

POLICY BRIEF | ISSUE NO: 1/2022, APRIL 2022

THE ECONOMIC IMPACT OF THE WAR IN UKRAINE ON KENYA'S ECONOMY

Summary

This paper analyses the implications of the ongoing war in Ukraine on the Kenyan economy. It observes that this would come with disruptions in value chains for some critical inputs for Kenya's manufacturing and agriculture sectors over and above exports destined to these countries. Disruption in value chains has resulted in price increases in; fuel and energy, wheat and fertilizer prices which are critical inputs for Kenya's manufacturing and agriculture sector. Over and above this exchange rate depreciation has also been observed and will also feed to inflation causing an even slower economic recovery and reduction of poverty. The paper concludes by recommending the strengthening of the social protection system to protect fragile livelihoods following the advent of the COVID-19 pandemic and seeking alternative export markets for Kenyan coffee and tea. Enhanced social security support can be guaranteed through an aggressive debt restructuring strategy that will keep debt service at constant levels within the short-term, suspension of fuel subsidy as well as reallocations into much needed social spending.

Introduction

On the 24th of February 2022, Russia launched a military offensive on their neighbour, Ukraine. Considering the economic role played by the two countries as a supplier of grain and energy to the rest of the world, this is anticipated to have implications on the value chains of these products thereby having an immediate impact on the countries dependent on these supplies. Over and above being a global supplier of grain and energy products, Western countries have responded by imposing sanctions on Russia which will come with disruptions in exports destined to the latter

and currency fluctuations. This short paper seeks to assess the economic implications of the war in Ukraine on Kenya's economy.

Kenya's international trade was estimated at 2.287 trillion in 2020, of which Russia and Ukraine accounted for less than 3%.



Despite the small contribution to the country's trade, major inputs from Russia and Ukraine are wheat and flour which are critical inputs for both the manufacturing and agriculture sectors. Similarly, the two countries provide a critical market for Kenya cut flowers, tea, and coffee.

Analysis

i) Direct economic impacts –Value chain disruptions



Food and transport account for 42.56% of the Kenya inflation basket. Since October 2021, overall inflation has declined from 6.45% to 5.08% in February 2022 before increasing to 5.6% in March.

The fuel, energy and fertilizer price increases coupled with a currency depreciation are expected to continue increasing Kenya's import bill in the coming months, reducing aggregate demand, and slowing down employment within the economy.



Wheat imports and prices

In 2021 Kenya imported 85.7% of its wheat from the rest of the world - both Russia and Ukraine, in a ratio of about 60:40 between the two countries. In 2021 wheat importation stood at 2.1 million tonnes against 350 tonnes produced within the country. In terms of value, it was Ksh.11.6 billion and Ksh.8.6 billion from Russia and Ukraine respectively. The war disrupts the supply chain for these critical products that would come with price implications, especially so since bread is the third most consumed food commodity in Kenya after mealie meal and rice.

Figure 1(a)

Kenya Wheat Consumption by Source 2021 (%)

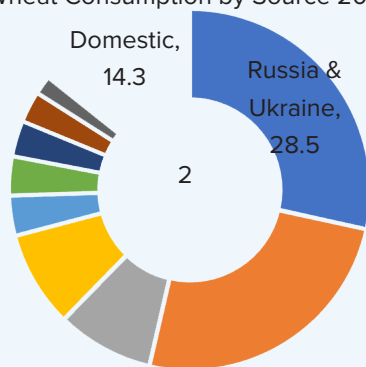


Figure 1(b)



Source: KNBS and Market Business Insider

The Wheat Millers Association (WMA) is a major customer of imported wheat. The WMA processes wheat to wheat flour and sells to the local baking and confectioneries industry within the manufacturing sector as their major customer and to a lesser extent export to neighbouring countries.

As reflected in Figure 2(b) above, global wheat prices increased from \$260 per tonne prior to Ukraine invasion, peaked at \$423 before stabilizing at \$360 per tonne in the past few weeks. This will see prices of all wheat made products increasing

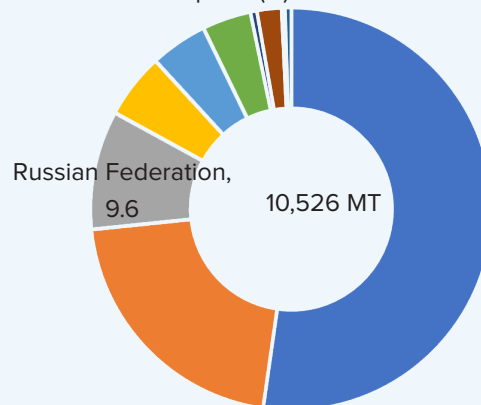
in the coming months. Kenya Association of Manufacturers are projecting an over 20% increase in the price of bread with current increases in wheat prices prevailing. Increasing food prices will have an implication on the cost of living especially for the poor.

Fertilizer imports

Fertilizer imports from the rest of the world into Kenya are estimated at 10,526 metric tonnes in 2019. Of this amount, 1,008 metric tonnes or 9.6% were imported from the Russian Federation, making the latter the third-largest source of fertilizer after Jordan and Germany which accounted for 73.4% of total Kenya fertilizer imports. See Figure 2. Over 70% of the fertilizers are used in maize, tea, and flower production, which are critical for the export market.

Figure 2

2019 Fertiliser Imports (%)



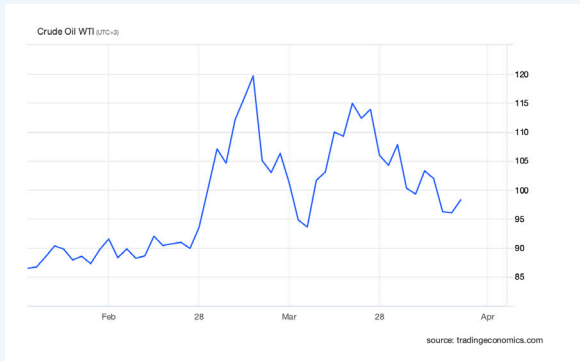
Source: Kenya National Bureau of Statistics

Kenya also imports significant amounts of fertilizer from Russia and China which is a key input in the agriculture sector that accounts for 23% of GDP. Early in the month of March, fertilizer prices hit an all-time high of Ksh 6,000 per 50kg, from an average price of Ksh4,000 prior to the war. The government estimates that a break-even price for fertilizer is Ksh2,800 for tea and coffee farmers, hence Ksh31.8 billion would be needed to subsidize the fertilizer price. Higher fuel and fertilizer prices would greatly compromise productivity and employment in the agriculture sector and the entire Kenyan economy. Also of note is that the anticipated disruption happens at the beginning of the planting season.



Crude oil prices

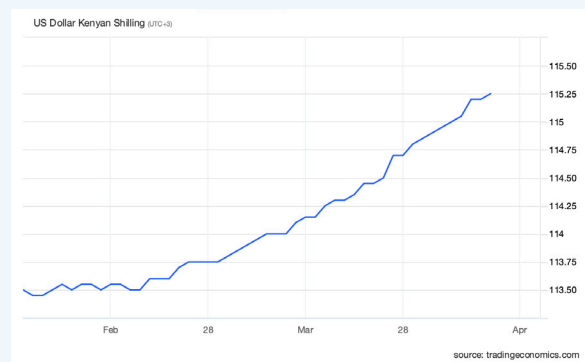
Kenya's petroleum imports averaged 18.9% of the total import bill and occasionally exceeded the 20% threshold as and when crude oil prices increase. On the 14th of March, the international Brent crude increased by 8.54% to the US \$ 128.2. On the same day, the Government of Kenya through the Energy and Petroleum Regulatory Authority (EPRA) announced a Ksh 5 increase, below 5%, in the price of fuel per litre. The prevailing fuel price of Ksh134.33 per litre is subsidized by at least Ksh.23 per litre. The Government provided an additional KSh 24.9 billion in the 2021/22 supplementary budget to cushion the Petroleum Development Levy Fund and assure below market pump prices for petroleum products.



Beginning April 2022, fuel shortages were reported across the country against accumulated arrears of the subsidy to fuel suppliers amounting to KSh20 billion. Of this amount, Ksh8.2 billion was paid leaving out a balance of Ksh5 billion. Assuming the same level of subsidy to the end of the year, the Government of Kenya would need to provide an additional KSh 53 billion to the Energy and Petroleum Regulatory Authority to continue subsidizing the fuel price to the end of the year. The fuel shortage has led to rationing of fuel as well as long queues in petrol stations posing a security risk within an already volatile environment ahead of the national elections in August 2020. Reports of emerging black market by retailers where the fuel prices increased to Ksh200 per litre, higher than gazette prices of Ksh 134.33 for diesel. Smaller independent retailers who control around 40% of the fuel market have suffered fuel prices increases from fuel wholesalers as the shortage intensified.

Exchange rate developments

The local currency (Kenya Shilling) reached a low of over 114 per US Dollar in early March 2020 (compared to 113.65 in early February) and is expected to weaken further due to the war period fueled by the anticipated US interest rate hike this month. The depreciation trend is expected to continue in 2022, amplified by election-related uncertainty. Both the increase in fuel prices and exchange rate depreciation would increase Kenya's import bill and cost of production for the business sector thereby slowing down on much needed employment.



Reports (The East African/Business 4 March 2022) to the effect that exports of flowers, tea coffee and fruit worth US \$87.5 million or Ksh 10 billion to Russia, the fifth largest importer of Kenyan tea, have been delayed due to the suspension of shipments to the latter because of the ongoing sanctions.

ii) Indirect economic impacts channels for Kenya

Fiscal impact

According to the June 2021 Central Bank of Kenya Annual Report, Public debt currently stands at Ksh 8.2 trillion or 68.4% of GDP as of June 2021 compared to 65.6% in June 2020. The 15.2% growth reflects the impact of the COVID-19 pandemic on revenue and expenditures in the first half of FY2020/21. External debt is Ksh 4.2 trillion while domestic debt is Ksh 4.04 trillion. In the 2021/21 fiscal year, debt repayment was allocated Ksh1.17 trillion, with a weaker Shilling, repayment costs are expected to increase before the end of the year (June 2022). A weak Shilling will also see the cost of servicing the country's debt, which is mainly dollar-denominated, increase.

Of the Ksh 4.04 trillion domestic debt, the treasury bonds to bills ratio stood at 78.4:21.6, surpassing the government's medium-term objective of achieving 70:30 ratio of Treasury bonds to Treasury bills as the Government of Kenya continued with its strategy to issue more treasury bonds to bills. Domestic debt increased by 14.2% within the 12-month period. Since January 2022, yields of the Government short-term paper – 91 days Treasury Bills has been trading around 30 basis points above that of the previous year. Even though there has been no changes on average yields, real-interest rates increased to over 200 basis points between January and February 2022 compared to below 120 basis points for the same period in 2021. Following a less than 5% increase in fuel prices, inflation is expected to increase which would also increase treasury bill yields and domestic debt costs going forward.

Conclusion and policy recommendations

The implication of the war in Ukraine will water-down the strong economic recovery of over 7% observed in 2021. High input prices imposed by the fuel and energy, wheat and fertilizer would compromise the productivity and economic recovery. This will also have implications on consumer prices, thus further slowing down Kenya from the attainment of SDGs.

More focus should be put on acceleration in the implementation of SDGs and exploration of sustainable financing mechanism for the upcoming Fourth Medium Term Plan for 2023 to 2028 would be of priority. Concluding on the work already started on the Development Finance Assessment would be key in assuring a steady flow of resources towards critical Government projects.

The Government's policy to subsidize fuel has led to artificial shortages within the country as the Petroleum Development Levy Fund got depleted due to fuel prices increases that were recorded from the last quarter of 2021. Long queues in petrol stations have been reported which risks compromising the security environment that is already fragile ahead of national elections. A carefully planned review of the fuel price subsidy to zero would ease fuel shortages, eliminate the emerging black market for fuel and provide predictability, albeit at an economic cost. The fuel

subsidy reform would greatly benefit from the UNDPs "Don't Choose Extinction Campaign" toolkit.

With protracted recovery of the economy and increasing inflation, the Government would need to extend targeted cash transfers to lower income groups to protect struggling low-income earners. Cash transfers levels would also need to be revised recognizing price increases since they were set. To create the necessary fiscal space to support improved social protection spending, the Government would need to restructure its short-term debt to longer-term instruments and suspend the fuel subsidy for more targeted social spending. Kenya's limited export market has been affected by the war in Ukraine as the former is the third-largest importer of Kenyan coffee and tea. Supply chain disruptions are not expected to ease during the war and associated sanctions on the Russian economy. An aggressive search for alternative markets for Kenya tea and coffee exports that were destined for the Russian market would also go a long way in mitigating the loss of export earnings. Consideration of the African market under the AfCTA market could provide an alternative export market for Kenyan products.

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The views expressed in this policy brief remain those of the author(s).



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