The KENYA INSTITUTE for PUBLIC POLICY RESEARCH and ANALYSIS

Policy Brief

No. 01/2020-2021

Thinking Policy Together

Short-term Effects of COVID-19 and Containment Measures on Kenya's Economy

By Laichena J., Kihiu E., Omanyo D., Musamali R., Kiriga B., Victor Nechifor V. and Ferrari E.

Introduction

This policy brief summarizes the key findings of the research work undertaken by the Joint Research Centre (JRC) of the European Commission and the Kenya Institute for Public Policy Research and Analysis (KIPPRA) and published on JRC/EC website[1]. The study examines the short-term effects on Kenya's economy and the effects of the COVID-19 measures taken by the Government to cushion the economy and her people from the impact of COVID-19.

Since the first case of COVID-19 was confirmed in Wuhan, China in November 2019, the virus has been reported in all African states, with Lesotho being the last African country to report a COVID-19 case. In the first eight months since the onset of the pandemic, businesses, economies and people's livelihoods have been disrupted globally. The world economies now face a grim future as cases and deaths continue to increase daily across the world, with some countries experiencing a second wave of COVID-19.

Globally, the crisis has resulted in unprecedented output shocks as the health emergency and related containment measures have disrupted global supply chains. The labour, leisure and tourism sectors have equally been affected with increased job losses. There is increased uncertainty on how long the pandemic will last and the duration and intensity of the related economic shocks. The June 2020 IMF Economic Outlook Report envisions a contraction in global economic growth at -4.9% compared to 3.3% estimated growth at the beginning of 2020. The COVID-19 crisis presents a unique challenge to economic policy management. Ideally, during periods of recessions, governments economic policy interventions are normally targeted at stimulating aggregate demand. While it is evident that the pandemic has affected the global economy, full recovery will depend on the measures countries have put in place to contain the virus, revive and re-engineer their economies.

Since the declaration of COVID-19 as a global pandemic by the World Health Organization (WHO), Kenya undertook several measures including declaration and gazettement of the virus as a Notifiable disease on 2nd March 2020 and a Formidable Epidemic Disease on 27th March 2020. Further, since 13th March 2020 when the first case was confirmed, the Government issued several directives aimed at containing the spread of COVID-19 and to mitigate the negative impact of the pandemic to the population and the economy.

i) Behavioural Protocols

Behavioural measures were adopted to contain the spread of COVID-19, such as the suspension of learning in all educational institutions, suspension of all international and domestic passenger flights except cargo and evacuation planes, imposition of nation-wide curfew between 7.00 p.m to 5.00 a.m and requirement of employers to close work and release their employees by 4.00 p.m, suspension of all churches and mosques and religious and social gatherings such as weddings and funerals across the country and banning of all meetings, conferences and events of international nature. However, some of these measures have been varied and/or relaxed gradually based on the COVID-19 situation in Kenya.

The Government further required all traders to provide water and soap for hand washing or alcohol based hand sanitizers in their business premises for their customers, closing of all bars and restaurants across the country and restriction of movement of persons in the counties of Nairobi, Mombasa, Kilifi and Kwale. In addition, restrictions were imposed on the number of people to be carried in public transport vehicles, reducing by up to 40% below normal capacity, requirement for all persons to wear face masks while in public places and imposition of a mandatory 14-day quarantine for the persons returning from abroad as of 16th March 2020.

ii) Fiscal Measures

Under the fiscal space, the total fiscal action included: 1) tax policy measures; 2) health expenditure to deal with the pandemic, including enhanced surveillance, laboratory services, isolation units, equipment, supplies, and communication; 3) social protection and cash transfers; 4) food relief and; 5) funds for expediting payments of existing obligations to maintain cash flow

1 *https://publications.jrc.ec.europa.eu/repository/bitstream/JRC121284/jrc_technical_report_-_covid-19_kenya_final.pdf*

for businesses during the crisis and to support the County Governments to deal with the pandemic.

The Tax Laws (Amendment) Act 2020 amended several statutes including the Income Tax Act (CAP 470), Value Added Tax Act of 2013, Excise Duty Act (2015), Tax Procedures Act (2015), Miscellaneous Levies and Fees Act (2016) and Retirement Benefits Act (1997) to cushion the economy and Kenyans against effects of COVID-19 pandemic.

iii) Monetary and Macro-Financial Measures

The Central Bank of Kenya (CBK) announced emergency measures to apply to all borrowers whose loan repayments were up to date as of 2nd March 2020. These included relief to borrowers of personal and business loans to restructure them based on individual circumstances arising from the pandemic.

To discourage cash handling as a way of containing the spread of COVID-19, the Government and the private sector moved to institute measures aimed at encouraging use of digital payments. This included but not limited to zero-rating of both M-Pesa transfers below Ksh 1,000 and all Pesalink (real-time bank to bank account) transactions until December 2020. The Central Bank further suspended listing of negative credit information for borrowers whose loans were performing as at 1st April 2020 for six months and set a new minimum threshold of US$ 10 for credit listing with Credit Reference Bureaus. To ensure liquidity by the banks, the CBK also lowered Central Bank Rate (CBR) from 8.25% to 7.25% and reduced commercial banks' cash reserve ratio (CRR) to 4.25 % from 5.25 %.

Short-term Effects Analysis

To evaluate short-term economic effects of government interventions to contain the outbreak, KIPPRA in collaboration with the Joint Research Centre of the European Commission conducted a Computable General Equilibrium (CGE) analysis to examine the economic and social welfare effects of the Government's policy responses to the pandemic (see Nechifor et al., 2020), COVID-19 impacts and short-term economic recovery in Kenya. Simulations were done based on different scenarios during and post-pandemic period. These scenarios include drop in labour productivity due to social distancing protocols, a reduction in exports given export bottlenecks and a reduced global demand, a shift in internal demand with a reduction in transport and recreation activities, an increase in internal trade costs and a decrease in household remittances. The simulations also included changes to the fiscal regime following the enactment of the Tax Laws (Amendment) Act 2020 and the additional public spending from the COVID-19 Spending Plan and the Economic Stimulus Plan.

Impacts of April-June 2020 Lockdown

The simulation shows that the April-June 2020 lockdown resulted to a 5.6% reduction in GDP relative to the baseline (Figure 1a) driven mainly by drops in labour productivity (-4%), export demand (-0.8%) and internal demand (-0.4%). Total absorption reduced by 6.7% with a contraction of both the aggregate supply (-6.9%) and consumer demand (-7.2%). The general employment dropped by 11.8% in annual terms (Figure 1b). This drop translates to approximately 2.1 million job losses using 2019 employment levels. Further, a reduction in aggregate exports demand together with the decrease in remittances contributed to a depreciation of the Kenya Shilling (an increase in the exchange rate).

Figure 1: Macroeconomic impacts of April-June 2020 COVID-19 lockdown by impact channel

The simulation also shows that a reduction in income from the economic contraction would determine lower overall savings and a consequent reduction in investment levels by 8.3% at an annualized rate. Also, the reduced economic activity would determine a decrease in Government tax revenues with total Government income down by 5.4% and an increase in Government deficit.

The decomposition of the impact channels in Figures 1a-b shows that labour productivity drops determine a reduction on the supply side through lower output, but also on the demand side through lower income from labour payments. The resulting contraction of the economy yields a reduction in the consumer price index and lower demand for both domestic and imported commodities. Investment is also impacted by lower household income and enterprises' revenue.

The reduction in export demand (including tourism by foreigners) has a significant effect on the depreciation of the Kenya Shilling accompanied by adjustment to the trade balances through a decrease in imports. Overall income is also negatively affected. Government deficit increases due to lower domestic output, income and reduced tariff revenues. The increase in internal trade costs through higher costs of transportation and the changes to the internal demand structure only have marginal effects at a macroeconomic level.

The reduction in remittances has a negative impact over household income and domestic savings.

Taken alone, lower remittances determine about 1% depreciation of the Kenya Shilling with potentially positive impacts on exports. However, this effect is more than counterbalanced when combined with the reduced export demand and tourism in the All Impacts simulation.

Have the Measures by the Government had any Effects?

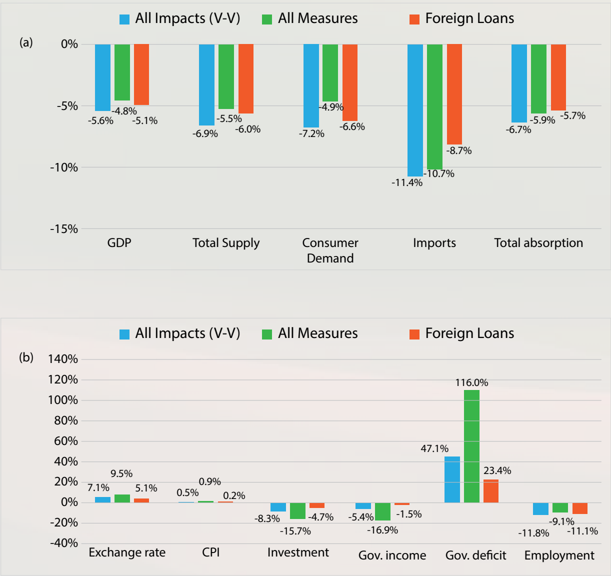
i) Macroeconomic effects

The Government measures comprising fiscal reduction and changes to public spending, but also an increase in foreign lending, has a clear positive impact over GDP, activity levels and consumer demand. When all measures described are included in the analysis, the GDP impacts of the April-June lockdown decrease to -4.8%, implying an economic growth rate of approximately 0.9% for 2020, total supply to -5.5% (from -6.9%) and consumer demand to -4.9% (from -7.2%) – Figure 2a.

These measures have a positive effect on the short-term recovery as the tax rate reductions determine an increase in real income which would boost internal demand. Nevertheless, constraints on the supply side could lead to an increase in imports accompanied by a further depreciation of the Kenya shilling (an increase in exchange rate) and an increase in the CPI (Figure 2b). The fiscal measures and increased public spending also increase the differences between tax revenues and total public spending.

The resulting Government deficit which would need to be financed through internal means would increase by Ksh 42.3 billion relative to the baseline and by Ksh 25.1 billion relative to the deficit without measures resulting from the April-June lockdown. Without the foreign loans, to cover expenses the Government would need to borrow domestically and would thus constrain credit access by the private sector and would further contract investment levels.

Figure 2: Macroeconomic effects of Government measures

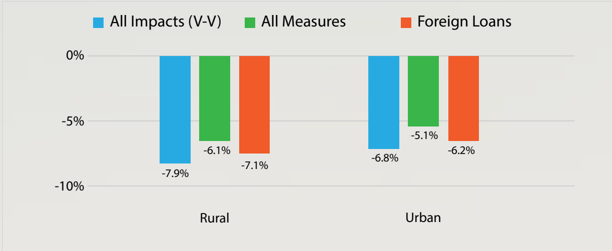


With just an increase in foreign borrowing (Figure 2a-b), excluding the fiscal changes and the Government additional spending, the macroeconomic indicators still improve, notably on the supply side. The resulting lower Government deficit enables a partial recovery of investment levels and a consequent increase in capital stock goods. This has a positive impact on total supply and employment but also implies higher imports of machinery and equipment.

ii) Household and commodity-level effects

At a household level, the combined impact channels of the April-June lockdown lead to a decrease in welfare by -7.9% and -6.8% for rural and urban households, respectively (Figure 3). The Government measures reduce the negative welfare impacts by only 1.8% and 1.7% for rural and urban, respectively, as income from employment would recover.

Figure 3: Household welfare impacts



With a lower income from the lockdown impacts, households would generally decrease their demand for food commodities (Figure 4a). This change in demand would mostly be felt for market commodities, as household would continue to rely on home production to similar levels as in the baseline. Vegetables and poultry are the only categories for which demand increases as these also face some of the most significant price reductions due to the contraction of exports and tourism.

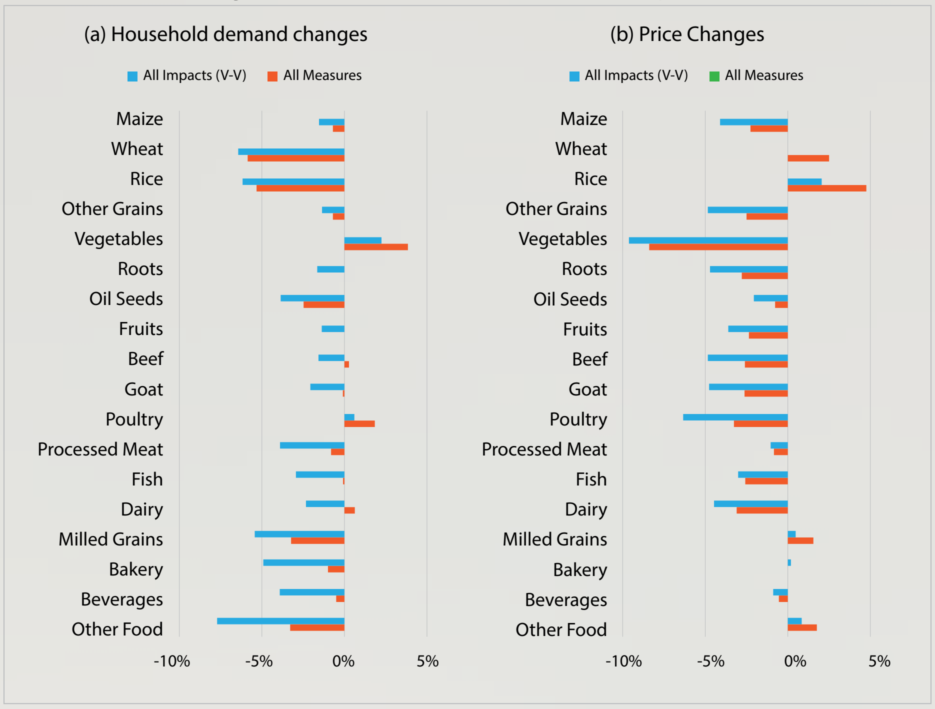
The lower food demand contributes to a general reduction of crop prices (Figure 4b), with the exception of wheat and rice for which the domestic prices increase along with those of milled grains and bakery products – the imported volumes relative to total demand of wheat and rice are high, hence these two cereals become more expensive with the depreciation of the Kenya shilling.

With the Government measures included, the resulting increase in real income across household groups determines a recovery of food demand. The demand loss resulting from the lockdown is reduced by more than half for most food commodities. Wheat, rice and oil seeds are the only categories with a lower effect from the recovery interventions.

Policy recommendations

The recovery of economic activities obtained in this analysis is conditional on overcoming some of the very short-term impacts at firm and household level. For Micro, Small and Medium Enterprises (MSMEs), liquidity will be essential in retaining jobs. Therefore, measures by the Central Bank and the commercial banks have a pivotal role in supporting cash flows and preventing insolvencies. The Government could also temporarily offer support for the main running costs such as

Figure 4. Food commodities demand and prices



electricity and water for firms to ensure continuation of operations.

With the largest share of negative impacts coming from a reduction in labour productivity and employment, further fiscal support should focus on areas that stimulate job creation and competitiveness. In this regard, the Government could consider introducing incentives for employers for new hires and for uninterrupted employment in areas that will continue to be negatively affected by COVID-19, such as tourism and export industries.

To further support recovery of exports, as external demand starts to pick up, the export capacity in terms of freight and border processing will have to increase. At the same time, enhancing the preparedness of the logistic chains and electronic commerce to continue operations during potentially new COVID-19 restrictions would ensure the resilience of distribution networks and trade.

The schooling system is another area that would benefit from preparation in case of further restrictions. Implementing the measures for remote schooling such as e-schooling could improve attendance on the short-term but could also be an opportunity for human capital development and computer literacy on the long-run. E-schooling would nevertheless have its non-negligible costs as it would require children to have access to tablets and computers, that the equipment and e-schooling software are easy to use, and that internet and electricity access is provided. Therefore, investment programmes in this area would need to carefully consider the inclusion of the rural and low-income households.

Investment in capital stock should be harnessed to encourage those industries with large multiplier effects for employment. Public-private partnership (PPP) investment in areas such as geothermal and solar energy, road infrastructure, water, Information Communication Technology (ICT), Personal Protective Equipment (PPE) and housing could provide short-term employment and foreign exchange but could also boost productivity across all sectors of the economy and stimulate trade in the long run. Public investment amid a growing deficit could be supported by increasing the efficiency of spending and by restructuring public debt towards long-term maturity loans and concessional loans, if available.

Lastly, the recovery of both private and public investment supported by loans, grants and Foreign Direct Investment (FDI) will be essential for the dynamics of economic development and poverty reduction to go back to pre-COVID-19 levels. While the present study explored the short-term implications of Government measures to alleviate the negative impacts of the pandemic, further work will be dedicated to exploring the medium-term recovery pathways.

About KIPPRA Policy Briefs

KIPPRA Policy Briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

KIPPRA acknowledges generous support from the Government of Kenya and the Think Tank Initiative of IDRC, who have continued to support the Institute's activities over the years.

For More Information Contact:

Kenya Institute for Public Policy Research and Analysis
Bishops Road, Bishops Garden Towers
P.O. Box 56445-00200, Nairobi
Tel: 2719933/4, Cell: 0736712724, 0724256078
Email:admin@kippra.or.ke
Website: http://www.kippra.org
Twitter: @kippra.kenya