EAST AFRICAN DEVELOPMENT BANK

Economic and market analysis

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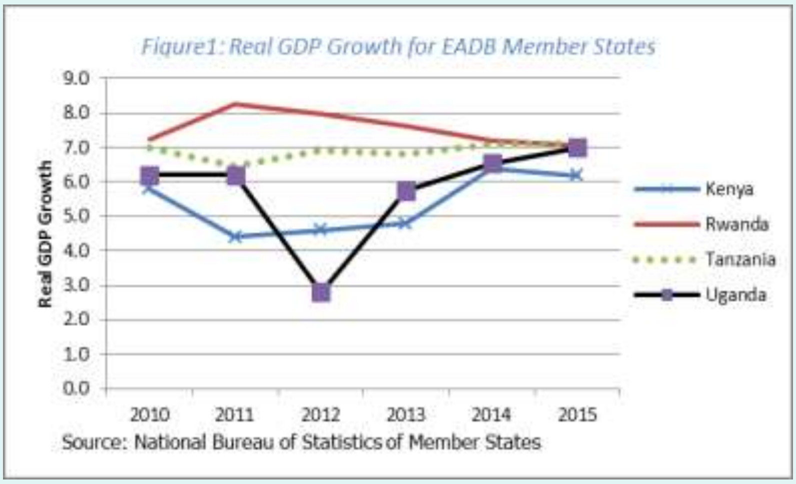
ECONOMIC PERFORMANCE AND OUTLOOK

Global Growth Outlook: In June 2013 the IMF further trimmed down the global economic growth forecast for this year to 3.1% less than the 3.3% forecast in April 2013. The main cause being: the slowdown in emerging market economies, lowered expectations for U.S. growth and deepening recession in the Eurozone. Declining global demand for goods and services will impact negatively on growth in developing economies.

Growth Outlook for EADB Member States: EADB Member States will continue to sustain robust growth for the coming three years. Growth is expected to average 6.6% for three years going forward (See figure 1).



Kenya

Real GDP at market price is estimated to have expanded by 4.6% in 2012 as compared to 4.4% in 2011. The Real Market GDP growth rate is projected at 5.6% in financial year 2013/14. The forecast in the medium term is for sustained rising growth. The services sector (banking, telecommunication and regional trade) will remain key driver of growth in 2013/14. This growth will be supported by:

- Lower interest rates from mid-2012 as compared to the period before mid-2012. Low interest rates will continue to boost credit to households and firms.

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Highlights

- GDP growth for EADB Member State remains robust despite slowing global output
- Growth in services sector and investment in infrastructure development remains key drivers of growth in 2013/14
- Inflation rate decelerates to record low levels by end June 2013
- Monetary policy easing to stimulate growth
- Expansionary fiscal policies likely to exert pressure on interest rates across Member States
- Yields on Securities likely to remain high for Tanzania and Uganda
- Member States currencies gradually depreciate against the USD but remain stable

Kenya (from page 1)

- A stable macroeconomic environment: Inflation is expected to remain at single digit levels at an average of less than 7% (2013/14) supported by lower food prices on account of sufficient rain so far and stability in commodity prices in particular international oil prices. Lower inflation will facilitate consumer spending. The shilling is expected to remain stable with minor fluctuations i.e. Less than 10% year on year.
- Fiscal stimulus in infrastructure financing for road construction, geothermal development, power transmission, ports and railways development.

Risks to Growth

- Trade and investment finance risks remain high: delays in implementing key infrastructure projects could undermine growth.
- Fiscal deficit and borrowings could exceed expectations. The anticipated 8.3% increase in revenue for 2013/14 is unrealistic given past trends. Distortionary fiscal policies could impact negatively on growth.

Rwanda

Real GDP grew by 8% in 2012 as compared to 8.2 in 2011. Growth was driven by rapid expansion in construction and the services sector particularly communication which expanded by 19.5% followed by Financial Intermediation and Insurance sub-sectors which grew by 17%. Other sub-sectors which registered high growth include Wholesale and Retail Trade (12%), Public Administration (12%) and Health (10%). Growth continued to be robust during the first quarter of 2013. The GDP expanded by 5.9% as the industrial sector recorded highest growth at the rate of 14% and contributed about 1.9% of GDP growth. Going forward Key drivers of growth include:

- Investments in infrastructure (power generation and distribution, road construction and ICT development.
- Investment in Agriculture development.

Risks to growth

- The risk to the growth outlook centers around weak external budget support.
- A weak global economy will reduce commodity export earnings, donor aid flows, migrant remittances and foreign direct investment thus impacting negatively on growth.

Tanzania

Real GDP increased by 6.9% in 2012 as compared to 6.4% in 2011. Growth was driven mostly by improvement in transport and communication infrastructure together with growth in industrial production. Sustainable high growth was possible on account of Government efforts in ensuring availability of reliable electricity, together with utilization of alternative energy in the industrial production.

Communication recorded the highest growth at 20.6% (2012/13) but contributed only 2.3% of GDP as compared to agriculture which contributed 24.3% of GDP in 2012 and employs about 70% of workforce. Agriculture grew by 4.3% in 2012 as compared to 3.6% in 2011 mainly on account of a bumper harvest following favourable rainfall and subsidised farm implements from the Government. Growth will remain buoyant above 7% in the medium term driven by:

- Increased spending on infrastructure (energy particularly gas, transport, ICT and water) financed by new funds and public private partnerships.
- Investments in Agriculture.
- Development of industries and skills.

Risks to growth

Key risks to the outlook may stem from:

- Ambitious revenue targets and pressure to increase spending in the 2013/14 budget.
- Potential delays in implementing the action plan in the power sector.
- Decline in gold prices which accounts for 40 of forex earning will curtail Growth.

Uganda

Real GDP was at historical low of 2.8% in 2012 as compared to 6.2. in 2011. Low growth was a result of increased spending cuts by Government following reduction of aid and anti-inflationary measures to contain a surge in inflation. Output is recovering gradually and inflation is close to its 5% target level. In the financial year 2012/13 GDP is estimated to have grown by 5.1%. The medium term growth is expected to return to 6-7% per annum. Growth will further be supported by lower interest rates following a decline in inflation. Key drivers of growth in 2013/14 include:

- Construction which is expected to grow at an average rate of 7-10% per annum.
- Manufacturing: Steel manufacturing will benefit from planned construction of railway lines and construction.
  Real Sector development.
- Services sector which will continue to register robust growth.

Risks to Growth

- The reduction in aid flows has had its toll on growth figures for Uganda. In 2013/14, budget support grants are expected to decline by 84%. More permanent reduction in aid inflows may have more severe implications for the macroeconomic outlook with a potential reduction of GDP growth amounting to 0.5-0.6 percentage points. In order to protect spending on basic services, Government will continue efforts to mobilize more domestic resources to mitigate the risks from continued shortfalls in aid inflows in the medium term.
- Investment delays in critical infrastructure projects particularly in energy and transport will have negative implications on GDP growth in the medium term.
- Lower than projected rainfall will lead to price spikes, and thus undermine growth during the year 2013/14.

PRICES AND MONETARY POLICY

INFLATION

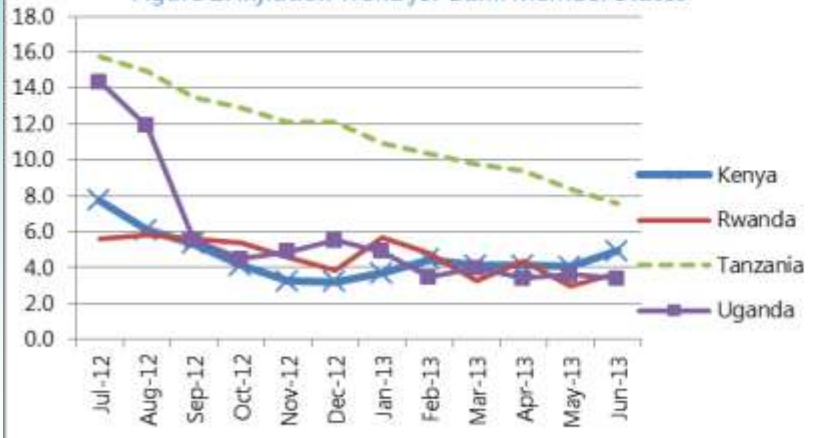
Inflation for Member States continued to decelerate over the year reaching an average of 4.9% by end June 2013

Kenya: A Low inflation expectation has taken its toll as demonstrated by a downward shift of the yield curve. The Central Bank of Kenya has consistently been lowering its key policy rates in line with declining inflation. The rate was lowered cumulatively by 950 basis points from June 2012 to its current level of 8.5%. Subject to inflation remaining subdued the CBK could further lower its policy rates going forward.

Rwanda: Inflation pressures have eased on account of effective monetary policy, eased pressures on foreign exchange market, and declining inflationary pressures in main trade partner economies. Headline inflation has declined to 2.98% in May 2013 from 4.4% in April and 5.7% in January 2013. In June 2013 inflation decelerate d to 3.68%. Inflationary pressures are expected to remain moderate. The Key repo rate remains at 7% per annum.

Tanzania: Though subsiding over time, the inflation rate has remained higher than the rest of the Member States from mid-last year up until June 2013. This is on account of less aggressive monetary policy to reign over inflation. The declining inflation from March 2013 is facilitated by stability in global commodity prices and a fall in the pace of price rise for all non-food product categories. The Bank of Tanzania discount rate remains at 12% per annum.

Figure 2: Inflation Trend for Bank Member States



Source: Bureaus of Statistics for the Member States

Uganda: Inflation has decelerated over the past one year reaching record low levels of 3.4% in April 2013 before slightly increasing to 3.6% in May 2013. The decline in inflation over months has mainly been driven by a decline in food crop inflation which is largely determined by domestic and regional weather conditions. The decline in food crop inflation has been supported by stable global commodity prices and subdued demand. Overall annual inflation is expected to remain at 6% for the second half of 2013 . There is no evidence of stronger global recovery to fuel an increase in commodity prices or trigger high import costs. The negative output gap is likely to persist in the next two years and thus dampen any inflationfary pressures. In response to decelarating inflation the Central Bank has lowered its key policy rate to 11% the lowest rate in more than two years. However commercial bank rates and interest rates on security still remain high as compared to the current inflation rate of 3.4%

The Monetary policy statement for July 2013 forecast a rise in Annual core inflation over the next two to three months on account of threat posed by drought. In June US-funded Famine Early Warning Systems Network said that acute food insecurity in Karamoja was increasing because of the early cessation of seasonal rains between April and May. Crucially, it also expects bad harvests in Kenya and South Sudan, which could push up food prices in Uganda, as food is traded across these porous borders.

PRICES AND MONETARY POLICY *(from page 3)*

Yield on Securities

There is mixed trend on the yield curves across Bank's Member States. While in Kenya the yield curve has been shifting downward from the beginning of the year, yield curves for both Uganda have shifted slightly upward from position in March 2013. Figure 3 depicts the yield curve position for Kenya, Tanzania and Uganda at the beginning of July 2013.

Tanzania: There are prospects for interest rate to decline in line with inflation which is expected to fall to 7% by December 2013. However Expansionary fiscal policy could offset the impact of lowering inflation on government yields. Fiscal expenditure is expected to grow by 20% in 2013/14 as compared to previous financial year. The Government may not achieve the ambitious domestic revenue to GDP ratio of 20.2% from 17.7% in 2012/13. Efforts to increase domestic borrowing will likely sustain high interest rates in government securities.

Uganda: Although the central bank rate and commercial bank interest rates have declined in tandem with decelerating inflation, the interest rates on securities declined during the first quarter of 2013 but picked up again during the second quarter. Yields on long term securities are likely to edge high during the remaining half of 2013. The situation is aggravated by the likelihood of increased domestic borrowing to offset the impact of aid withdrawal by development partners.

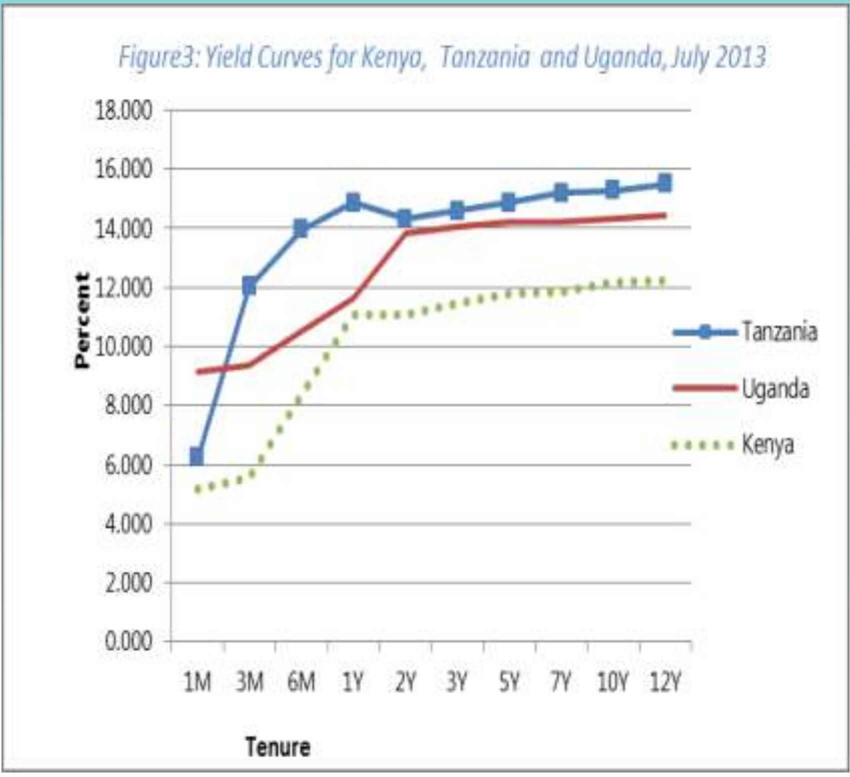


Figure 3: Securities with 3 years tenure and above fetch yields above 14% for Tanzania and Uganda

Securities with 3-12 years tenure fetch yields ranging between 11.45% to 12.23%

Expansionary Fiscal polices for Uganda and Tanzania will push interest rate upward

Kenya: By June 2013, the yield curve had shifted downward to the levels experienced 18 months ago. Interest rates are generally on a declining trend in tandem with declining inflation. However further decline in interest rates depends largely on the fate of a debut sovereign bond worth USD 1 billion which is expected to be issued late this year. It is not certain that the bond issue will go ahead given numerous delays in the past and the rising cost in the international market following recent moves by the Federal Reserve to unwind its stimulus. Some investors may discount Kenya's better rating with political atmosphere in the country. The Government may recourse to domestic financing should the Eurobond issuing go unsuccessful. It is very likely that this will exert upward pressure on domestic interest rates and shift the yield curve upward from its current position.

PRICES AND MONETARY POLICY *(from page 4)*

Foreign Markets

Figure 4 shows currency movements for Bank Member States. Generally, Member States' currencies have been losing value against the USD from the fourth quarter of 2013. The Rwandan Franc and Tanzanian shilling have been less volatile for the past one year as compared to other Member States' currencies.

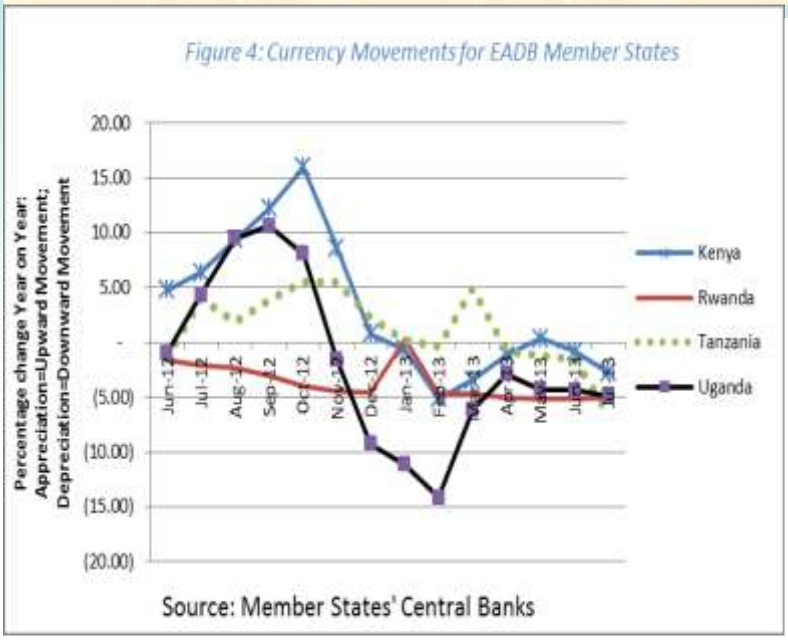


Figure 4: Currency Movements for EADB Member States

Source: Member States' Central Banks

Kenya Shilling: The trend show that the shilling began to lose its value against the USD from the last quarter of 2012 up through February 2013 when year on year depreciation was 5.13% at KNS 87.45% per 1USD. The depreciation was due to election related uncertainties. The Kenyan shilling will continue to enjoy relative stability for the remaining period. Loosening monetary policy and import demand could exert some downward pressure on the shilling.

Rwandan Franc: From the beginning of June 2012 the Franc had been losing value against the USD. Year on year comparison shows consistent deprecation of the Franc with exception of January 2013. The depreciation is mainly a result of shortfall in foreign inflows leading to dwindling external reserves. As a result the National Bank of Rwanda could not sustain exchange rate stability through its interventions in forex market. The currency will continue to be volatile on account of dwindling foreign aid inflows.

Tanzanian Shilling: The shilling has been on a gradual depreciation trend from last quarter of 2012 with the exception of March 2013 when it appreciated by 4.5% to TZS 1,511.39 per 1 USD. The widening fiscal and current account deficit will exert downward pressure on the shilling. Growth in Foreign Direct Investment will help to dampen currency volatility going forward.

Ugandan Shilling: The Uganda shilling is the most volatile as compared to other Member States' currencies. The Ugandan shilling depreciated significantly since the fourth quarter of last year. The weakening shilling is the result of a deteriorating balance of payments position due to an increase in imports, slow growth in exports and reduced remittances and donor inflows which have weakened the ability of the Bank of Uganda to intervene in foreign exchange markets.

The aid suspension and strong corporate demand for the dollar will exert further downward pressure on the Ugandan shilling.

Primary Business Address
East African Development Bank
4 Nile Avenue
P.O. Box 7128
Kampala, Uganda

Please send your comments to:
Oswald Leo
Email: oleo@eadb.org
Phone: +256 417112900/28
Fax: +286 312230000

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