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FUNDAMENTALS

KENYA FY25 BUDGET: REVISED FISCAL DEFICIT WIDENS TO 4.3%

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IN BRIEF

- The revised FY25 fiscal deficit has now widened by 1.0pp to 4.3%, following the shelving of the Finance Bill 2024. Even though the authorities initially eyed a spending cut in the order KES 200.0bn (1.1% of GDP) and mainly on the discretionary budget items, the execution risk has been high.
- Whereas the shelving of the Finance Bill 2024 resulted in a funding gap of KES 346.0bn, the limited spending cut leaves room for caution. The authorities are likely to tread carefully in introducing newer tax proposals in future budgets, casting doubts on implementation of the Medium-Term Revenue Strategy (MTRS) that covers FY25 – FY30 period.
- Critically, President Ruto's appointment of Hon. John Mbadi, nominated Opposition MP, as the Cabinet Secretary (CS) for the National Treasury caught our eye. Granted that Mbadi has assumed senior positions in his political party and in the National Assembly, his tenure as Treasury CS, should he be approved after the vetting stage, looks like a poisoned chalice.
- Legislative process is taking shape with the National Assembly formally deleting all the clauses of the Finance Bill 2024 and approving the spending cut to the national government. This paves the way for the publishing and approval of the Supplementary Appropriations Bill (No. 2) 2024 this week.
- Broadly, this should give the IMF some level of comfort ahead of the expected Executive Board approval later in August. With the programme targeted to end in March 2025, the authorities have alluded to some extension, speaking to fiscal targets for June 2025.
- The clarity regarding FY25 budget, limited scope for aggressive revenue mobilization in the future, and execution risks with budget implementation gives us the conviction that Fitch Ratings and S&P will downgrade Kenya a notch lower to B- on 02 August and 23 August 2024, respectively.

Birds' eye view: Attendant risks tees odds of one-notch downgrades in August 2024

The revised FY25 fiscal deficit has now widened by 1.0pp to 4.3%, following the shelving of the Finance Bill 2024. Even though the authorities initially eyed a spending cut in the order KES 200.0bn (1.1% of GDP) and mainly on the discretionary budget items, the execution risk has been high. Parliament approved a plan that sees a spending cut of KES 99.1bn by the national government. On the other hand, carry overs from FY24 (KES 30.8bn) more than offset the targeted spending cut (KES 20.1bn) to the county governments. Whereas the shelving of the Finance Bill 2024 resulted in a funding gap of KES 346.0bn, the limited spending cut leaves room for caution. The authorities are likely to tread carefully in introducing newer tax proposals in future budgets, casting doubts on implementation of the Medium-Term Revenue Strategy (MTRS) that covers FY25 – FY30 period. In the meantime, we await the publication of the Kenya Revenue Authority's (KRA) ninth corporate plan that covers FY25-FY29 period, and we shall assess the realism of revenue targets from an operational perspective.

The recent inclusion of four opposition politicians in the broad-based government will be a litmus test for implementation of the revised FY25 budget. Critically, President Ruto's appointment of Hon. John Mbadi, nominated MP, as the Cabinet Secretary (CS) for the National Treasury caught our eye. Mbadi has been critical of the Ruto administration's fiscal policies, and this appointment brings to the fore the political maelstrom that President Ruto found himself, following the youth revolt that rocked Kenya the last few weeks. Granted that Mbadi has assumed senior positions in his political party as the current Chairman of the Orange Democratic Movement (ODM) Party, and in the National Assembly, as the Chairman of the oversight Public Account Committee (PAC), his tenure as Treasury CS, should he be approved after the vetting stage, looks like a poisoned chalice.

Legislative process is taking shape, with the National Assembly formally deleting all the clauses of the Finance Bill 2024 and approving the spending cut to the national government. This paves the way for the publishing and approval of the Supplementary Appropriations Bill (No. 2) 2024 this week. Broadly, this should give the IMF some level of comfort ahead of the expected Executive Board approval later in August. With the programme targeted to end in March 2025, the authorities have alluded to some extension, speaking to fiscal targets for June 2025, or end FY25. This has been a dominant theme in our recent investor discussions; an extension of the current financed programme or a precautionary facility at the conclusion of the current programme. The clarity regarding FY25 budget, limited scope for aggressive revenue mobilization in the future, and execution risks with budget implementation gives us the conviction that Fitch Ratings and S&P will downgrade Kenya a notch lower to B- on 02 August and 23 August 2024, respectively.

FY25 BUDGET: INITIAL -VS- REVISED

	KES, Bn's		% of GDP	
	Original	Revised	Original	Revised
EXPENDITURE	3,992.00	3,927.44	22.2%	21.8%
National Government	2,378.43	2,279.37	13.2%	12.6%
Consolidated Fund Services	1,213.45	1,237.23	6.7%	6.9%
Interest	1,009.88	1,009.88	5.6%	5.6%
Pensions & Others	203.58	227.36	1.1%	1.3%
Counties' equitable revenue share	400.12	410.83	2.2%	2.3%
TOTAL REVENUE AND GRANTS	3,394.99	3,156.47	18.8%	17.5%
Total Revenue	3,343.16	3,104.65	18.6%	17.2%
Ordinary Revenue	2,917.20	2,631.40	16.2%	14.6%
Appropriations-in-Aid	425.97	473.25	2.4%	2.6%
Grants	51.83	51.83	0.3%	0.3%
FINANCING	597.01	770.96	3.3%	4.3%
Net Foreign Financing	333.82	356.42	1.9%	2.0%
Net Domestic Financing	263.20	414.55	1.5%	2.3%
NOMINAL GDP	18,015.20	18,054.00	100.0%	100.0%

SOURCE: NATIONAL TREASURY, ICAMMU

Blunting the impact of the financial hole

Shelving of the Finance Bill 2024 created a KES 346.0bn (1.9% of GDP) and complicates revenue mobilization going forward. Despite this financing gap, we note some offsetting revenue raising measures. They include the extension of the amnesty program (KES 30.0bn), impact of winding up of 47 State Owned Enterprises - SOEs - (KES 7.3bn) and increase in the Road Maintenance Levy (RML) from KES 18/litre to KES 25/litre (KES 32.0bn) under ordinary revenue. As a result, ordinary revenue recalibrates lower by KES 285.8bn to KES 2,631.4bn. Following the shelving of the aggressive Finance Bill 2024, the current target looks more realistic, in our view.

We question the characterization of the inclusion of this expected higher RML revenue yield under ordinary revenue, as it is an Appropriations-in-Aid revenue. Besides, the proposed KES 7/litre increase in RML has not been approved by Parliament, following its gazettement of the Road Maintenance Levy (Imposition of Levy) Order 2024. Unlike the Finance Bills that requires public participation before the Finance Committee gives its recommendation, the Delegated Legislation Committee is

required to either recommend a rejection or approval of the proposed increment in the RML. The authorities have baked in the 75.0% increment in the targeted Affordable Housing Levy collection from the initial KES 63.2bn to KES 110.5bn this FY25. The KES 47.3bn increase is the unspent amount in the Affordable Housing Fund Account of KES 38.5bn at the end of FY24, and upward KES 8.8bn revision in the targeted collection based on the outturn in FY24 budget.

Austerity headache amidst FY24 carry overs and unfunded requests

From our preliminary assessment of FY24 outturn, spending to the national government fell short by KES 151.0bn. Despite the in-year downward revisions to capex budgets in FY24, the less-than-targeted spending was in capex. The accommodation of select carry overs, amidst some requests to the authorities to revise the budget upward, has been the proximate cause of the eventual spending cut of KES 99.1bn against the earlier target of KES 200.0bn. The authorities accommodated FY24 carry overs totaling KES 68.1bn for KES 13.5bn towards Constituency Development Fund (CDF), KES 30.8bn as the undisbursed equitable revenue share to counties, while KES 23.8bn towards pensions and gratuities payments. There is the case for carry overs to counties, as the devolved units rely heavily on the equitable revenue share disbursements, and pensions and gratuities, prioritized budget items under the Kenyan Constitution. However, the optics of prioritizing CDF that is largely oversighted by MPs is contestable. In our view, we see this as a necessary lever by the Executive to the Legislature as the former seeks the buy-in from the latter.

One common theme in Kenya's supplementary budgets has been cuts biased towards capex budget. The approved FY25 Supplementary budget has penciled in capex budget cut of KES 59.8bn compared to the slash of KES 39.3bn for recurrent spending. This path of least resistance of budget cuts biased towards capex comes at odds with the initial austerity plan that was targeting discretionary recurrent budget. Furthermore, our assessment of the Budget Committee report on the FY25 Supplementary budget amplifies the upside risks with in-year budget revisions, Specifically, the Committee received unfunded requests to the tune of KES 242.2bn, specifically to the health and education sectors at KES 116.4bn and KES 83.0bn, respectively. Notably, these higher spending pressures has been on two reforms under the Kenya Kwanza administration. The first one is the New Funding Model for higher education whose effect has necessitated higher funded scholarships and loans programs for new students joining Universities and Technical Vocational and Education Trainings (TVETs). Secondly is the planned Social Health Insurance Fund (SHIF) to replace the National Health Insurance Fund (NHIF), that is targeting enhanced collections. Delay in disbursements from Treasury towards the New Funding Model has led to higher fee costs at the tertiary level, whereas the High Court declared SHIF unconstitutional in its current framework and granted Parliament four-month timeframe to enact the necessary corrective measures.

FY24 BUDGET: PRELIMINARY -VS- TARGET

	KES, Bn's		% of GDP	
	Preliminary	Target	Preliminary	Target
EXPENDITURE	3,633.40	3,870.97	22.5%	24.0%
National Government	2,289.31	2,440.28	14.2%	15.1%
Consolidated Fund Services	989.50	1,045.27	6.1%	6.5%
Interest	837.20	853.67	5.2%	5.3%
Pensions & Others	152.30	191.60	0.9%	1.2%
Counties' equitable revenue share	354.59	385.43	2.2%	2.4%
REVENUE AND GRANTS	2,730.80	2,887.73	16.9%	17.9%
Total Revenue	2,711.00	2,849.23	16.8%	17.7%
Ordinary Revenue	2,288.90	2,402.74	14.2%	14.9%
Appropriations-in-Aid	422.10	446.49	2.6%	2.8%
Grants	19.80	38.49	0.1%	0.2%
*Discrepancy**	*(91.10)*	-		
FINANCING	811.50	983.25	5.0%	6.1%
Net Foreign Financing	222.10	259.33	1.4%	1.6%
Net Domestic Financing	589.40	723.92	3.7%	4.5%
NOMINAL GDP	16,131.50	16,131.50	100.0%	100.0%

*The FY24 financial reconciliation is yet to be finalized

SOURCE: NATIONAL TREASURY, ICAMMU

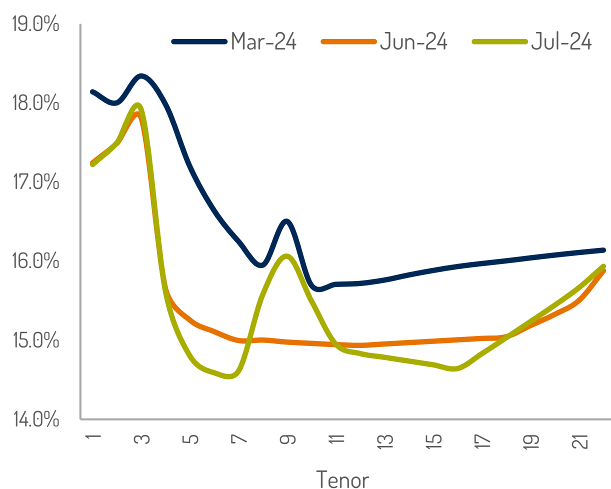
Revised financing plan leans towards domestic

Financing mix in the FY25 budget now moves to 54:46 split in favour of domestic financing, from the 56:44 split biased towards external financing initially. Not surprisingly, domestic borrowing is to do the heavy lifting amidst tight constraints to absorb more external financing. Even with the Fed futures markets penciling in three rate cuts, cumulative 75bps, at the backend of the year, the market remains tight for a potential KENINT USD-denominated issuance in the near-term on the back of recent Moody's downgrade. As for multilateral financing, Kenya will lean on the expected World Bank Development Policy Operation

(DPO), the second consecutive disbursement in the current series that begun in FY24, and the remaining disbursement in the IMF programme with the next expected inflow following the approval by the Executive Board at the end of August.

Tight domestic liquidity and financial repression has dampened appetite for domestic bonds at the primary market. The second FY24 supplementary budget widened the domestic borrowing target in the final month by KES 249.4bn to KES 723.9bn, in our estimates. This offsets the similar reduction in the ordinary revenue necessitated by a series of TAP Sales at the tail end of the fiscal year. From the preliminary accounts, domestic borrowing in the last fiscal year settled at KES 589.4bn, falling short of the target by KES 134.5bn. The ongoing sale of two infrastructure bonds, KENIB 17.9327% 2030 and KENIB 14.3990% 2039, speaks to the need of ramping up funding gap following the shelving of the Finance Bill 2024. Given the market conditioning of outsized demand for infrastructure bonds, the choice for re-openings and TAP Sales over fresh issuances solidifies the rate suppression by the authorities.

IMPLIED YIELD CURVE



SOURCE: NAIROBI SECURITIES EXCHANGE

The Shilling, KES, has reacted positively in the FX interbank market against the US dollar in the trading sessions following the announcement of this month's bond sale, but this is a presumptive cause and effect. KES liquidity has been thin, necessitating the liquidity intervention by the central bank via reverse repo transactions. To be exact, the outstanding cumulative 7-day and 14-day reverse repos are KES 167.0bn with weighted average rates of 13.7% and 14.9%, respectively. With inflation firmly within the target 5.0% ± 2.5%, and July inflation print, scheduled for tomorrow, expected to entrench the disinflation trend, there is a case for the Central Bank of Kenya to begin its easing cycle in next week's MPC meeting. Policy easing is a low hanging fruit in signaling lower rate environment amidst the fiscal concern.

Stand-by Arrangement looks likely as IMF's successor programme

Increasingly, we have received questions on the successor for the current IMF programme that is scheduled to end in March 2025. Notably, the National Treasury presentation to the Budget Committee refers to fiscal targets as of end June 2025, that are aligned with the targets in the revised budget. The fiscal targets for the final ninth review zooms in end December 2024 targets and which are to be reviewed in March 2025. Thus, the reference to June 2025 suggests the possibility of the current IMF programme being extended by at least six months, with the last review scheduled for September 2025. Our thinking is fortified by the fact that the financing instruments for the current programme, Extended Fund Facility (EFF) and Extended Credit Facility (ECF), typically runs for 48months and coincides with the maximum duration for the current programme that started in April 2021. Thus, Kenya can receive a 6-month exceptional extension. But with revenue mobilization no longer tenable as planned in the IMF programme, we do not see a strong case for an extension. Completion of the current programme that paves way for a 12-15-month Stand-by Arrangement (SBA) looks more probable. This could be the framework that the National Treasury anchored the June 2025 fiscal targets on.

Despite the protracted seventh review, we remain unimpressed by the slow implementation of some of the structural benchmarks. Restructuring of Kenya Airways initially targeted for end-April 2024, has been rescheduled to end of this month but the firing of the Cabinet earlier this month has left the approval in limbo. The governance structure for Petroleum Development Fund with an aim of clarifying fuel pricing policy which was also rescheduled from end-April to end of this month, remains unresolved. Last week, President Ruto reiterated the need for increasing transparency in Tax Expenditures with Parliament expected to provide the legislative and regulatory framework within 90 days. Coincidentally, one proposed structural benchmark dwells on tax reforms by the MTRS Steering Committee by November 2024. With the delicate balancing act of mobilizing revenue going forward, this proposed structural benchmark will be challenging to implement.

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