Cytonn Note on the 3rd October 2023 Monetary Policy Committee (MPC) Meeting

The Monetary Policy Committee (MPC) is set to meet on Tuesday, 3rd October 2023, to review the outcome of its previous policy decisions and recent economic developments, and to decide on the direction of the Central Bank Rate (CBR). In their previous meeting held on 9th August 2023, the committee noted that they will closely monitor the impact of the policy measures taken, as well as developments in the global and domestic economy, and stood ready to take further action as necessary. Additionally, the MPC noted the impact of its move to tighten the monetary policy in June 2023 to anchor inflationary expectations was still transmitting in the economy and therefore it concluded that the current stance on monetary policy was appropriate and decided to retain the central Bank Rate at 10.50%. Some of the key highlights from the previous MPC included;

i. The need to maintain inflation at the government's target range of 2.5%-7.5%. The Overall Inflation eased to 7.3% in July 2023, from 7.3% in June 2023 on the back of lower food and non- food non- fuel (NFNF) inflation. Food inflation eased to 8.6% in July 2023 from 10.3% in June 2023, mainly driven by lower prices of vegetables as a result of long rains. Additionally, fuel inflation remained elevated at 14.5% in July 2023 from 12.9% in June 2023 attributable to the increased electricity prices and implementation of the 16.0% VAT on petroleum products. The fuel inflation was however moderated by lower prices of cooking gas following the removal of VAT on liquefied petroleum gas (LPG). Consequently, the overall inflation rate was expected to ease further in the short-term, due to the lower food prices and improving supply of key food items particularly maize. Notably, the August inflation came in at 6.7%, down from the July inflation of 7.3%.
ii. The recently released GDP data for the first quarter of 2023 showed continued strong performance of the Kenyan economy, with real GDP growing by 5.3%. This was attributable to a strong rebound in the agriculture sector due to favourable weather conditions and resilient performance of the services sector. Leading indicators of economic activity pointed to continued strong performance in the second quarter of 2023. Despite the global uncertainties, the economy is expected to continue to strengthen in 2023, supported by resilient services sector, the rebound in agriculture, and implementation of measures to boost economic activity in priority sectors by the Government

The Monetary Policy Committee noted that the then ongoing implementation of the FY2023/24 Government Budget, particularly the performance in tax revenue collection will continue to reinforce fiscal consolidation. Notably, the total revenue collected as at the end of August 2023 amounted to Kshs 324.4 bn, equivalent to 12.6% of the original estimates of Kshs 2,571.2 bn, with tax revenues amounting to Kshs 317.6 bn, equivalent to 12.7% of the original estimates of Kshs 2,495.8 bn. Additionally, the Monetary Policy committee noted that the leading economic indicators pointed to a strong performance of the Kenyan economy mainly driven by the activities in services sector and recovery of the Agricultural sector. Notably, Stanbic's PMI for the month of August came in at 50.6, up from 45.5 in July 2023, signaling an expansion in business conditions for the first time since January 2023. The committee further noted that goods exports remained strong having a year on year growth by 2.1% in the 12 months to June 2023. Notably, receipts from tea and manufacturing goods exports increased on the back improved prices due to demand from the traditional market. Additionally, imports decreased by 6.1% in the 12 months to June 2023, compared to the 20.2% growth recorded in a similar period last year, due to drop of imports of infrastructure related equipment, mainly on the back of completed projects as well as manufactured goods. Remittances in the 12 months to June 2023 amounted to USD 4,017.0 mn, representing a 0.1% gain compared to a similar period last year. However, the current account deficit is projected at 4.8% of GDP in 2023, from the estimate of 5.1% of GDP in 2022. Notably, private sector credit growth had declined 12.2% in June 2023 from 13.2% in May 2023, with the number of loan application and approval remaining strong, highlighting increased demand and resilient economic activities.

Below, we analyze the trends of the macro-economic indicators since the June MPC meeting, and how they are likely to affect the MPC decision on the direction of the CBR:

Indicators	Experience since the last MPC meeting in August 2023	Our Expectation Going forward	CBR Direction (August)	Probable CBR Direction (October)
Government Revenue Collection	• Total revenue collected as at the end of August 2023 amounted to Kshs 323.4 bn, equivalent to 12.6% of the original estimates of Kshs 2,571.2 bn for FY'2023/2024 and is 75.5% of the prorated estimates of Kshs 428.5 bn. Cumulatively, tax revenues amounted to Kshs 317.6 bn, equivalent to 12.7% of the original estimates of Kshs 2,495.8 bn and 76.3% of the prorated estimates of Kshs 416.0 bn, • We note that the government has not been able to meet its prorated revenue targets for the first three months of the FY'2023/2024 partly attributable to the deteriorated macroeconomic environment in the country as evidenced by Purchasing managers' index which increased only marginally to 50.6 for the first time since January. Additionally, The September inflation came in at 6.8% an increase from the 6.7% recorded in August 2023	• In the short term, we expect the revenue collections to lag behind the prorated targets given the subdued business environment on the back of elevated inflationary pressures as a result of high fuel and electricity prices, coupled with the sustained depreciation of the shilling against the dollar which continue to put pressure on the economic environment • However, the government's continued efforts to broaden the tax base will lead to increased tax revenue collection, evidenced by the provisions in the current Finance Act Among the key provisions in the Act are increase of the VAT on Petroleum from 16.0% to 8.0%, introduction of a higher personal income tax rate of 35.0% on the income of individuals earning above Kshs 500,000.0 per month from the current 30.0%, introduction of tax of 3.0% on income derived from the transfer or exchange of digital assets, and an increase in turnover tax to 3.0% from the current 1.0%. As such, we expect the tax collections to increase in the long-term and thus boost the government's efforts of meeting it revenue collection target, • Nevertheless, given the subdued general business environment which is underpinned by depreciation of the Kenyan shilling, tightened liquidity in the money market, and elevated inflationary pressures, we expect the subdued business environment to weigh down the tax revenue given that consumers have cut back on their spending due to reduction in disposable income	**Neutral**	**Neutral**
Government Borrowing	• Total Borrowings as at the end of August 2023 amounted to Kshs 178.7 bn, equivalent to 11.5% of the original estimates of Kshs 1,558.4 bn for FY'2023/2024 and are 68.8% of the prorated estimates of Kshs 259.7 bn. The cumulative domestic borrowing of Kshs 688.2 bn comprises of Net Domestic Borrowing KSh. 313.7 bn and Internal Debt Redemptions (Rollovers) Kshs 374.5 bn. • Kenya's Public debt as at September 2023 stood at Kshs 10.3 tn, equivalent to 76.6% of GDP, 26.6% points above	• Kenya's rising debt sustainability remains a significant concern with the government's borrowing appetite remaining high given the subdued economic environment coupled with an ever-present fiscal deficit. Additionally, the rising debt servicing with Kenya's external debt service costs is expected to rise sharply by 53.6% to USD 4.3 bn in FY'2023/2024 up from USD 2.8 bn that was spent on debt service in the previous year, FY'2022/2023 mainly due to the upcoming maturities such as the 10-year USD 2.0 bn (Kshs 226.0 bn)	**Negative**	**Negative**

	the IMF recommended threshold of 50.0% for developing countries,	Eurobond maturing in June 2024. This has led to Credit rating agencies such as Moody's Credit Rating Agency, S&P Global Rating and Fitch to downgrade their outlook of Kenya. Notably, Kenya's latest rating by moody was at B3 for both local issuer and foreign currency issuer an indication of a high credit risk • The total borrowing for the FY'2023/24 is set to reduce by 12.9% to Kshs 718.0 bn, from Kshs 824.0 bn, in FY'2022/23 budget estimates. Additionally, the government has reduced its appetite for foreign debt, projecting to borrow Kshs 131.5 bn in foreign debt in the FY'2023/24, a 66.8% decrease from 395.8 billion in the FY'2022/23. The move is expected to lower the cost of debt servicing, given that foreign debt has been ballooning as a result of the Kenya shilling's sustained depreciation against major currencies. However, the debt servicing costs are set to rise by 19.4% to Kshs 1.6 tn in FY'2023/24, from Kshs 1.4 tn in the FY'2022/23 budget. The rise in debt servicing expenses can be partly attributable to the depreciation of the Kenyan shilling given that a larger proportion of external debt is denominated in US dollars		
Inflation	• Year on year (y/y) inflation rate for September 2023 came in at 6.8%, an increase from 6.7% recorded in August 2023, while the month on month (m/m) inflation increased marginally by 1.0% points. The headline inflation for September 2023 was majorly driven by an increase in prices for Transport; Food and Non-alcoholic beverages; and housing, water, electricity, gas and other fuels of 13.0%, 7.9% and 6.3% respectively. • Notably, the significant increase of Transport index by 13.0% year on year is on the back of the increase in fuel prices which increased by 8.7%, 11.8% and 19.4% to Kshs 211.6, Kshs 200.6 and Kshs 202.6, per litre of Super Petrol, Diesel and Kerosene, respectively. The high fuel prices are attributable the high cost of fuel imports as a result of the sustained depreciation of the shilling against the US dollar, as well as the high taxation of petroleum products as provided in the finance Act 2023. • The overall increase of the headline inflation in the month of September	• We expect inflation rates to remain elevated but within the CBK's target range of 2.5% - 7.5% supported by the current fiscal stance by the Monetary Policy Committee, having Maintained the Central Bank Rate to 10.5% in August 2023. • However, the sustained depreciation of the Kenyan shilling against major currencies is also expected to underpin inflationary pressures in the country as manufacturers pass on the high cost of importation to consumers through hikes in consumer prices in order to maintain their margins	**Positive**	**Neutral**

	2023 compared to August 2023 comes despite the monetary policy committee decision to maintain the Central Bank Rate at 10.5% in August 2023 a move which aimed to anchor inflation. However the headline inflation still remains within the Central Bank of Kenya target range of 2.5% - 7.5%.			
Currency (USD/Kshs)	• Since the last meeting, the Kenyan Shilling has depreciated by 3.4% against the US Dollar to Kshs 148.1 as at 29th September 2023, from Kshs 143.3 recorded on 9th August 2023 mainly attributable to persistent high dollar demand from importers, especially in the oil and energy sector • However, the Forex Reserves have decreased by 5.7% to USD 6.9 bn (equivalent to 3.8 months of import cover) as of 28th August 2023 from USD 7.4 bn (equivalent to 4.0 months of import cover) recorded in 10th August 2023. Notably, the forex reserves are within the statutory requirement of maintaining at least 4.0 months of import cover, albeit lower than the EAC region's convergence criteria of 4.5 months of import cover	• We expect the Kenyan Shilling to remain under significant pressure in the medium term as demand for the dollar continues to increase in the oil and energy sectors. However, the government-government dealing involving firms such as the Saudi Aramco (ARAMCO), Abu Dhabi National Oil Company (ADNOC) and Emirates National Oil Company (ENOC) to supply Kenya with diesel and super petrol on credit was extended to December 2024. As such we expect that this will lead to an ease in dollar demand by oil importers • Additionally, the shilling performance and strength is expected to be supported by the sufficient forex reserves currently at USD 6.9 bn (equivalent to 3.8-months of import cover), which is slightly below the statutory requirement of maintaining at least 4.0-months of import cover. Moreover, tourism receipts have significantly increased by 82.9% to Kshs 268.1 bn in 2022, from Kshs 146.5 bn inflow receipts recorded in 2021. The tourism receipts are expected to increase evidenced by the increased number of visitor arrivals through the Jomo Kenyatta and Moi International airports, which has increased by 50.0% to 337,937 in Q1'2023 up from 225,321 recorded in Q1'2022	**Negative**	**Negative**
GDP Growth	• Kenyan's economy recorded a 5.3% growth in Q1'2023, lower than the 6.2% growth recorded in Q1'2022, pointing towards a slower economic growth. The performance was driven by; i. The positive growth recorded in all sectors, with the Accommodation and Food Service Sector recording the highest growth rate of 21.5% in Q1'2023, albeit lower than the 40.1% growth recorded in Q1'2022. The sector's performance continues to be cushioned by the rising tourism activities as evidenced by increased visitor	• We expect Kenya's GDP to continue growing at a slower pace in line with the global economy trends. However, the economy will be supported by sustained recovery in sectors like accommodation and food services sector, as well as recent fiscal policies such as subsidizing costs of crucial farm inputs such as fertilizer that are expected to support growth in the agriculture sector, which remains to be Kenya's largest contributor to GDP, • However, the continued depreciation of the Kenya shilling has continued to weigh down on the business	**Neutral**	**Neutral**

	ii. arrivals through the Jomo Kenyatta and Moi International airports, increasing by 50.0% to 337,937 in Q1'2023 up from 225,321 recorded in Q1'2022 ii. The rebound of Agricultural Sectors, recording a growth of 5.8% compared to a contraction of 1.7% in Q1'2022. This is after a consecutive contraction of four quarters. The positive growth recorded during the quarter was mainly attributable to the sufficient rainfall experienced in the quarter under review, which resulted in increased agricultural production. However, the sectoral contribution of the Agriculture sector, declined the most by 4.9% points to 18.5% in Q1'2023, from the 23.4% GDP contribution in Q1'2023	environment, by increasing the cost of imported inputs and adding the finance cost of the foreign currency denominated debts • Notably, the country's PMI for the month of August 2023 improved to 50.6, for the first time since January 2023, an indication of an improved business environment in the country. However, according to CEO's survey-May 2023 report, optimism regarding growth prospects for the Kenyan economy improved due to the easing of inflation rate and the expected increase agricultural production. On the global economy, respondents had a subdued optimism attributable to the lingering war in Ukraine and interest rates hike in advanced economies		
Private Sector Credit Growth	• The latest data from CBK indicates that private sector credit growth continues to recover having grown by 12.2% in June 2023, attributed to strong credit growth in sectors such as; transport and communication, manufacturing, trade, and consumer durables of 19.9%, 18.0%, 12.5% and 11.8% respectively. Additionally, the number of loan applications and approvals remained strong, reflecting resilience in economic activities.	• We anticipate continued adoption of the risk-based pricing model in the banking sector to continue to unlock access to credit to individuals and businesses who were not captured by the previous frame works due to being considered too risky, • However, the increased government borrowing is expected to continue crowding out the private sector in the short term as seen by the weighted average yield for T-Bonds coming at 17.7% in the month of September effectively edging out majority of the corporate bonds currently in the trading in market • Additionally, banks have adjusted their lending rates in line with the CBR rate which was maintained at 10.5% in August MPC meeting. This is expected to slow down the private sector credit demand	**Positive**	**Neutral**
Liquidity	• Liquidity levels in the money markets tightened, with the average interbank rate since the previous MPC meeting increasing by 2.1% points to 12.4% as of 29th September 2023, from 10.4% recorded in 9th August 2023, partly attributable to tax remittances that offset government payments	• We expect liquidity in the money markets to be supported by the high domestic debt maturities that currently stand at Kshs 511.3 bn worth of T-bill maturities and Kshs 161.7 bn worth of T-bond maturities for FY'2023/2024.	**Negative**	**Neutral**

Conclusion

Out of the seven factors that we track, three are negative, while four are neutral. Notably, most of the Central Banks of developed economies around the world have continued to raise their rates with the aim of anchoring inflation within their target ranges. The main goal of the monetary policy is to maintain price stability and support economic growth by controlling the money supply in the economy. We expect the MPC to maintain the Central Bank Rate (CBR) at the current rate of 10.50% with their decision mainly being supported by:

i. The ease in y/y inflation in August 2023 to 6.7%, from 7.3% recorded in July 2023 marking the second consecutive month that inflation has fallen within the CBK target range of 2.5%-7.5%. However, the risk lies on the back of elevated fuel prices which has seen the recent rise in y/y inflation for the month of September to 6.8%, from the 6.7% in August following the increase in VAT on petroleum products to 16.0% from 8.0%. As such, we expect the MPC to maintain the CBR as the current monetary stance still transmits in the economy, and

ii. The need to support the economy by adopting an accommodative policy that will ease financing activities. Notably, the Purchasing Managers Index (PMI) has for the first time since January improved to 50.6 in August, from the 45.5 recorded in July surpassing the 50.0 threshold, an indication of greater improvement in the business environment. Point to note, an additional hike in the CBR rate might curtail economic growth given the current macroeconomic and business environment and may result in deterioration in the business activity of the country.