Cytonn Note on the 29th May 2023 Monetary Policy Committee (MPC) Meeting

The Monetary Policy Committee (MPC) is set to meet on Monday, 29th May 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 29th March 2023, the committee decided to reconvene in May 2023, while highlighting that they were ready to reconvene earlier if necessary. Additionally, the MPC decided to raise the Central Bank Rate by 75.0 bps to 9.75% from the previous 8.75%, citing that the scope to raise the rate was mainly due to the sustained inflationary pressures, the elevated global risks and their potential impact on the domestic economy. This was in line but above our expectations of a 25.0 bps hike to 9.00% as per our MPC note with our view having been supported by:

i. The need to bring down inflation to the government's target range of 2.5%-7.5%. Inflation for the month of February had increased to 9.2%, a reversal from the easing in inflation pressures experienced in the months of November, December and January 2023. Additionally, we expected inflation to remain elevated in the short term driven by the high fuel and food prices. We also expected the fuel prices to rise as the current administration planned to completely do away with the fuel subsidy program and adjust the domestic fuel prices to ease pressure on expenditure. Further, we expected food prices to remain elevated in the short term, due to the erratic weather patterns. As such, we expected the MPC to increase the CBR in order to anchor inflation, 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. The Kenyan shilling had depreciated by 6.4% to a low of Kshs 131.3 as at 24th March 2023, from Kshs 113.1 recorded at the beginning of 2023, adding to the 9.0% depreciation recorded in 2022. The depreciation was mainly attributable to increased dollar demand in the oil and energy sectors as a result of high fuel prices. The high crude oil prices have inflated Kenya's import bill and as a result, petroleum products imports have continued to weigh heavily on the country's import bill. Additionally, the interest rates hike in developed economies with USA and the Euro Area increasing their rates to the range of 4.75%-5.00% and 3.50%, respectively in March 2023 was expected to significantly put pressure on the Kenyan shilling. Notably, forex reserves had been under pressure coming in at USD 6.6 bn as at 23rd March 2023, representing 3.7 months of import cover, below the statutory requirement of maintaining at least 4.0-months of import. As such, this put pressure on the Central Bank to pursue additional policy measures to slow the accelerated depreciation of the shilling.

The Monetary Policy Committee the ongoing implementation of the FY2022/23 Government Budget, particularly the performance in tax revenue collection and the approved FY2022/23 Supplementary Budget, which continues to reinforce fiscal consolidation. Notably, the total revenue collected as at the end of February 2023 amounted to Kshs 1,281.3 bn, equivalent to 89.7% of the prorated estimates of Kshs 1,427.7 bn, with tax revenues amounting to Kshs 1,236.2 bn, equivalent to 89.5% of the prorated estimates of Kshs 1,381.3 bn. Additionally, the Monetary Policy committee noted that the leading economic indicators pointed to a strong performance of the Kenyan economy in the Q1'2023, reflecting robust activity in services sector particularly wholesale and retail trade, accommodation and food services among others. As such, the economy is expected to remain resilient in 2023 supported by continued strong performance of the services sector and expected recovery in agriculture sector. The committee further noted that goods exports remained strong having grown by 11.0% in the 12 months to February 2023, compared to 12.1% recorded in a similar period in 2022. Notably, receipts from tea and manufacturing goods exports increased by 13.4% and 27.2%, respectively during the period. The increase in receipts from tea exports is attributed to improved prices due to increased demand from traditional markets. However, the current account deficit is projected at 5.4% of GDP in 2023, from the estimate of 4.9% of GDP in 2022. Notably, private sector credit growth stood at 11.7% in February 2023, compared to 12.7% in December 2022, with the number of loan application and approval recording a decline, highlighting reduced demand.

Below, we analyze the trends of the macro-economic indicators since the March 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 March 2023	Our Expectation Going forward	CBR Direction (March)	Probable CBR Direction (May)
Government Revenue Collection	• Total revenue collected as at the end of April 2023 amounted to Kshs 1,639.8 bn, equivalent to 78.4% of the revised estimates of Kshs 2,192.0 bn for FY'2022/2023 and was 89.8% of the prorated estimates of Kshs 1,826.7 bn, • We note that the government has not been able to meet its prorated revenue targets ten months into the FY'2022/2023, partly attributable to the deteriorated macroeconomic environment in the country as evidenced by the Purchasing Managers Index (PMI) averaging at 48.8 so far in 2023, below the 50.0 no change threshold, as well as elevated inflationary pressures with April 2023 inflation rate coming at 7.9% remaining above the CBK target range of 2.5%-7.5%.	• With barely 2 months before the end of current financial year, we are convinced that the government's ability to meet its revenue targets will be significantly impaired by the current challenging macroeconomic environment which has forced businesses to cut production and consumers to cut back on spending, • However, in the recently released [Finance bill 2023](), the government has proposed new tax measures aimed at broadening its tax base as well as increase tax revenue. Among the key provisions in the Bill are 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 proposals to increase tax revenue and thus boost the government's efforts of meeting it revenue collection target, • Nevertheless, we maintain our view that the proposals are overly ambitious given the subdued general business environment, underpinned by depreciation of the Kenyan shilling, tightened liquidity in the money market, and elevated inflationary pressures that have suppressed both consumer spending and business production levels. Additionally, we note that the proposed increase in taxation, especially the turnover tax, may act as a disincentive to most SMEs, and further dampen the production levels in the country.	**Neutral**	**Neutral**
Government Borrowing	• The government, as at 18th May 2023, was 3.7% behind of its prorated borrowing target of Kshs 379.6 having borrowed Kshs 365.3 bn of the total borrowing target of Kshs 425.1 bn as per the revised domestic borrowing target for FY'2022/2023. The government has domestic maturities	• 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 5.7% of GDP in FY'2022/23. Additionally, the rising		

	worth Kshs 328.5 bn and will have to borrow Kshs 323.5 bn monthly to meet the upcoming domestic maturities and the budget deficit in the FY'2022/2023, • Kenya has continued to receive financing from the World Bank and other bilateral lenders such as the International Monetary Fund (IMF). In 2022, Kenya received a total of USD 750 mn (Kshs 80.9 bn) under the Development Policy Operation (DPO) from the World Bank and USD 1.7 tn (Kshs 204.0 bn) from the IMF under the 38-month Extended Fund Facility (EFF) and Extended Credit Facility (ECF)-funding program aimed at boosting Kenya's economic recovery process and to strengthen fiscal sustainability through reforms, • Recently, IMF announced that it had reached a staff-level agreement with Kenya on a fifth review of Kenya's EFF and ECF. Upon completion of the reviews, Kenya will receive an additional USD 410.0 mn (Kshs 56.4 bn) including from the augmentation access under the ECF/EFF • Kenya's Public debt as at March 2022 stood at Kshs 9.4 tn, equivalent to 64.7% of GDP, 14.7% points above the IMF recommended threshold of 50.0% for developing countries, • USD denominated external debt constituted of 67.3% of all external debt as of March 2023 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	debt servicing costs represented 53.5% of the actual revenue collected as the end of April 2023 which continues to put pressure on the government to borrow more in an aim to fund the servicing, • 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 June 2024. This has since raised concerns on the government ability to finance the bond, having cancelled the issuance of a new Eurobond in June 2022 on the back of increasing interest rates in the Eurobond markets making borrowing more expensive, and, • The initial plans to reduce expenditure for the FY'2022/23 by Kshs 300.0 bn, seem to have failed to materialize with the total gross budget for FY'2022/23 increasing by 0.4% to Kshs 3,373.3 bn from Kshs 3,358.6 bn. This was initially expected to reduce the current fiscal deficit for FY'2022/2023 by 34.8% to Kshs 562.5 bn from Kshs 862.5 bn. However, in the recently released Finance bill 2023, the government has proposed new tax measures in an effort to boost tax collection that will help reduce the budget deficit to 4.3% as targeted in the FY2023/24 Draft Policy Statement	**Negative**	**Negative**
Inflation	• Year on year (y/y) inflation rate for April 2023 came in at 7.9%, a decrease from 9.2% recorded in March 2023, while the month on month (m/m) inflation increased by 0.5% points. The increase was mainly driven by a 10.1% and 9.6% increase in the food and non-alcoholic beverages index and water, electricity, gas and other fuel index in April 2023 when compared to 13.4% and 7.5% increases in March 2023, respectively, • The overall easing of the headline inflation in April came on the back of the rainy season that eased food prices as well as the impact of the monetary policy committee's decision to hike the Central Bank Rate by 75.0 bps to 9.50% in March 2023 from 8.75% in January 2023, a move aimed at anchoring inflation which since	• We expect inflation rates to remain elevated in the short term arising from high fuel prices as a result of expected increase in the import bill due to the government's decision to completely remove fuel subsidy program, • Additionally, we expect food prices to remain elevated in the short term, given the uneven weather patterns. 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 ongoing importation of duty-free rice, maize and sugar. As a result, these measures will lower the cost of farming and result in a drop-in food price, respectively.	**Neutral**	**Negative**

	remained above the Central Bank of Kenya upper bound of 7.5% in the past 11 months • Notably, the high commodity prices in the country are also attributed to the high cost of production and importation due to the depreciation of the Kenya shilling, which has made imports expensive. As a result, manufactures pass on the cost to consumers through hikes in commodity prices. However, given that fuel and electricity are major input in most businesses, we are adamant that the country's elevated fuel prices, as well as increased electricity tariffs, are expected to impede the eventual ease of the inflation rate within the CBK's target range.			
Currency (USD/Kshs)	• Since the last meeting, the Kenyan Shilling has depreciated by 4.1% against the US Dollar to Kshs 137.8 as at 23rd May 2023, from Kshs 132.3 recorded on 31st March 2023 mainly attributable to increased dollar demand from commodity and energy sector importers, and, • Forex Reserves declined by 3.9% to USD 6.3 bn (equivalent to 3.5 months of import cover) as of 18th May 2023 from USD 6.6 bn (equivalent to 3.6 months of import cover) recorded in 30th March 2023. Notably, the forex reserves are below the statutory requirement of maintaining at least 4.0 months of import cover as well 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, • The shilling performance and strength is expected to be weighed down further by the depleted forex reserves, currently at USD 6.3 bn (equivalent to 3.5 months of import cover) and below the statutory requirement of 4.0 months of import cover. Moreover, diaspora remittance has declined by 9.8% y/y to USD 320.3 mn in April 2023, from USD 355.0 mn recorded in April 2022, • We also expect that the recent interest hikes in developed economies, such as the interest hike by the U.S Fed to a range of 5.00%-5.25%, from a range of 4.75%-4.5.00%, as well as, the European union to 3.75% from 3.50% to exert downward pressure on the value of the Kenyan currency	**Negative**	**Negative**
GDP Growth	• Kenyan's economy recorded a 4.8% growth in 2022, lower than the 7.6% growth recorded in 2021, pointing towards a slower economic growth. The performance was driven by; i. Sustained Recovery in Accommodation and Food Service Sector with the sector growing by 26.2% in 2022, from the 52.6% growth recorded in 2021. The sector's performance continues to be cushioned by the rising tourism activities as evidenced by increased visitor arrivals through	• 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 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 are expected to support growth in the agriculture sector, which remains as Kenya's largest contributor to GDP,	**Neutral**	**Neutral**

	the Jomo Kenyatta and Moi International airports, ii. Financial and Insurance sector which recorded the highest growth rate of 12.8% in 2022, compared to 11.5% growth recorded in 2021, attributed to 11.7% growth in financial service activities with broad money supply increasing by 7.5% to Kshs 5.0 tn, from Kshs 4.7 tn in as of December 2021. Additionally, domestic credit grew by 10.7% to Kshs 6.2 tn in 2022 from Kshs 5.6 tn in 2021.Credit to the private sector grew by 13.9% to Kshs 4.2 tn while credit to national government grew as well by 13.9% to Kshs 2.0 tn. The insurance sub-sector grew by 15.8% in 2022 compared to 26.9% in 2021, with net premiums increasing by 11.4% to Kshs 128.8 bn in 2022 from Kshs 115.1 bn in 2021. However, the growth was impeded by 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 1.6% in 2022 compared to a decline of 0.4% in 202. The performance was mainly due to unfavorable weather conditions which has undermined agricultural production poor performance in Agriculture, Forestry and Fishing sectors	• However, risks lie on the downside, given the elevated inflationary pressures which have continued to weigh on the business environment, as well as the expensive agricultural inputs that remain elevated above pre-pandemic levels impeding agricultural output • Notably, the country's PMI for the month of April 2023 dropped to 47.2, recording below the 50.0 threshold for a 3rd consecutive months to April 2023, pointing towards a deterioration of business environment in the Kenyan private sector. Additionally, according to CEO's survey-March report, optimism regarding growth prospects for the Kenyan and global economy weakened on the back of domestic inflation, which has forced consumers to cut back on spending. On the global economy respondents, the subdued optimism was attributed to the lingering war in Ukraine, interest rates hike in advanced economies and the collapsed banks in the US.		
Private Sector Credit Growth	• The latest data from CBK indicates that private sector credit growth continues to recover having grown by 11.7% in February 2023, 2.6% points higher than the 9.1% growth recorded in the same period in 2022 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, • 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 April T-Bonds coming at 14.4% effectively edging out majority of the corporate bonds currently in the trading in market	**Neutral**	**Neutral**

Liquidity	• Liquidity levels in the money markets tightened, with the average interbank rate in the month of May 2023 so far averaging at 9.5% as of 23rd May 2023, 2.5% points higher than the 7.0% recorded in March 2023.	• Since the last MPC sitting in March 2023, liquidity tightened with the interbank rate reaching a high of 9.9% in 22nd May 2023, the highest since 10.0% recorded in 23rd December 2022. • However, we expect liquidity to be supported by: i. High domestic debt maturities that currently stand at Kshs 114.1 bn worth of T-bill maturities and Kshs 214.4 bn worth of T-bond maturities for FY'2022/2023, and, ii. Low Cash Reserve Ratio (CRR) currently at 4.25% from 5.25% previously which continues to support private sector credit growth	**Negative**	**Neutral**

Conclusion

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 central bank rates, given the elevated inflation rates. In the United States, the y/y inflation for the month of April 2023 eased to 4.9% from 5.0% in March 2023, but remained 2.9% points above the 2.0% target. As a result, on 3rd May 2023, the United States Federal Bank Monetary Policy Committee opted for a 25.0 bps interest rate hike, to the range of 5.00%-5.25%, from 4.75%-5.00% in a bid to anchor inflation. Additionally, in their most recent sittings England, Australia, South Africa and Euro Area also increased their rates while China, Ghana and Canada maintained their rates. 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;

Cytonn Report: Monetary Policy stances around the globe					
No	**Country**	**Central Bank**	**Previous Rate**	**Current Rate**	**Change (% Points)**
1	Malaysia	Bank Negara Malaysia	2.75%	3.00%	0.25%
2	China	Bank of China	3.65%	3.65%	Unchanged
3	England	Bank of England	4.25%	4.50%	0.25%
4	Australia	Reserve Bank of Australia	3.60%	3.85%	0.25%
5	USA	Federal Reserve	4.75% - 5.00%	5.00% - 5.25%	0.25%
6	Ghana	Bank of Ghana	29.5%	29.5%	Unchanged
7	Canada	Bank of Canada	4.50%	4.50%	Unchanged
8	South Africa	South Africa Reserve bank	7.25%	7.75%	0.50%
9	Euro Area	European Central bank	3.50%	3.75%	0.25%

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 9.50% with their decision mainly being supported by:

i. The ease on y/y inflation in April 2023 to 7.9%, from 9.2% recorded in March 2023, despite remaining above the CBK's target range of 2.5%-7.5%. Additionally, food inflationary pressures are expected to slow in the near term, aided by continued rains as well as importation of duty-free staples such as maize, rice, cooking oil and sugar. However, elevated inflation is expected to endure in the short to medium following the increase in fuel prices after the government completely removed the fuel subsidies which was aimed at cushioning consumers from high fuel prices. 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. Additional hike in the CBR rate might slow down economic activities given the current macro and business environment fundamentals cannot accommodate further hikes.

Notably, despite the macroeconomic indicators being inclined towards an increase in the Central Bank Rate with focus on easing inflation to to the CBK target range while supporting the Kenyan currency, the committee must be cautious as the country's economic growth has been declining. This is evidenced by Kenya's economy recording a 4.8% growth in 2022 compared to the 7.6% expansion in 2021. Therefore, we expect the MPC to maintain the CBR at 9.50% as they monitor the impact of the policy measures, as well as developments in the global and domestic economy.