Cytonn INVESTMENTS

Cytonn Note on the 23rd November 2022 Monetary Policy Committee (MPC) Meeting

The Monetary Policy Committee (MPC) is set to meet on Wednesday, 23rd November 2022, 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 September 2022, the committee decided to reconvene in November 2022, while highlighting that they would remain ready to reconvene earlier if necessary. Additionally, the MPC raised the Central Bank Rate by 75.0 bps to 8.25% from 7.50% in their July setting, 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 against our expectations as per our MPC note with our view having been supported by:

i. The need to stimulate economic growth rather than curtail post-pandemic recovery with Kenya's economy recording a 6.8% growth in Q1'2022, up from the 2.7% growth recorded in Q1'2021, which highlighted the continued recovery of the economy post pandemic. As such, we expected the MPC to maintain the CBR with the main aim of supporting the post pandemic economic recovery and we believed that the MPC would keep monitoring the macroeconomic indicators before pursuing any additional policy measures, and,
ii. The need to support the business environment which was characterized by a deteriorating performance evidenced by the country's PMI which had remained below 50.0 since April 2022 mainly due to elevated inflationary pressures emanating from high global fuel prices and persistent supply chain bottlenecks. However, we noted the need to curb the increasing inflation rate with the inflation for the month of August 2022 having risen to 8.5%, from the 8.3% recorded in July 2022, driven by increasing food and fuel prices. Additionally, we anticipated the inflation to remain elevated in the short term driven by the high fuel prices coupled with the government's decision to partially removed the fuel subsidy and plans on completely eliminating it.

The Monetary Policy Committee noted progress towards the achievement of the FY'2022/2023 Government Budget in its September 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 August 2022 amounted to Kshs 284.0 bn, equivalent to 79.6% of the prorated estimates of Kshs 356.9 bn with tax revenues amounting to Kshs 280.2 bn, equivalent to 81.1% of the prorated estimates of Kshs 345.3 bn. Monetary Policy Committee also noted that the current account deficit to GDP was estimated at 5.2% in the 12 months to August 2022, same as that was recorded in a similar period in 2021 and was projected increase further to 5.9% of GDP by end of 2022 on account of higher international oil prices. Additionally, exports of goods remained strong, growing by 11.0% compared to similar a period in 2021. Key to note, private sector credit growth came in at 12.5% in August 2022, 5.5% points higher than the 7.0% over the same period in 2021.

Below, we analyze the trends of the macro-economic indicators since the September 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 September 2022	Our Expectation Going forward	CBR Direction (September)	Probable CBR Direction (November)
Government Revenue Collection	• Total revenue collected as at the end of October 2022 amounted to Kshs 636.4 bn, equivalent to 29.7% of the original estimates of Kshs 2,141.6 bn for FY'2022/2023 and was 89.2% of the prorated estimates of Kshs 713.9 bn, • We note that the government has not met its prorated revenue target for the	• 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 prices. Additionally, the persistent supply chain constraints	**Neutral**	**Neutral**

	first four months of the FY'2022/2023 mainly due to the high cost of living as a result of the elevated inflationary pressures that have seen consumers cut on spending.	are expected to weigh on the business environment, • 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 to continue supporting the tax revenue collected.		
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 November the IMF announced that it had reached staff level agreement with Kenyan authorities on the fourth review of the 38-month Extended Fund Facility (EFF) and Extended Credit Facility (ECF)-funded program. Upon completion of the formal approval by IMF management, Kenya will access the fifth tranche of USD 433.0 mn (Kshs 52.7 bn), bringing the total funding to USD 1.6 tn (Kshs 199.7 bn) aimed at boosting Kenya's economic recovery process and to strengthen fiscal sustainability through reforms, • Kenya's Public debt as at July 2022 stood at Kshs 8.6 tn, equivalent to 68.1% of GDP, 18.1% points above the IMF recommended threshold of 50.0% for developing countries, • USD denominated external debt constituted of 68.1% of all external debt as of July 2022 increasing 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 a need for funding. Additionally, the rising debt servicing costs represented 52.1% of the actual revenue collected as the end of October 2022 which continues to put pressure on the government to borrow more in an aim to fund the expenditure, • 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, • However, the new regime has mentioned of a plan to reduce the expenditure for the FY'2022/23 by Kshs 300.0 bn aimed at cutting down on borrowing. This is expected to reduce the current fiscal deficit for FY'2022/2023 by 34.8% to Kshs 562.5 bn from 862.5 bn	**Negative**	**Negative**
Inflation	• Year on year (y/y) inflation rate for October 2022 came in at 9.6%, an increase from 9.2% recorded in September 2022, while the month on month (m/m) inflation increased by 0.4% points. The increase was mainly driven by a 15.8%, 11.6% and 7.1% increase in the food and non-alcoholic beverages index, transport index and housing, water, electricity, gas and other fuels, respectively, • Key to note is that the Monetary Policy Committee raised the Central Bank Rate to 8.25% in their September sitting, from the previous 7.50% with the aim of anchoring the inflation rate which has continued to increase over the last nine months. Despite the	• We expect inflation rates to remain elevated arising from high fuel prices due to the Organization of the Petroleum Exporting Countries (OPEC) decision to lower their production target by 2.0 mn barrels per day which will affect global oil supply as well the partial removal of the fuel subsidy which we expect to be completely eliminated in the coming months. This has consequently led to a rise in food prices as fuel is a major input in many sectors of the economy, • Additionally, we expect food prices to remain elevated, given the uneven weather patterns and drought that have reduced the country's food security. Going forward, we expect the	**Negative**	**Negative**

	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.	new administration to completely phase out the fuel subsidy program and adjust the domestic fuel prices to ease pressure on expenditure and consequently reduce the need for excessive borrowing.		
Currency (USD/Kshs)	• Since the last meeting, the Kenyan Shilling has depreciated by 1.1% against the US Dollar to Kshs 122.0 as of 17th November 2022, from Kshs 120.7 on 29th September 2022, mainly attributable to increased dollar demand from commodity and energy sector importers, and, • Forex Reserves declined by 2.5% to USD 7.2 bn (equivalent to 4.1 months of import cover) as of 11th November 2022 from USD 7.4 bn (equivalent to 4.2 months of import cover) recorded in September 2022. However, 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 sector and as traders beef up their hard currency positions in anticipation for an even higher demand for the dollar during the festive period, • However, the shilling performance and strength is expected to be supported by the sufficient forex reserves, currently at USD 7.2 bn (equivalent to 4.1 months of import cover) which will be boosted by the expected USD 433.0 mn (Kshs 52.7 bn) from the IMF. The shilling is also expected to be supported by Sufficient diaspora remittances evidenced by a 2.6% y/y increase to USD 318.0 mn cumulative remittances as of September 2022, from USD 309.8 mn recorded over the same period in 2021	**Negative**	**Negative**
GDP Growth	• Kenyan's economy recorded a 5.2% growth in Q2'2022, lower than the 11.0% growth recorded in Q2'2021, pointing towards slower economic growth. The performance was driven by i. Mining and quarrying sector which recorded the highest growth rate of 22.6% in Q2'2022, from 10.9% growth recorded in Q2'2021, ii. The continued recovery of accommodation and food services sector which recorded a 22.0% growth rate in Q2'2022 compared to the 6.2% growth recorded in Q2'2021 mainly driven by the relaxation of most of the COVID -19 travel and other restrictions globally which saw activity in the sector increase.	• We expect Kenya's GDP to continue growing in tandem with the global economy 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, • However, risks lie on the downside, given the elevated inflationary pressures which have continued to weigh on the business environment, • Notably, the country's PMI has come in at an average of 48.8 for the first 10 months in 2022 as compared to the average of 50.3 over the same period in 2021 signaling 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 August 2022, 5.5% points higher than the 7.0% 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,	**Neutral**	**Neutral**

		• However, we anticipate continued caution on lending especially to the sectors that continue to record slowed growth such as Manufacturing Agriculture and manufacturing, which saw their gross non-performing loans increase by 28.9% and 14.9% to Kshs 26.3 bn and Kshs 89.4 bn in Q2'2022, from Kshs 20.4 bn and Kshs 77.8 bn in Q1'2022, respectively, • Additionally, the increased government borrowing is expected to continue crowding out the private sector in the short term.		
Liquidity	• Liquidity levels in the money markets eased, with the average interbank rate as of 17th November 2022 coming in at 4.3%, 1.3% points lower than the 5.6% recorded in the period prior to the September 2022 meeting, partly attributable to government payments that offset tax remittances	• Liquidity is expected to remain favorable due to: i. High domestic debt maturities that currently stand at Kshs 568.5 bn worth of T-bill maturities and Kshs 193.7 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	**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 persistent increase in inflation rates. In the United States, the y/y inflation for the month of October 2022 eased to 7.7% from 8.2% in September 2022, and 5.7% points above the 2.0% target. However, the United States Federal Bank Monetary Policy Committee, in their November 2022 sitting, decided to tighten the policy stance by increasing the rate by 0.75% points. In their most recent sittings, Malaysia, England, Australia and Ghana also increased their rates while China maintained its rate. 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)
1	Malaysia	Bank Negara Malaysia	2.50%	2.75%	0.25%
2	China	Bank of China	3.65%	3.65%	Unchanged
3	England	Bank of England	2.25%	3.00%	0.75%
4	Australia	Reserve Bank of Australia	2.60%	2.85%	0.25%
5	USA	Federal Reserve	3.00%	3.75%	0.75%
6	Ghana	Bank of Ghana	22.00%	24.50%	2.50%

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 8.50% from the current 8.25% with their decision mainly being supported by:

i. We anticipate the MPC to raise the Central Bank Rate (CBR) by 25.0 bps to 8.50%, from the current 8.25%, with a focus on the need to curb the increasing inflation rate which has surpassed the government's target range of 2.5%-7.5%. Key to note, inflation for the month of October 2022 rose 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. Going forward, inflation is expected to remain elevated in the short term driven by the high fuel 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, given the erratic weather patterns and drought that have put pressure on the country's food security. 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 has depreciated by 7.8% to an all-time low of Kshs 122.0 as of 17th September 2022, from Kshs 113.1 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 also been dwindling since the last sitting having declined by 2.5% to USD 7.2 bn (equivalent to 4.1 months of import cover) as of 11th November 2022, from USD 7.4 bn (equivalent to 4.2 months of import cover) in September 2022. Additionally, forex reserve is expected to remain under pressure despite the expected loan facility from the IMF. 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 not yet fully recovered from the effects of the pandemic. Notably, Kenya's economy recorded a 5.2% growth in Q2'2022 pointing towards slower economic growth as compared to the 6.8% and 11.1% expansion rates recorded in Q1'2022 and Q2'2021, respectively. The increase in the Central Bank Rate coupled with the deteriorated business environment as a result of inflationary pressures and ripple effects of the uncertainties surrounding the elections held in August 2022 are expected to slow down the economic recovery.

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