FOCUS NOTE

Strengthening resilience: Inclusive finance in Kenya

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Creating value through **inclusive finance**

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INTRODUCTION

The COVID-19 pandemic has made clear that the capacity to withstand shocks is critical for sustained poverty reduction, well-being and long-term development. In a baseline scenario using projected global growth rates, the World Bank estimates that COVID-19 could generate 176 million additional poor at $3.20/day[1]. With the youngest population in the world, the impact on human capital in Sub-Saharan Africa – through greater food insecurity, school closures and reduced access to health care and nutrition for children and pregnant women – will also have profound effects on development in the long run.
In Kenya, with real GDP contracting by 9.1 percent in the second quarter of 2020, the World Bank estimates that the economic disruption brought on by COVID-19 has already pushed about 2 million Kenyans into poverty.

While the COVID-19 crisis has effects that are global, broad in scope and long lasting, its impact exacerbates an already risky economic landscape for ordinary Kenyans. In 2018, 35 percent of adults reported that their household experienced large financial costs associated with at least one major adverse event in the past year. In 2016, nearly 4 in 5 adults experienced a shock in the past 2 years. Of these, risks associated with climate, inflation and health were the most common (Figure 1)[2]. Nearly 2 in 3 rural households had to deal with a flood, drought or crop and livestock losses. Between 2014 and 2018, food prices rose at an average annual rate of 9 percent (Figure 2), a major stressor in a setting where food consumption makes up over half of typical monthly household spending. During this time frame, the percentage of Kenyan adults able to jointly meet basic needs, cope with risk and invest in livelihoods or the future fell from 39 to 22 percent (FinAccess). With COVID-19 destroying jobs, reducing incomes, depleting personal savings and exhausting other coping mechanisms, families have become acutely vulnerable to all the other unexpected shocks that may emerge in a 'typical' year.

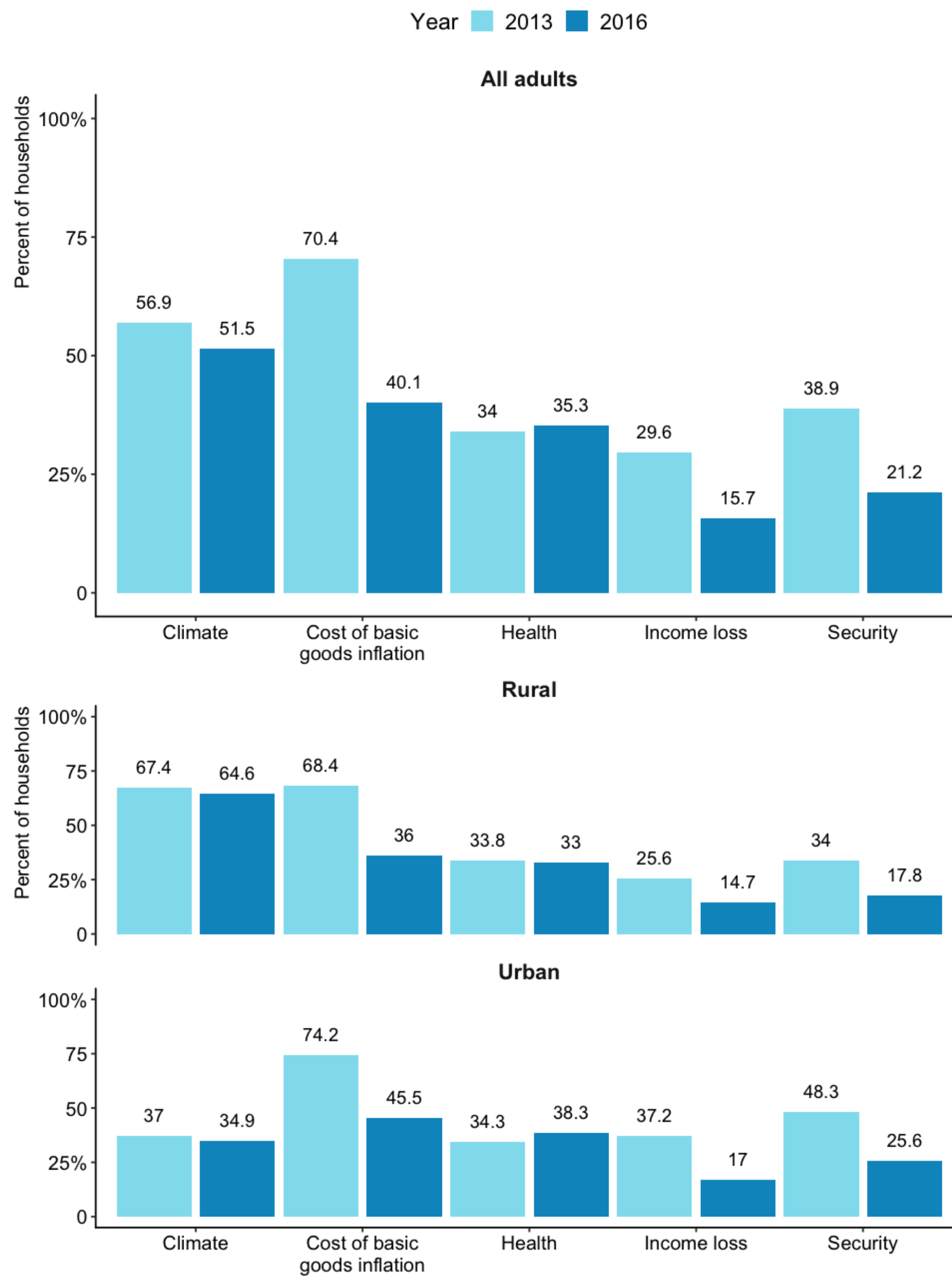
[1] World Bank Project Poverty Impacts of COVID-19:
http://pubdocs.worldbank.org/en/461601591649316722/Projected-poverty-impacts-of-COVID-19.pdf

[2] Forty percent of adults nationwide were affected by a rise in the cost of basic goods.In addition, 1 in 3 adults were affected by illness or injury in the 2014-2016 period.

FIGURE 1

Exposure to risk in Kenya

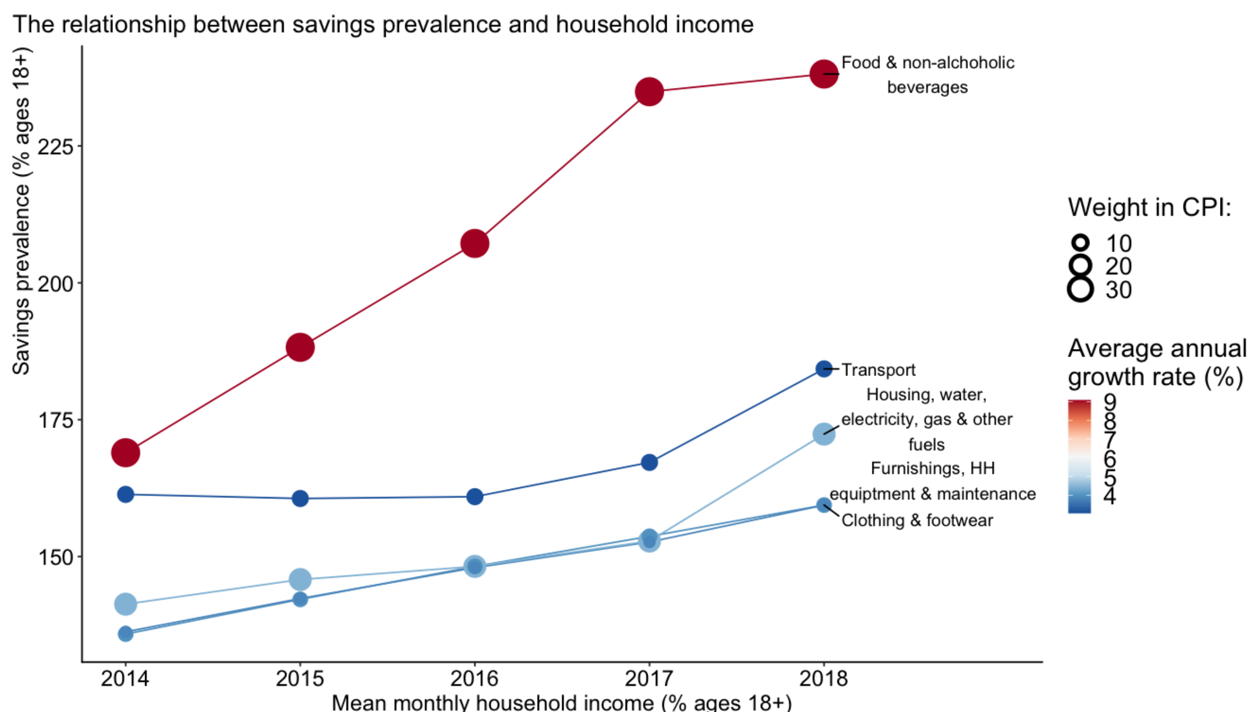
Share of households who faced a financial risk in 2 years prior to survey, by major risk category



Source: 2013 and 2016 FinAccess household survey (FSD Kenya and KNBS). Notes: Climate risks include: Flood, Dr crops or livestock. Health risks include: Large medical costs due to family member's ill-health or the death of a family r Income loss rirks includes: Loss of income of the main wage earner or another family member. Security risk includes: deterioriting political condition or personal insecurity.

FIGURE 2

The relationship between savings prevalence and household income



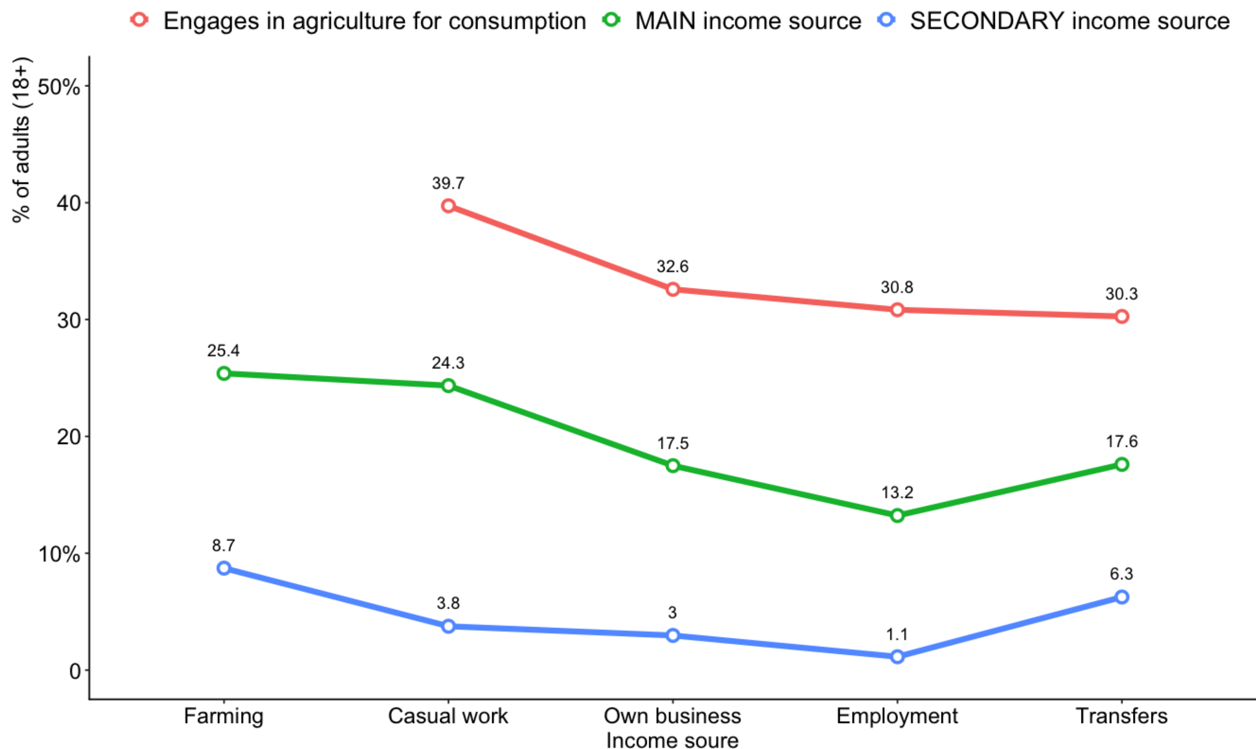
Source: Author's calcuations based on World Bank Findex. Notes: The black line shows the OLS fit. The light grey line is a non-paramet fit intended to show whether there is evidence of a non-linear relationship. The grey area depicts the typical range of the residuals (the root mean squared error) around the OLS prediction. Observations above and below that typical range are labeled.

This risk landscape is made more challenging by agricultural and informal livelihoods that produce low- and variable- income and are unprotected by legislation. In Kenya, like in Sub-Saharan Africa more broadly, there is a 'missing jobs' crisis[3]. Kenya's increasingly educated workforce is growing by about 800,000 adults each year but only an average of 90,000 modern wage jobs are being produced yearly[4]. Amidst the COVID-19 crisis which has depressed demand and disrupted trade, that rate of formal job creation is likely to be significantly slower in the near term, so even larger shares of incoming workers will face un- or under-employment, putting downward pressure on wages. Income from family farming, micro or small business ownership and casual work represented the primary income source for 67 percent of adults and the secondary income source for an additional 15 percent of adults in 2018 (Figure 3). Nearly 3 in 4 farmers reported monthly income less than the average agricultural basic minimum wage (Ksh 8,595/ USD 86) and nearly 9 in 10 urban casual workers reported monthly income less than the urban average minimum wage (KSh 17,763, USD 176).

[3] See "Africa's 'youth crisis' is actually a 'missing jobs' crisis": https://www.brookings.edu/research/africas-youth-employment-crisis-is-actually-a-missing-jobs-crisis/

[4] Working age population growth estimates from United Nations Population division. Growth of formal jobs obtained from KNBS Economic Survey reports.

FIGURE 3



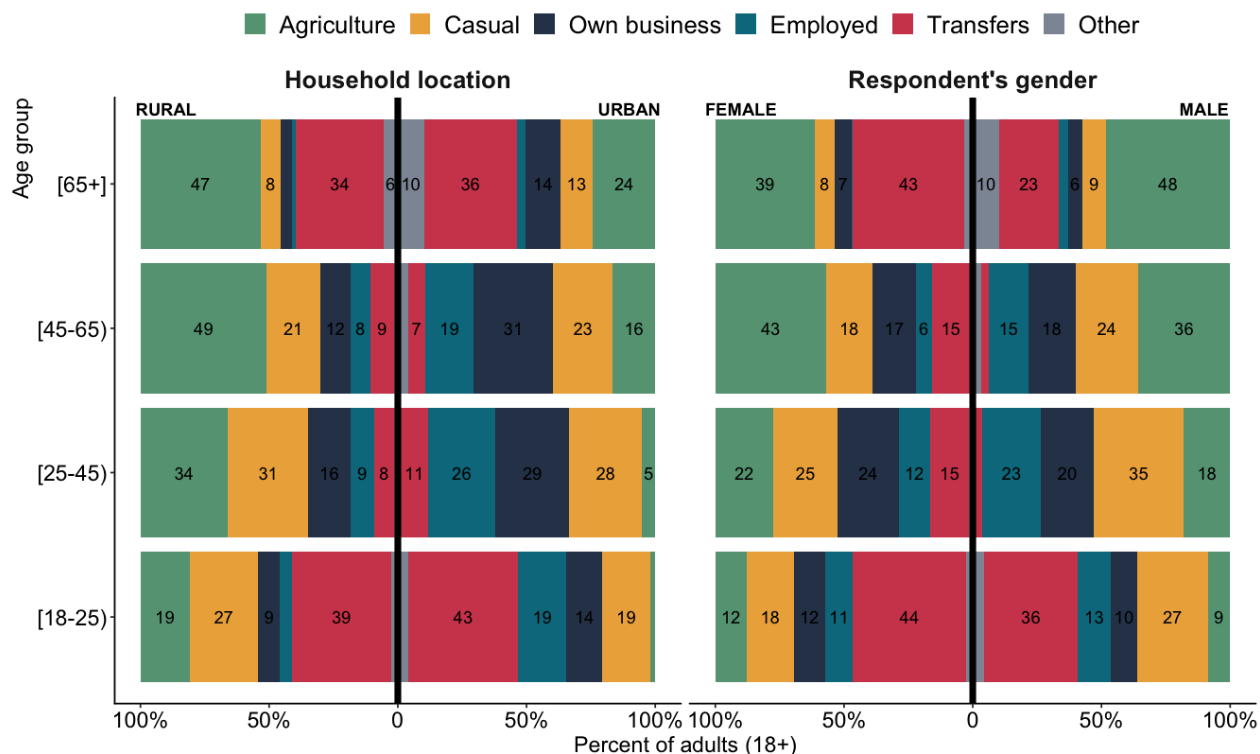
With little insulation from climate variability or swings in market demand and commodity prices, these livelihoods pose significant daily income risk. In 2018, nearly 3 in 4 adults reported having trouble making money last between income payments (FinAccess) and in a 2016 Gallup poll 75 percent of Kenyans said that they were unsatisfied with their incomes. A 2017 survey conducted by Dalberg found that 68 percent of Kenyans disagreed with the statement "In the morning, you usually know how much money you will earn that day".

Many economic decisions made by households such as diversification of livelihoods, seasonal migration to cities and cultivating strong networks of mutual assistance, can be viewed as being motivated by the need to build resilience to- or avoid- income risk and other sudden shocks. About 1 in 5 adults report having at least one secondary income source on top of their primary income source, and a third of adults who do not rely primarily on agricultural income are engaged in agriculture for other objectives (Figure 3). For many, cultivating crops or livestock is a way to mitigate against the risk of hunger, or as a store of wealth which can be liquidated in a time of need. For youth and retirement age adults, social transfers represent the single most important income source (Figure 4). Participation in community savings or welfare groups is widespread giving members the possibility of borrowing or accessing financial support from the group in a time of need. The informal sector also plays a role as a safety net, providing a way for individuals without access to social assistance or formal safety nets to make ends meet when they lose jobs or other income sources[5].

[5] For example along Nairobi's Northern bypass road, formerly employed workers resorted to selling vegetables and ready-made foods, see for example: https://twitter.com/sarahkimani/status/1265926441381908481?s=27

FIGURE 4

Main income sources by age group, household location and gender (2019)



Given the risks and daily uncertainty that Kenyans must shoulder, how well-prepared are they to address an unexpected financial emergency? For a global perspective, the World Bank's Findex survey gives us an opportunity to answer this question. The Global Findex asks people in economies around the world about their ability to raise funds (equivalent to 1/20th of GNI per capita) for an emergency in 30 days. In Kenya, this emergency money was equivalent to USD 72 (KSh 8,039 or about 1.6 months of typical household spending per person[6]) when the question was last asked in 2017.

Just over half of adults in Kenya (52.2 percent) reported being able to access emergency funds equivalent to 1/20th of GNI in 2017. The prevalence of financial resilience in Kenya is close both to the global median of 56.2 percent and the median for lower middle-income countries. Kenya performs better than the median country in Sub-Saharan Africa (44 percent). However, the differences in financial resilience associated with household income are large: 77 percent of the richest fifth are financially resilient compared to 28 percent of the poorest fifth.

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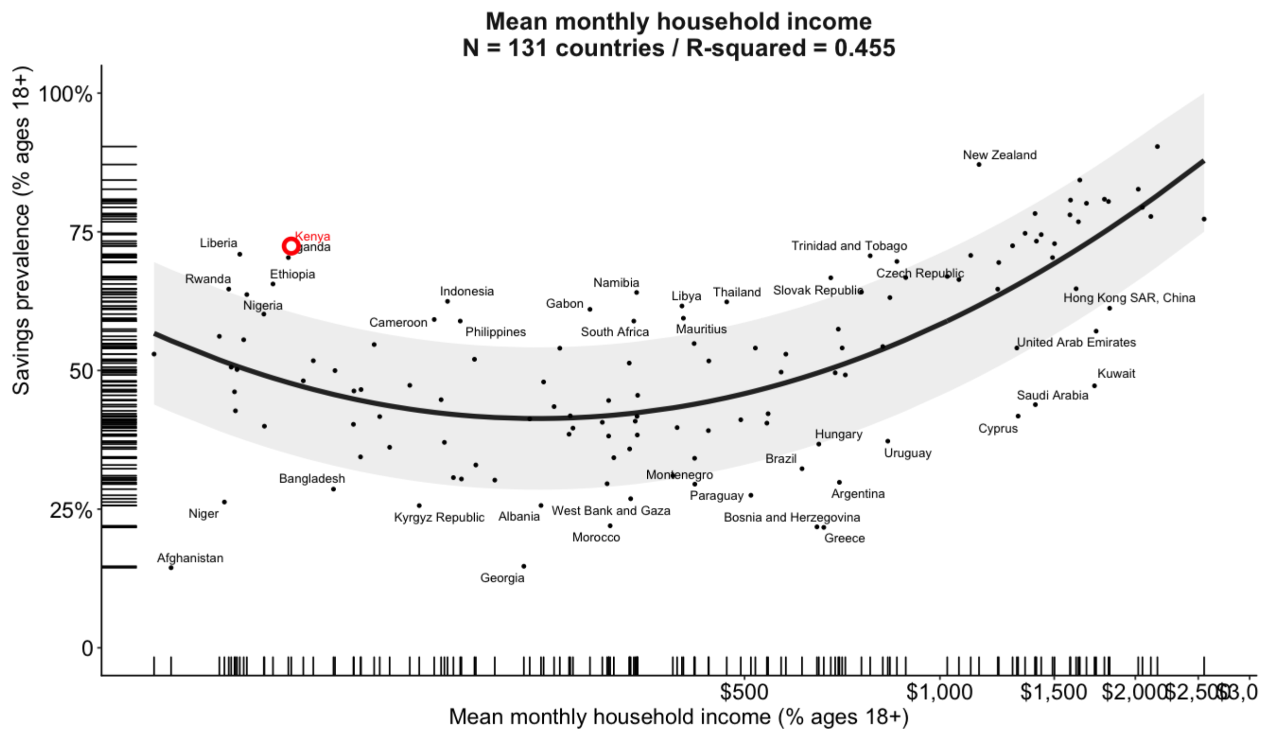
[6] In 2015, the Kenya Integrated Household Budget survey found that average household monthly consumption per person was Ksh 4,984. Based on the author's calculations using the publicly available KIHBS data available here: http://statistics.knbs.or.ke/nada/index.php/catalog/KIHBS

Among adults who are financially resilient, the three most common strategies for raising emergency funds within a month are personal savings (26 percent), transfers from friends, family or acquaintances (24 percent) and working more (32 percent). Resilient Kenyans are more likely to finance emergencies with savings and borrowing than what is typical in lower and upper middle-income countries. Notably, Kenya's savings prevalence in 2017 (75 percent of adults reporting saving for any purpose in the past year) was the highest on the continent and at a level more common among countries like Taiwan, Germany, Ireland and Singapore – where households earn about 20 times more per month on average (Figure 4). The percent of the financially resilient population in Kenya who borrow to cope with an emergency is even higher than the average among high income countries pointing to the common practice of borrowing from the social network and a high rate of digital financial inclusion which has enabled convenient but costly borrowing from digital lenders.

Figure 5

The relationship between savings prevalence and household income



Source: Author's calcuations based on World Bank Findex. Notes: The black line shows the OLS fit. The light grey line is a non-paramet fit intended to show whether there is evidence of a non-linear relationship. The grey area depicts the typical range of the residuals (the root mean squared error) around the OLS prediction. Observations above and below that typical range are labeled.

A multivariate analysis of the drivers of financial resilience using the Findex data suggests that several factors beyond high incomes matter for resilience in the Kenyan context. While adults in the top quintile of the national income distribution are about 20 percentage points more likely to be financially resilient than adults in the middle quintile, holding demographic and socio-economic factors constant, income from friends and family, income from salary payments, and savings behaviour (including depositing into an account) substantially increase the likelihood of resilience. Borrowing for any reason in the past year is associated with a reduction in the probability of financial resilience. The positive effect of savings on resilience is all accounted for by production-oriented savings and the negative effect of borrowing on resilience is all accounted for by borrowing for health or medical purposes. Women are about 10 percentage points less likely to be financially resilient than men.

These results, reinforced by analysis of the global data, point to the importance of structural factors as well as financial behaviours and tools in supporting financial resilience. Structural factors include the market conditions, policies and norms that shape the *distribution* of income, opportunities and social support for adults with different socio-economic backgrounds. When used to transform income streams into wealth (short or long term stores of value that are shielded from consumption and available for risk management or investment), financial behaviours and tools are of particular importance to financial resilience, especially for working individuals (and their dependents) lacking social support or access to government social protection programmes.

Improving financial outcomes for Kenyans cannot be solved in isolation from the broader economic challenges that are structural in nature. The fact that decent paying jobs that provide stable income and formal safety nets are out of reach for so many is one major constraint to resilience in the Kenyan context. A second structural constraint to resilience relates to the social roles and norms that limit women's participation in work, decision-making and access to financial resources and services. Lastly, that borrowing for health care is associated with lower financial resilience suggests that recent health shocks in an environment where seeking health care induces income loss, large out of pocket expenses or both, exhausts reserves and other coping mechanisms that individuals might draw on for additional emergency needs. In Kenya, health shocks can entail significant direct financial costs. In 2016, 12 percent of households had at least one family member who needed hospital admission in the past year, which in 15 percent of cases required out of pocket expenditures upwards of Ksh 55,000 (or about 1 year of typical household spending)[7].

Climate change looms over Kenya's heavy reliance on climate-sensitive and low productivity farming systems. As COVID-19 social distancing measures were initiated in cities across Kenya cutting off many urban workers from their livelihoods, farmland and pastures in rural areas received above average rainfall during the March to May long rains, driving favourable harvests and a hopeful food security outlook (Famine Early Warning Systems Network, August 2020). Had rains faltered, Kenya would be in a much more difficult position. Agriculture accounts for a quarter of Kenya's GDP and two-thirds of its export earnings. Not counting casual workers hired seasonally during harvests, agricultural activities provided income or food for 56 percent of adults in 2019 (FinAccess). Prevailing farming and livestock systems are rainfed, small scale and highly susceptible to extreme weather events and variability in seasonal rainfall patterns. In addition, due to economic and population pressures, rapid deforestation has led to reduced water availability[8] and crop cultivation has increasingly pushed into marginal areas that receive lower rainfall. Adverse shocks have repeatedly disrupted the agricultural sector, resulting in highly variable yearly output and contributing to food deficits, recurring food insecurity and diversion of development resources to emergency response and recovery measures[9].

Historical trends and future projections based on climate models suggest that Kenya will face hotter conditions in the years to come. Between 1960 and 2016, mean temperature in Kenya rose by 1°C at an average rate of 0.21°C per decade (Figure 5) and is projected to increase by another 1°C to 2.8°C by 2060[10]. While there haven't been any clear long-term trends in the average amount of rainfall, studies have found evidence that the seasonal

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[7] Based on the 2016 Kenya Household Health Expenditure and Utilization Survey (KHHEUS).

[8] UNEP: https://www.unenvironment.org/news-and-stories/press-release/deforestation-costing-kenyan-economy-millions-dollars-each-year-and

[9] World Bank Agricultural Sector Risk Assessment. 2015. http://documents1.worldbank.org/curated/en/294711467992513646/pdf/97887-REVISED-WP-P148139-PUBLIC-Box393257B-Kenya-Agricultural-Sector-Risk-Assessment.pdf

[10] World Bank, Kenya Climate Change Knowledge Portal: https://climateknowledgeportal.worldbank.org/country/kenya/climate-data-projections

cycles of rainfall in East Africa have changed, with delays in the onset of rains and shorter overall duration adversely affecting crops and livestock[11]. Extreme precipitation changes over East Africa have also been experienced more frequently in the past half century, but it is unclear whether those changes are due to human activity or natural variability[12].

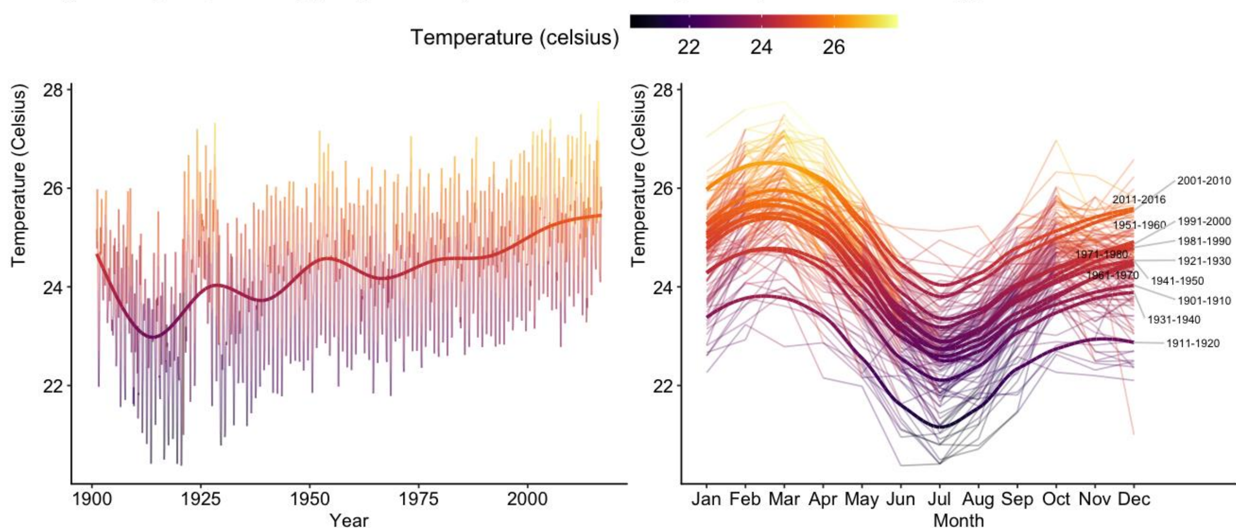
Compared to the importance of agriculture for livelihoods and food security, public and private investment in Kenya's agricultural sector is miniscule. Since 2012, government spending on agriculture as a share of total spending was less than 4 percent, reaching 1.7 percent in 2018. The agricultural orientation index (AOI) for Kenya - a measure of a government's investment in rural infrastructure, agricultural research and extension services and technology investment in proportion to the economic importance of agriculture in output- was 0.05 in 2018 compared to an average of 0.20 in SSA[13]. In addition, commercial bank lending to agriculture has made up less than 5 percent of the overall loan portfolio since 2011.

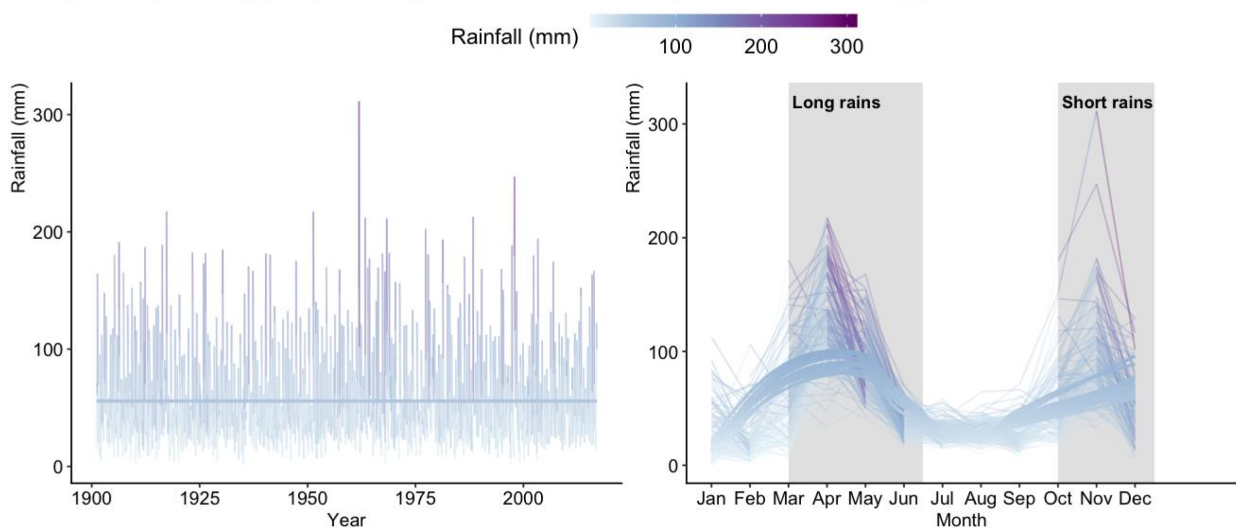
[11] Gebrechorkos, SH, Hülsmann, S, Bernhofer, C. Changes in temperature and precipitation extremes in Ethiopia, Kenya, and Tanzania. *Int J Climatol*. 2019; 39: 18– 30. https://doi.org/10.1002/joc.5777

[12] IPCC Climate Change 2014 "Impact, Adaptation and Vulnerability Part B: Regional Aspects": https://www.ipcc.ch/site/assets/uploads/2018/02/WGIIAR5-PartB_FINAL.pdf

[13] http://www.fao.org/sustainable-development-goals/indicators/2a1/en/

FIGURE 6





Taken together, it is hard to envision a path towards sustained economic and financial resilience for households in Kenya that does not involve investments that accelerate structural transformation while expanding access to safety nets. These investments would reduce the climate-sensitivity of prevailing farming systems, increase the growth of labour-intensive manufacturing and service sector firms and expand access to social insurance and protection programmes, most importantly affordable and effective health care. Cross cutting investments such as in green infrastructure and technology (such as weather-proof rural roads and micro-irrigation systems), digitization and regional trade integration can support these objectives. In addition, a considerable increase in government spending in the short run that reduces infrastructure deficits in rural areas, augments agricultural research and development capabilities and delivers extension services to increase awareness and adoption of farming practices that curb soil erosion, increase soil fertility, biodiversity and enhance productivity to millions of smallholder farmers, could simultaneously create a substantial number of decent jobs in the short run while improving the foundation for resilience in the long-run.

About FSD Kenya

The Financial Sector Deepening Kenya (FSD Kenya) is an independent trust dedicated to the achievement of an inclusive financial system that supports Kenya's long-term development goals. We work closely with government, the financial services industry and other partners to develop financial solutions that better address real world challenges faced by low-income households, enterprises and underserved groups such

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