reduce private credit growth. Credit growth has decreased to 4 % from previous growth levels of 16 %. President Kenyatta did allude in his recent state of the union address that the rate cap will be reconsidered, but we do not think that the government will act before the elections.

Tensions are common during elections, as party adherence tend to follow tribal fidelities and disagreements tend to surface. Similar unrests to 2007 are unlikely to resurface, as officials are better prepared this time around, partly with Western help.

The elections are scheduled for August, but delays are not out of the question, as the preparedness of the Independent Electoral and Boundaries Commission is partly under doubt. It is also probably that the elections will be protracted, as different petitions and complaints can be filed at several stages of the election. The opposition is yet to name it presidential candidate, but Raila Odinga is the only nationally credible candidate. Both the opposition and the government are seen as market friendly, so the key for markets is that the elections are not exceptionally drawn out and wider disorder is averted. The opposition coalition seems to be currently ahead according to tribal arithmetic.

The outlook for a stable currency remains good going forward, as central bank currency reserves record high (over 8 bn USD) and Kenya still has access to a 1.5 bn USD credit facility from the IMF.

"The economicallly critical copper production was record high last year. Even larger volumes are projected for 2017."

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Growth will be a healthy 6 % in 2017 according to the central bank. Tourism is still viewed as having loads of potential, especially after the election. A new standard gauge railway connects Nairobi to the port city of Mombasa, substantially cutting transport times for goods. The first steps towards direct flights to the USA have been taken, which will further enhance Kenya's attractiveness. GE, Bechtel and Boeing are opening their African headquarters in Kenya and Volkswagen is opening a new factory in the country. Exceptionally large interest has been seen from China. International corporations continue to view Kenya as an attractive investment target and FDI has remained high. The Kenyan manufacturing sector is beneficiary to the African Growth and Opportunity Act in the USA, which temporarily lifts import customs for certain goods. About 90 % of exports to the USA fall under this law, and Kenya is a relative winner after the partial demise of the TTP.

We continue to view Kenyan government bonds as attractive, especially in local currencies, where the stable currency and high rates support the market. Also, issuance of Eurobonds seems less likely in the near future, based on conversations with authorities.

Ethiopia

The competition between Ethiopia and Kenya covers much more than long distance running, as coffee, tee and flowers are also the foundation of the Ethiopian exports industry. Agriculture still has a central role in the country's economy (80% of exports). The government's big investment program has helped to sustain high levels of growth during the past years, but simultaneously raised the debt levels of the country. There is a clear understanding among politicians that this phase has come to an end, the large infrastructure projects are in their final stages and now it is time to reap the benefits of these investments. Hence, the economic future of Ethiopia probably lies in electricity generation and light manufacturing.

Gilgel Gibe III –dam was opened in 2016 and it is going to supply up to 40 % of the country's electricity. The true great leap will be taken with the 2018 completion of the Grand Ethiopian Renaissance Dam. The Blue Nile dam has the largest installed capacity in Africa (6000 MW, three times the peak demand of Kenya for reference) and electricity exports will soon generate 0.5 - 1 bn USD yearly according to the authorities.

The second cornerstone of the Ethiopian future economy will be a string of industrial parks, aimed at international export companies. The newly opened industrial park in Hawassa has already attracted the large international companies H&M and PVH (e.g. the Calvin Klein and Tommy Hilfiger brands). An estimated 60 000 jobs and exports worth 1 bn USD are projected to be created in the park. On the other hand, the companies receive long-term tax breaks, decreasing the short term benefits from a government budget point of view. Job creation and improvement of workers' skills is more of a realistic short-term objective. Ethiopia offers competitive salaries, reliable electricity provision and a relatively stable political environment, an attractive proposition for international investors.

The Addis Ababa – Djibouti standard gauge railway is on of the other large infrastructure projects in its final stages. The country does not have a coast of its own, so the link to the Red Sea port of Djibouti is of vital interest for the nascent manufacturing sector. The railway will decrease transportation times to a fourth. The country witnessed a record year for FDI last year, around 3 billion USD.

The opposition is not represented in parliament and the government has received lots of critique over the way it dealt with last year's unrest. The curfew was, however, very popular among foreign investors. The government has initiated a microcredit fund to help alleviate youth unemployment and decrease the chances of future unrest. Overall, the efficiency of the government was lauded by international observers, the government has completed World Bank projects in advance and the corruption is low by African standards; the planned roads, hospitals and schools are built and the infrastructure of remote areas is genuinely being improved. One diplomat, who had worked in several African countries, told us that he has never seen a similar pace of improvement, e.g. the life expectancy had increased by five years during the last five years.

We continue to view Ethiopian USD-bonds as attractive, regardless of the decreased risk premia of the last few months. The continuing strong growth and positive development of the economical structure support the country's debt service capabilities and will sustain further reduction in spreads. Also, the issuance of Eurobonds seems unlikely in the near future. Yields in local currency bonds are not attractive at the moment, due to current Ethiopian regulation. The availability of information could still be improved and we hope that our conversation with the finance ministry and central bank will bear fruit in the form of continuing increasing transparency.

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