Currency Note, A doomed Kenyan Shilling?

The Kenyan shilling has weakened for a sixth consecutive year, having recorded a Year to date depreciation of 4.4% against the US Dollar to close at an all-time low of Kshs 128.9 as at 10th March 2022, from Kshs 123.4 on 3rd January 2023. This adds to a 9.0% depreciation recorded in 2022 and a further depreciation of 3.6% and 7.7% in 2021 and 2020 respectively. The continued depreciation has been mainly driven by increased dollar demand in country from energy and merchandise importers with Kenya being a net importer and the import bill being in US Dollars. Additionally, elevated global inflationary pressures have led to high commodity prices and in turn inflating the import bill in dollars against a lower supply of hard currency. We recently covered a topical on Currency and Interest Rates Outlook, where we highlighted how the currency has evolved overtime and discussed the key drivers of the currency performance. In this note, we are going to give our views on the direction of the shilling by discussing factors that have impacted the recent performance of the shilling and the demand of the dollar in the country. Additionally, we shall give our recommendations on actionable steps that can be taken to support the performance of the shilling. The note shall have the following key talking points;

i. Discussion on the foreign exchange rate regime and its impact on supporting the shilling,
ii. Disparity in official exchange rate against market exchange rates,
iii. Discussion on IMF's statement in 2018 that Kenyan shilling is overvalued
iv. Current situation on dollar shortage for importers
v. Discussion on interbank rates and liquidity in the money market
vi. Current situation on forex reserves
vii. Conclusion and recommendations

I. Foreign Exchange Rate Regime and its impact on supporting the shilling

Kenya exercises a floating exchange rate regime where the value of the Shilling varies according to forces of demand and supply in the foreign exchange market. However, the regime also allows periodic interventions by the Central Bank of Kenya aimed at preventing undue fluctuations rather than setting the rate. Key to note, the Central Bank of Kenya adopted floating exchange rate regime in 1993, replacing the previous pegged exchange rate regime where the Kenyan Shilling was pegged to the US dollar, so that whenever the value of the dollar rose, the value of the shilling would also rise.

Since adoption of the floating exchange rate regime in Kenya, it has supported the shilling by providing for an automatic adjustment of the balance of payment with any change in the exchange rate. However, with Kenya remaining as a net importer and ever present trade deficit, the shilling has continued to weaken as a result of increased demand for foreign currency. Consequently, this has resulted in locally produced export goods to be cheaper and import goods to be more expensive. However, with the floating exchange regime in place in Kenya, external shocks which include high global fuel prices as a result of the supply constraints worsened by the geopolitical pressures have significantly affected the country's macroeconomic indicators and consequently the exchange rate. As such, the current regime has failed to reduce the negative effect of external shocks on the domestic economy with the shilling having weaken due to high import bill as a result of high commodity prices in the global market.

Additionally, the foreign exchange market has faced several headwinds with the participants in the market hoarding hard currency with a speculation of a further weakening of the local currency hence increasing the demand of the dollar in the market. Consequently, this has caused an increase in the dollar demand leading to a further fall in the exchange rate and negative ripple effects of on the economy.

II. Disparity in official exchange rate against market exchange rates

There exists a disparity in the official exchange rates published by the Central Bank of Kenya (CBK) and rates used in the market by banks and other forex exchange bureaus. The table below shows the exchange rate comparison:

Cytonn Report: Exchange Rates Comparison			
	Buy	Sell	Mean
Central Bank Rates*	128.8	129.0	128.9
Average Rates for Tier 1 Banks	128.5	138.9	133.7
Average Rates for all Banks	127.9	138.6	133.3

** Rates as of 10th March 2023*

As seen in the table above, there exists a wide disparity between the exchange rate from the CBK and the market rates for customers quoted by banks and other foreign exchange bureaus. Notably, buying rates quoted by banks for a unit of US dollars' range between Kshs 122.0 to Kshs 132.0 with an average rate of Kshs 128.5 and Kshs 127.9 for Tier 1 banks and all Banks, respectively. Also, the banks quote selling rates that range between Kshs 133.0 to Kshs 142.7 with an average rate of Kshs 138.9 and 138.6 for Tier 1 banks and all banks respectively. The market rates differ with the official rates published by the CBK with rates on 10th March 2023 indicating a buying rate of Kshs 128.8 and selling rate of Kshs 129.0. Key to note, several government agencies use a different rate as opposed to the rates provided by the CBK. For example the Energy and Petroleum Regulatory Authority (EPRA) during recent release of their monthly statement on the maximum retail fuel prices in Kenya effective 15th February 2023 to 14th March 2023, quoted an average exchange rate for the month of January at Kshs 130.6, while the average exchange rate according to the CBK was Kshs 124.4. Notably, the demand for the dollar in the economy has continued to increase mainly from the importers in energy and manufacturing sectors, as a result of high global fuel and commodity prices. As such, high demand for the dollars coupled with dollar shortage in the economy has forced importers to buy the dollars at premium rates higher than the rate published by the CBK.

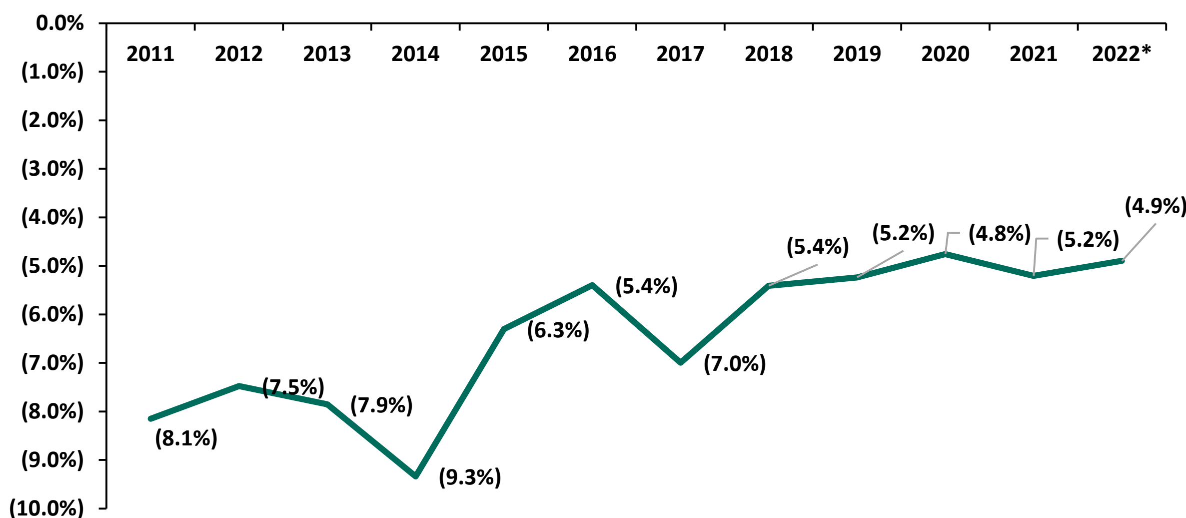
III. Discussion on IMF's statement in 2018 that Kenyan shilling is overvalued

Various concerns have also been raised on the country's currency being overvalued, with the International Monetary Fund (IMF) in 2018 stating that the Kenyan currency is overvalued by 17.5%, based on several macroeconomic factors such the widening current account. This was partly attributed to CBK engaging in periodic foreign exchange interventions, reflecting limited movement of the shilling relative to the US dollar. Additionally, the Central Bank of Kenya underscored their adherence to a flexible exchange rate policy and that their interventions were undertaken to avoid excessive exchange rate volatility, which they view as important for achieving macroeconomic and financial stability. In response to the IMF report, CBK stated that their calculations support the view that there is no fundamental misalignment beyond a range of about 5.0% reflected in the exchange rate and reiterates that the Kenya shilling reflects the currency's fundamental value. With the continued depreciation of the shilling coupled with disparity in the CBK's rate and the market rates, IMF sentiments could hold true that the shilling is a managed currency as opposed to a floating currency which should be market determined.

IV. Current situation on dollar shortage for importers

Kenya has continued to witness existence of an ever-present current account deficit estimate at 4.9% of GDP in 2022, which signifies the country's reliance on imports. The imbalance between the exports and imports coupled with high global commodity prices has increased the demand for the dollar in the country and consequently weighing down on the shilling. Additionally, global crude oil prices have remained high mainly attributable to the persistent supply chain constraints and high demand with fuel being an integral input in most sectors in the economy. Consequently, there has been an increase in the country's import bill and increased dollar demand by oil importers and manufacturers against a low supply of dollar currency. The high dollar demand has caused shortage of US Dollars in the Kenyan market and

consequently weakening the shilling. The chart below highlights the trend in the current account deficit as a percentage of GDP for the last 10 years:



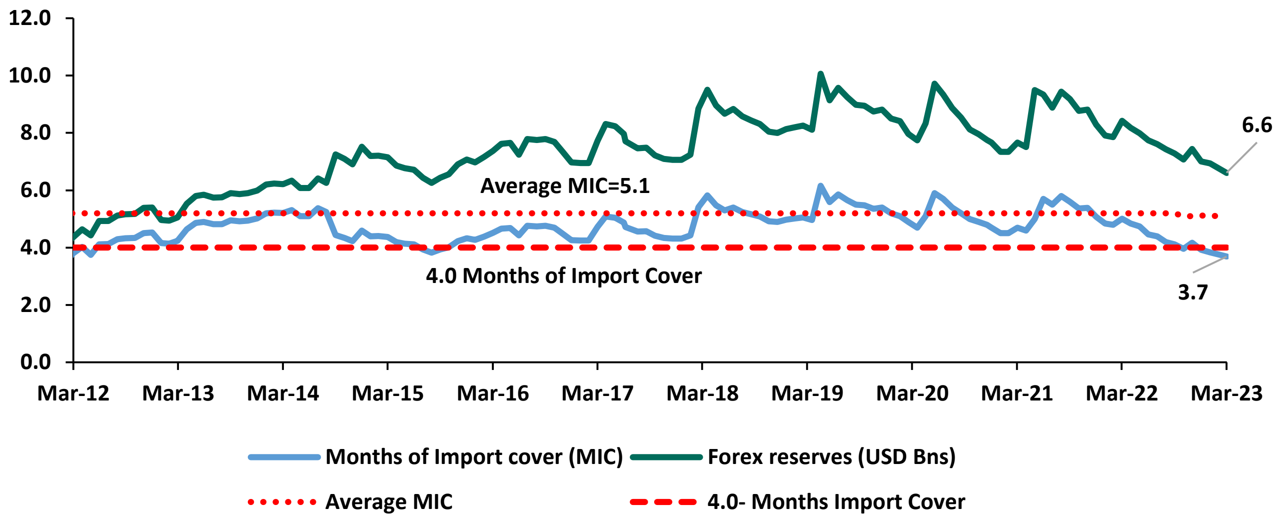
*Source: World Bank, *Estimates*

V. Interbank rates and liquidity in the money market

High exchange rates in the market have pushed commercial banks to significantly reduce lending to each other so that they can maintain their margins. Consequently, this has hampered liquidity in the money market as evidenced by an increase in interbank rates to an average of 6.4% in February from 6.0% in January 2023. The continued rise in the interbank rates highlights an increase in demand of cash at a point when the shilling has continued to depreciate. Notably, for the month of February, the average interbank volumes transacted in the interbank money market increased by 37.3% to Kshs 24.6 bn, from Kshs 17.9 bn recorded in January. However, the current Cash Reserve Ratio (CRR) to 4.25% has played a big role in maintaining favourable liquidity in the money market as well increases the supply of money by commercial banks. We expect the interbank rate to continue rising and liquidity to be under pressure mainly as a result of the weakening of the shilling. This is because there will be an increased in the amount of shillings needed to exchange for units of dollars in order to facilitate imports.

VI. Current situation on forex reserves

The central Bank of Kenya endeavours to have sufficient forex reserves equivalent to 4.0-months import cover. However, the country's forex reserves have recorded a significant decline of 24.6% to USD 6.6 bn (equivalent to 3.7 months of import cover) in March 2023, from USD 8.8 bn (equivalent to 5.1 months of import cover) recorded in January 2022. The drop is largely attributed to increased debt service costs occasioned by continued appreciation of the dollar and aggressive depreciation of the shilling. Consequently, this has resulted in continued dwindling of the country's forex reserves given that 69.3% of Kenya's External Debt was US dollar denominated as of October 2022. Additionally, in the near term, the country's forex reserves are expected to be under significant pressure as a result of expected increase in dollar demand to facilitate payment of dividends to offshore investors by listed multinationals and firms with high foreign shareholding. However, we expect forex reserves to be boosted by expected increase in dollar inflows from external debt in form of both commercial and multilateral loans such as the IMF and the World Bank. The chart below summarizes the evolution of Kenya months of import cover and the forex reserves:



Conclusion and our recommendations

The future performance of the shillings is marred with a lot of concerns arising from the current pressures as well as the dwindling country's forex reserves. Additionally, the demand for dollar in the market is expected to increase especially from oil and energy importers who will have to increase the amounts they pay for oil imports and hence depleting dollar supply in the market. As such, we expect to see continued depreciation of the Kenyan shilling with our outlook for shillings to trade within the range of between Kshs 138.4 and Kshs 142.6 against the USD by the end of 2023 based on the purchasing power parity (PPP) and interest rate parity (IRP) approach respectively. This will in turn negatively impact the economy as prices of basic commodities will increase.

Base on the factors discussed above, there are actionable steps that can be taken by the government to address the concerns and at the same time mitigate continued depreciation of the shilling. These include;

i. **Maintaining a flexible exchange rate-** To avoid disparity of the exchange rate in the same market, the Central Bank of Kenya should stick to the current floating exchange rate regime. This will allow the rate to fluctuate in relation to what is happening in the market depending on forces of demand and supply. The CBK should further enact policies to ensure customers are not being overcharged to access units of the dollar from banks and other forex traders,

ii. **Streamline interbank trading-** The Central Bank of Kenya should put in place measures to streamline interbank trading by removing any restrictions on the rate to be traded aimed at improving liquidity and flow of forex exchange,

iii. **Building an export driven economy-** There is need to improve on the country's trade imbalance by improving the manufacturing sector as well as formulating robust export oriented policies in order to increase exports. Consequently, this will improve country's current account while reducing overreliance on imports to preserve our foreign exchange reserves which will go a long way stabilizing the exchange rate,

iv. **Reduction of commercial loans**- The government to do debt composition rebalancing by reducing commercial loans which attract high interest rates as compared to concessional borrowing so as to reduce debt servicing costs. Reduced debt service amounts would greatly help to bring down demand for the dollar and stabilize the exchange rate,

v. **Formulation of diaspora friendly policies.** With the current dwindling of the forex exchange reserve, the government should work in close conjunction with banks and other investments institutions to allow for favourable accounts for diaspora citizens, which will encourage them to remit more money back to the country hence cushioning the shilling against further depreciation. This can be done by reducing money transfer costs by exploring alternative

channels for remitting money by leveraging on digitization and technology and explore alternative channels.

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