**Cytonn Note on the 30th January 2023 Monetary Policy Committee (MPC) Meeting**

The Monetary Policy Committee (MPC) is set to meet on Monday, 30th January 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 Wednesday 23rd November 2022, the committee decided to reconvene in January 2023, while highlighting that they would remain ready to reconvene earlier if necessary. Additionally, the MPC raised the Central Bank Rate by 50.0 bps to 8.75% in their November sitting, from the previous 8.25%, citing the sustained inflationary pressures, the elevated global risks and their potential impact on the domestic economy and concluded that there was scope for tightening the monetary policy in order to anchor inflationary expectations. This was above our expectations of a 25.0 bps hike as per our MPC note with our view having been supported by:

i. The need to curb the increasing inflation rate which had surpassed the government's target range of 2.5%-7.5%, with the October 2022 inflation rising to 9.6%, the highest since June 2017, and an increase from the 9.2% recorded in September 2022, driven by increasing food and fuel prices, the highest contributors to headline inflation. Additionally, we anticipated inflation to remain elevated in the short term driven by the high fuel and food prices. As such, we expected the MPC to raise the CBR as it continued to monitor the situation and react accordingly, as per its mandate to maintain price stability, and,
ii. The need to support the shilling from further depreciation as other Central Banks continued to raise their rates, with the Kenyan shilling having depreciated by 7.8% to Kshs 122.0 as at 17th September 2022, from Kshs 113.1 recorded at the beginning of 2022. The depreciation was mainly attributable to increased dollar demand in the oil and energy sectors as a result of high fuel prices. We expected the shilling to depreciate even further should the prices of fuel continue to rise leading to an increased import bill, Kenya being a net importer. Furthermore, the country's forex reserves had continued to dwindle, having declined by 2.5% to USD 7.2 bn (equivalent to 4.1 months of import cover) as at 11th November 2022, from USD 7.4 bn (equivalent to 4.2 months of import cover) in September 2022. As such, we expected the forex reserves to remain under pressure which would call on the Central Bank to pursue additional policy measures to slow the accelerated depreciation of the shilling.

The Monetary Policy Committee noted progress towards the achievement of the FY'2022/2023 Government Budget in its November meeting, with an emphasis on the strong tax revenue collection, reflecting enhanced tax administration efforts and increased economic activity. Total revenue collected as at the end of October 2022 amounted to Kshs 636.4 bn, equivalent to 89.2% of the prorated estimates of Kshs 713.9 bn, with tax revenues amounting to Kshs 607.9 bn, equivalent to 88.0% of the prorated estimates of Kshs 690.6 bn. Monetary Policy Committee also noted that the current account deficit to GDP was estimated at 5.3% in the 12 months to September 2022, a 0.3% points lower than the 5.6% recorded in a similar period in 2021 and was projected to widen further to 5.6% of GDP by end of 2022, down from the previous estimates of 5.9% attributable to improved receipts on exports and resilient remittances. Additionally, exports of goods remained strong, growing by 13.9% in the 12 months to September 2022 compared to similar a period in 2021. Key to note, private sector credit growth came in at 13.3% in October 2022, 5.5% points higher than the 7.8% over the same period in 2021.

Below, we analyze the trends of the macro-economic indicators since the November 2022 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 November 2022 | Our Expectation Going forward | CBR Direction (November) | Probable CBR Direction (January) |
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| **Government Revenue Collection** | • Total revenue collected for the first half of FY'2022/2023, ending 30th December 2022 amounted to Kshs 987.9 bn, equivalent to 46.1% of the original estimates of Kshs 2,141.6 bn for FY'2022/2023 and was 92.3% of the prorated estimates of Kshs 1,070.8 bn,<br>• We note that the government has not met its prorated revenue target for the first half of the FY'2022/2023 mainly due to the deteriorated macroeconomic environment evidenced by the decline of the PMI to 46.8 for the last six months of 2022 from 51.7 recorded in a similar period of 2021, and a slowdown in economic growth to 4.7% in Q3'2022 from 9.3% recorded in a similar period last year. | • 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. Additionally, the persistent supply chain constraints are expected to weigh on the business environment,<br>• However, we expect the implementation of the Finance Act 2022 coupled with how fast the new regime implements its economic growth related and tax collection initiatives such as the draft regulations for the Excise Duty Regulations 2023 to continue supporting the tax revenue collected. | **Neutral** | **Neutral** |
| **Government Borrowing** | • Kenya has continued to receive financing from the World Bank and other bilateral lenders such as the International Monetary Fund (IMF). Notably, in December 2022, the IMF announced that it had completed the review of the 5th tranche under the 38-month Extended Fund Facility (EFF) and Extended Credit Facility (ECF)- funding program. This approved a disbursement of USD 447.4 mn (Kshs 55.1 bn), bringing the total funding to USD 1.7 tn (Kshs 204.0 bn) aimed at boosting Kenya's economic recovery process and to strengthen fiscal sustainability through reforms,<br>• Kenya's Public debt as at October 2022 stood at Kshs 8.7 tn, equivalent to 62.3% of GDP, 12.3% points above the IMF recommended threshold of 50.0% for developing countries,<br>• USD denominated external debt constituted of 69.3% of all external debt as of October 2022 leading to an increase in the debt servicing cost at a time when the Kenyan shilling has depreciated against the dollar to an all-time low | • 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, projected at 5.8% of GDP in FY'2022/23. Additionally, the rising debt servicing costs represented 51.0% of the actual revenue collected as the end of December 2022 which continues to put pressure on the government to borrow more in an aim to fund the expenditure,<br>• Both domestic and external debt maturities continue to increase with concerns remaining high on servicing, especially with upcoming maturities such as the 10-year USD 2.0 bn (Kshs 226.0 bn) Eurobond maturing in 2024. This has since raised need to finance it with the government having been phased out on the two Eurobonds that it had announced to issue by June 2022 on the back of increasing interest rates in the Eurobond markets making borrowing more expensive, and,<br>• However, the new regime had mentioned of a plan to reduce the expenditure for the FY'2022/23 by Kshs 300.0 bn aimed at cutting down on borrowing which we have not seen traction towards achievement of the same. This was expected to reduce the current fiscal deficit for FY'2022/2023 by 34.8% to Kshs 562.5 bn from 862.5 bn. Additionally, the current administration's efforts to boost tax collection such as the draft regulations for the Excise Duty Regulations 2023 will help reduce the budget deficit, and this cut the need for excessive borrowing. | **Negative** | **Negative** |

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| **Inflation** | • Year on year (y/y) inflation rate for December 2022 came in at 9.1%, a decline from 9.5% recorded in November 2022, while the month on month (m/m) inflation eased by 0.4% points. The decline was mainly driven by a 13.8% and 9.9% slower increase in the food and non-alcoholic beverages index and furnishing, household equipment and routine maintenance index in December 2022, when compared to 15.4% and 10.6% increases in November, respectively,<br>• Notably, Kenya's inflation has eased for two consecutive months in November and December 2022, to 9.5% and 9.1% respectively from a 5-Yr peak of 9.6% recorded in October 2022, pointing towards continued cooling down of inflation,<br>• Additionally, the Monetary Policy Committee raised the Central Bank Rate to 8.75% in their November sitting, from the previous 8.25% with the aim of anchoring the elevated inflation rate which has stayed above the government target range of 2.5%-7.5%. Despite the monetary stance, we still believe that the inflationary pressures are due to external shocks and a decline is largely pegged on how soon global supply chains stabilize. | • We expect inflation rates to remain elevated in the short term arising from high fuel prices due the partial removal of fuel subsidies by the current regime as they were unsustainable, which we expect to be completely eliminated in the coming months. However, global fuel prices have recorded a 37.7% drop to USD 85.5 per barrel as at 27th Jan 2023, from the peak of USD 117.7 recorded in June 2022, due the measures taken by different governments to sheath themselves against the high fuel prices due to the Russian's invasion of Ukraine. This has resulted to the decline in the average landed costs of fuel to Kenya, but weighed down by the partial removal of fuel subsidies. As such, we expect the cost of production to remain high as fuel is a major input to many businesses<br>• Additionally, we expect food prices to remain elevated in the short term, given the uneven weather patterns and drought experienced in the first three quarters of 2022 that have reduced the country's food security. However, the agricultural sector is expected to be supported by the recent fiscal policies such as subsidizing costs of crucial farm inputs such as fertilizers and this lower the cost of farming, resulting to a drop in food prices | **Negative** | **Negative** |
| **Currency (USD/Kshs)** | • Since the last meeting, the Kenyan Shilling has depreciated by 1.7% against the US Dollar to Kshs 124.2 as of 25th January 2023, from Kshs 122.2 on 23rd November 2022, mainly attributable to increased dollar demand from commodity and energy sector importers, and,<br>• Forex Reserves improved by 4.8% to USD 7.4 bn (equivalent to 4.1 months of import cover) as of 20th January 2023 from USD 7.0 bn (equivalent to 4.0 months of import cover) recorded in 25th November 2022, mainly boosted by the USD 447.4 mn financing from the IMF in December 2022. Additionally, forex reserves remain above the statutory requirement of maintaining at least 4.0 months of import cover, but is below 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,<br>• However, the shilling performance and strength is expected to be supported by the sufficient forex reserves, currently at USD 7.4 bn (equivalent to 4.1 months of import cover) above the statutory requirement of 4.0 months of import cover. The shilling is also expected to be supported by Sufficient diaspora remittances evidenced by a 8.3% y/y increase to USD 4.0 bn cumulative remittances to the end of December 2022, from USD 3.7 bn recorded by the end of December 2021. | **Negative** | **Negative** |

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| **GDP Growth** | • Kenyan's economy recorded a 4.7% growth in Q3'2022, lower than the 9.3% growth recorded in Q3'2021, pointing towards slower economic growth. The performance was driven by<br>i. Accommodation and food services sector which recorded the highest growth rate of 22.9% in Q3'2022, however slower than the 127.5% growth recorded in Q3'2021, remained resilient during the quarter mainly driven by relaxation of COVID-19 travel restrictions that has seen increased visitor arrivals through the Jomo Kenyatta and Moi International airports,<br>ii. The subdued growth in the agricultural sector which is a main contributor to the country's GDP, with Agriculture, Forestry and Fishing activities recording a decline of 0.6% in Q3'2022 compared to a growth of 0.6% in Q3'2021, due to unfavorable weather conditions which has undermined agricultural production | • We expect Kenya's GDP to continue growing at a slower pace in tandem with the global economy amid fears of a global recession. However, the economy will be supported by 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 are expected to support growth in the agriculture sector, which remains as Kenya's largest contributor to GDP,<br>• However, risks lie on the downside, given the elevated inflationary pressures which have continued to weigh on the business environment,<br>• Notably, the country's PMI averaged at 49.2 for the year 2022 from 50.8 recorded in 2021 pointing towards a deteriorated business environment in the Kenyan private sector. | **Neutral** | **Neutral** |
| **Private Sector Credit Growth** | • The latest data from CBK indicates that private sector credit growth continues to recover having grown at by 12.5% growth in December 2022, 3.9% points higher than the 8.6% growth recorded in the same period in 2021 as demand recovered following the increased economic activities | • We expect the general business environment to remain subdued in the short term mainly as a result of elevated inflationary pressures consequently pushing the prices of commodities hence curtailing private sector credit growth,<br>• We anticipate the 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,<br>• However, the increased government borrowing is expected to continue crowding out the private sector in the short term. | **Neutral** | **Neutral** |

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| **Liquidity** | • Liquidity levels in the money markets tightened, with the average interbank rate as of 25th January 2023 coming in at 6.2%, 1.5% points higher than the 4.7% recorded in the period prior to the November 2022 meeting, partly attributable to tax remittances that offset government payments | • Despite the tightened liquidity recorded in the last months of 2022, it is expected to remain favorable due to:<br>i. High domestic debt maturities that currently stand at Kshs 487.1 bn worth of T-bill maturities and Kshs 214.4 bn worth of T-bond maturities for FY'2022/2023, and,<br>ii. Low Cash Reserve Ratio (CRR) currently at 4.25% from 5.25% previously which continues to support private sector credit growth | **Positive** | **Positive** |

## Conclusion

Of the seven factors that we track, three are negative, three are neutral and one is positive. Notably, most of the Central Banks of developed economies around the world have continued to raise their central bank rates, given the elevated inflation rates. In the United States, the y/y inflation for the month of December 2022 eased to 6.5% from 7.1% in November 2022, and 4.5% points above the 2.0% target. However, the United States Federal Bank Monetary Policy Committee, in their December 2022 sitting, decided to tighten the policy stance by increasing the rate by 0.50% points. In their most recent sittings England and Australia also increased their rates while China, Malaysia and Ghana maintained their rates. We expect reactionary moves from other Central Banks around the world to stem outflows from their economies as investors seek to profit from higher rates in the US and other countries. However, Central Banks, particularly in emerging markets, will have to perform difficult balancing acts in order to avoid stifling economic growth and post-pandemic recovery by raising their benchmark rates. The table below highlights the policy stance adopted by Central Banks of major economies;

| No | Country | Central Bank | Previous Rate | Current Rate | Change (% Points) |
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| 1 | Malaysia | Bank Negara Malaysia | 2.75% | 2.75% | Unchanged |
| 2 | China | Bank of China | 3.65% | 3.65% | Unchanged |
| 3 | England | Bank of England | 3.00% | 3.50% | 0.50% |
| 4 | Australia | Reserve Bank of Australia | 2.85% | 3.10% | 0.25% |
| 5 | USA | Federal Reserve | 3.75% - 4.00% | 4.25% - 4.50% | 0.50% |
| 6 | Ghana | Bank of Ghana | 27.00% | 27.00% | Unchanged |

***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 hike the Central Bank Rate (CBR) by 25.0 bps to 9.00% from the current 8.75% with their decision mainly being supported by:***

i. We anticipate the MPC to raise the Central Bank Rate (CBR) by 25.0 bps to 9.00%, from the current 8.75%, with a focus on the need to continue cooling down inflation to the government's target range of 2.5%-7.5%. Key to note, inflation for the months of November and December 2022 eased to 9.5% and 9.1%, respectively, in line with the easing global inflation, especially in the advanced economies such as the U.S and the EU. Going forward, inflation is expected to remain elevated in the short term as it continues to ease gradually driven by the high fuel and food prices. Additionally, we expect the fuel prices to rise as the current administration plans to completely do away with the fuel subsidy program and adjust the domestic fuel prices to ease pressure on expenditure. Further, we expect food prices to remain elevated in the short term, due to the erratic weather patterns and as the measures being taken by the current administration to address food security concerns take effect. As such, we expect the MPC to raise the CBR as it continues to monitor the situation and react accordingly, given that its main role is maintaining price stability, and,

ii. The need to support the shilling from further depreciation as other Central Banks raise their rates. Notably the Kenyan shilling depreciated by 9.0% during 2022, and to an all-time low of Kshs 124.2 as of 25th January 2023, from Kshs 123.4 recorded in the beginning of 2023, representing a 0.7% depreciation year to date. The depreciation is mainly attributable to increased dollar demand in the oil and energy sectors as a result of high fuel prices. In the short term, we expect the shilling to depreciate even further should the prices of fuel continue to rise leading to an increased import bill, Kenya being a net importer. Key to note, forex reserves have been under pressure despite the financing facility by the IMF, coming in at USD 7.4 bn as at 20th January 2023, representing 4.1 months of import cover, only 0.1 months above the statutory requirement of 4.0 months. As such, this might put pressure on the Central Bank to pursue additional policy measures to slow the accelerated depreciation of the shilling.

However, we expect this to curtail the economic growth, given that the economy has continued to suffer from global shocks such as the Russian invasion in Ukraine that saw food and fuel prices soaring to record highs. Notably, Kenya's economy recorded a 4.7% growth in Q3'2022 pointing towards slower economic growth as compared to the 5.2% and 9.3% expansion rates recorded in Q2'2022 and Q3'2021, respectively. As such, the increase in the Central Bank Rate (CBR) to anchor the sustained inflation emanating from high food and fuel prices and support the Kenyan Shilling from even further depreciation is expected to unleash further negative impacts on the local economy amid a deteriorated local business environment and continued global shocks.