**Fitch downgrades Kenya's Credit ratings**

Recently, Fitch Ratings, a global credit rating agency, downgraded Kenya's credit ratings, with Kenya's Long-Term Foreign Currency issuer default rating to "B" from "B+" indicating elevated risks of defaults in debt repayments. The downgrade mainly emanates from Kenya's relatively high debt with a debt to GDP ratio of 67.4% as at October 2022 and high debt service obligations in FY'2023/2024, including a maturing USD 2.0 bn (Kshs 245.6 bn) Eurobond in 2024. Additionally, the high current account deficit which widened by 9.7% to Kshs 174.4 bn in June 2022 from Kshs 158.9 bn recorded in June 2021 and tighter external liquidity which will put the country on pressure to meet its debt obligations. The downgrade follows the S&P ratings in August 2022 which maintained Kenya's sovereign credit ratings at 'B' for both long and short term foreign and local currency debt issue with a stable outlook. In an aim to understand the credit ratings and their implications, this note shall cover the following;

i. Introduction
ii. Fitch's ratings scale
iii. Kenya's credit ratings
iv. Conclusion and Recommendation

## I. Introduction

Credit rating refers to ratings assigned to an entity i.e. sovereign entities, corporations and public finance entities (local and regional governments) to indicate the relative ability or willingness to meet financial obligations i.e. debt repayment without defaulting. The three prominent global credit rating agencies are; Moody's Investor Services, Standard & Poor's and Fitch Group. Credit ratings are used by investors, intermediaries such as investment banks, business and corporations to gauge the credit worthiness of an entity or a country and thus having a big impact on the borrowing cost. A downgrade in credit rating make it difficult for a country to access funds from outside the country which implies a high cost of borrowing and also lowers the ability to attract other forms of financing such as foreign direct investment

## II. Fitch's ratings scale

The Fitch Ratings are grouped into two wider categories "AAA" to "BBB" termed as investment grade and "BB" to "D" termed as speculative grade with an additional +/- for AAA to CCC levels to show different levels of possibility of default. The investment grade category indicate relatively low to moderate risk, while ratings in speculative category indicates higher level of credit risk. The table below outlines the different categories of Fitch ratings.

| Categories | Meaning | Ratings symbols | Rating notches | Comments |
|---|---|---|---|---|
| Investment grade | Highest credit quality | AAA | - | AAA' Denotes the lowest expectation of default risk. This capacity is highly unlikely to be adversely affected by foreseeable events |
| | Very high credit quality | AA | AA+ | AA' Denotes expectations of very low default risk. This capacity is not significantly vulnerable to foreseeable events |
| | | | AA | |
| | | | AA- | |
| | High credit quality | A | A+ | A' Denotes expectations of low default risk. This capacity may, nevertheless, be more vulnerable to adverse business or economic conditions than is the case for higher ratings |
| | | | A | |
| | | | A- | |
| | Good credit quality | BBB | BBB+ | BBB' Indicate that expectations of default risk are currently low. The capacity for payment of financial commitments is considered adequate, but adverse business or economic conditions are more likely to impair this capacity |
| | | | BBB | |
| | | | BBB- | |
| | Speculative | BB | BB+ | BB' indicate an elevated vulnerability to default risk, particularly in the event of adverse changes in business or economic conditions over time; however financial flexibility exists that supports debt servicing |
| | | | BB | |
| | | | BB- | |
| | | | B+ | |

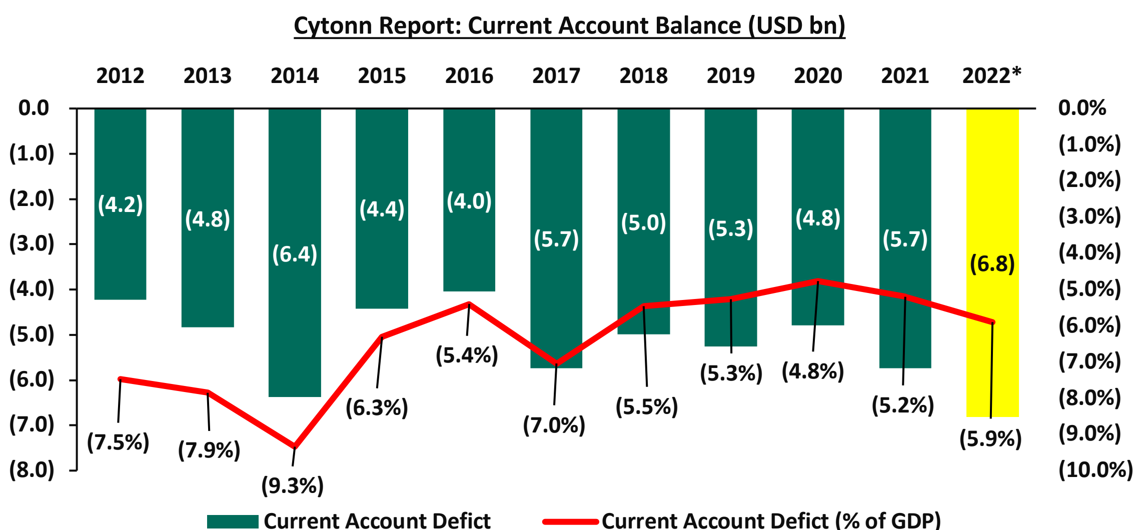
| Speculative grade | Highly speculative | B | B<br>B- | B’ indicate that material default risk is present, but a limited margin of safety remains. Financial commitments are being met however capacity for continued payment is vulnerable to continued deterioration in business and economic environment |
|---|---|---|---|---|
| | Substantial credit risk | CCC | CCC+<br>CCC<br>CCC- | CCC’ indicate very low margin for safety |
| | Very high levels of credit risk | CC | - | CC’ indicate no margin of safety and default of some kind appears probable |
| | Near default | C | - | C’ indicate a default or default like process has begun, or the issuer is at standstill or payment capacity is irrevocably impaired |
| | Restricted default | RD | - | RD’ indicate the issuer has experienced an uncured payment default, but has not entered into bankruptcy filings, administration, receivership, liquidation, or other formal winding-up procedure. |
| | Default | D | - | D’ indicate an issuer has entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure |

## III. Kenya’s credit ratings

The downgrading of Kenya’s Long-Term Foreign Currency issuer default rating to “B” from “B+” points towards increased material default risk with a very limited margin of safety amid tighter liquidity. According to Fitch Ratings, the downgrade is mainly due to;

### i. Widened current account deficit

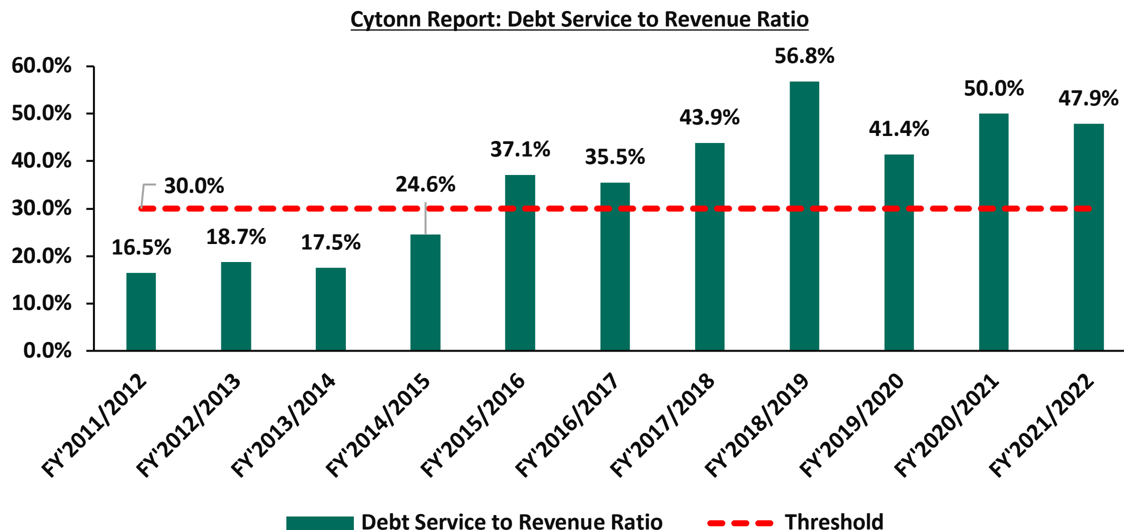
The country’s current account deficit (value of goods and services imported exceeds the value of those exported) widened by 9.7% to Kshs 174.4 bn recorded in June 2022 from Kshs 158.9 bn in June 2021 and it was estimated at 5.5% of GDP. Fitch forecasts the current account deficit to grow to 5.9% of GDP at the end of 2022 and to remain at broadly the same level in 2023 and 2024. As a result, the foreign reserves (foreign currency deposits held by a country’s central bank) has fallen to USD 7.2 bn as of November 2022, down from USD 9.5 bn recorded at the end of 2021 representing a 24.2% decline. As at 15th December 2022, the foreign reserve stood at USD 7.1 bn representing a 4.0 months of import cover (the number of months of imports that could be covered for by a country’s international reserve) which was at par with the minimum statutory requirement of 4.0 months. The chart below shows the current account deficit over the last 10 years;




****IMF Projection as of October 2022***
***Data source: International Monetary Fund***

ii. **High external debt service cost**

The external debt service is forecasted to rise to 24.8% in 2024, up from 16.6% in 2023, owing to the maturing of USD 2.0 bn (Kshs 245.6 bn) Eurobond in 2024, which when combined with other financial obligations will likely to impair its ability to meet its debt obligation. Key to Note, Kenya's total debt service to revenue ratio stood at 47.9% in FY'2021/2022, a 2.1% points decline from 50.0% recorded in FY'2020/2021. Below is a chart showing the evolution of debt service to revenue ratio;




***Source: National Treasury***

iii. **High public debt**

Kenya debt has been on the rise, standing at Kshs 8.7 tn in December 2022 from Kshs 1.8 tn in December 2012, representing a 10-year compound annual growth rate (CAGR) of 17.1%. Despite the debt to GDP ratio declining to 62.3% as of October 2022, from 67.7% recorded in 2021, Fitch has projected it to remain above 60.0% and to drop to 55.0% in 2024. The agency noted that continued deterioration of business and economic environment will likely to impair the country's ability to meet its financial commitments. The graph highlights the trend in the Kenya's debt to GDP ratio for the past 10 years,

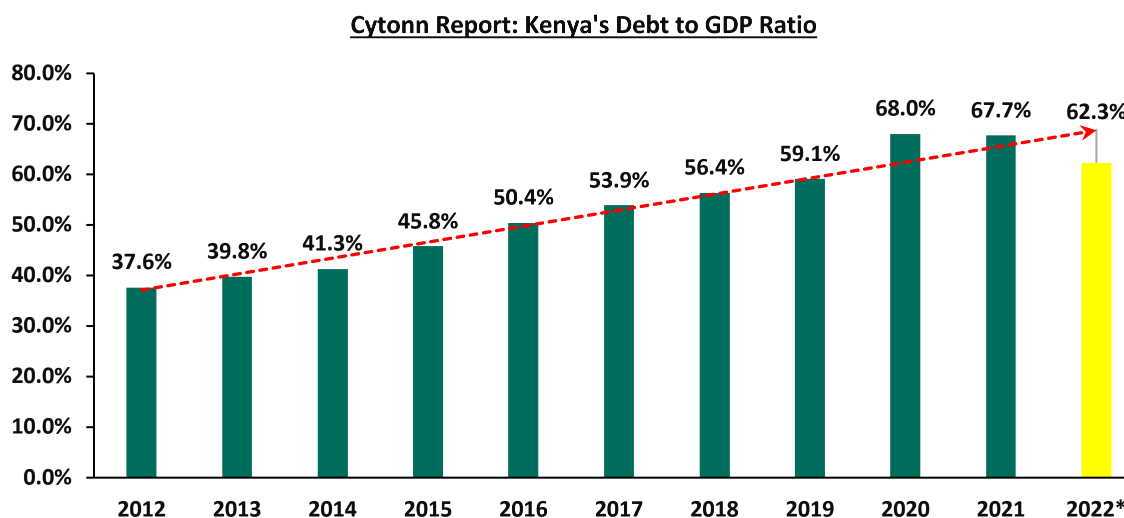



****Figure as of October 2022***

***Data Source: International Monetary Fund (IMF)***

iv. **Environmental, social and governance (ESG) considerations**

The recent track level of difficult political transition, weak institutional capacity, uneven application of the rule of law which has seen Kenya ranked 104 out of 140 countries globally by the World Justice Project with a score of 0.45 out of 1 in 2022 and perceived high level of corruption index, being ranked at 128 out of 180 countries with a score of 30 out of 100 as of 2021 by the Transparency International has also negatively impacted its credit profile.

However, Fitch assigned the country a stable outlook due to;

i. **Gradual fiscal consolidation-** The new administration reasserted Kenya's commitment to fiscal consolidation being supported by IMF following a USD 2.3 bn it received under the Extended Fund Facility (EFF) and the Extended Credit Facility (ECF), and the strong revenue collection, evidenced by the Kshs 2.0 tn collection in FY'2021/2022 which represented 2.8% outperformance. The continued fiscal consolidation remains key to reduce debt vulnerabilities. Key initiatives the new administration has undertaken include; largely involving private sector in its projects i.e. affordable housing and water supply being done via public private partnerships rather than the government budget and also establishment of a Financial Inclusion Fund (also known as "Hustler Fund") which has heavy private sector participation and thus limited impact on government budget,

ii. **Economic growth**

Fitch expects that Kenya's growth will remain steady in 2023 and 2024 evidenced by strong post pandemic growth which is expected to continue in the medium term, having recorded a 5.2% GDP growth in second quarter 2022. The agency also forecast the country real GDP to grow by 5.4% in 2022, supported by improved asset quality through higher private sector credit growth. However fiscal tightening, elevated inflation and slower global growth is expected to impair growth in 2023.

According to Fitch Ratings, a positive revision of the country's credit rating will largely depend on;

**i.** Reduction in external vulnerabilities that could come from sustained narrowing of the current account deficit, easing of external financing constraints and improvement of level of foreign reserves,

**ii.** Implementation of a sustainable consolidation strategy such as reducing debt vulnerabilities by cutting government spending and improve revenue collection, in order to maintain government debt to GDP on a downward trajectory.

## IV. Conclusion and Recommendation

Following the downgrade of Kenya's Long-Term Foreign Currency issuer default rating, we expect that Kenya's access to international capital markets will be hindered and will be very expensive when available. This is also expected to reflect in the Eurobond yields, with investors looking to price the additional risk. In conjunction, domestic investors will also demand higher interest rates due to the higher perceived risk of defaulting. This will translate to higher cost of borrowing thus impacting government spending and increase in debt vulnerabilities. Additionally, the downgrade will likely dampen the already deteriorated business environment brought on by the elevated inflationary pressures which has seen a reduction in business and consumer spending. Volatility in the stock market is also expected to increase due to capital outflows as foreign investors seek less risky markets.

As such the government need to treat the down grade as a wake-up call and enhance its fiscal consolidation measures. The government can narrow the deficit by supporting small businesses in the informal sector and improve tax policies in order to enhance compliance and increase its tax revenue. In conjunction, the government need to formulate affirmative policies that will improve domestic production and increase exports while lowering its imports in order to improve its current account and also preserve its foreign reserves. By ensuring adequate foreign reserves, the shilling will stabilize and limit the continued depreciation against the US dollar and thus preventing further increase in its foreign currency dominated debt.

Additionally, the government should prioritize multilateral and bilateral funding when in need of funds to supplement its budget, mainly due to their low interest nature over commercial funding, this will ensure debt vulnerabilities reduce in the medium term. The government also need to stimulate the capital markets in order to boost investors' confidence and increase capital inflows into the economy to different sectors such as real estate, stock market among others.