Cytonn Note on the 29th September 2022 Monetary Policy Committee (MPC) Meeting

The Monetary Policy Committee (MPC) is set to meet on Thursday, 29th September 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 27th July 2022, the committee decided to reconvene in September 2022, while highlighting that they would remain ready to reconvene earlier if necessary. Additionally, the MPC maintained the Central Bank Rate at 7.5%, citing that the tightening monetary policy in May 2022 together with the fiscal measures undertaken were still being transmitted and the oil prices were also expected to moderate hence ease on the domestic inflationary pressures in the near term. This was against our expectations of a 25 bps increase with our view having been supported by:

i. The need to curb the increasing inflation rate with the inflation for the month of June 2022 having risen to 7.9%, from the 7.1% recorded in May 2022, driven by increasing food and fuel prices. We anticipated the 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, given that its main role is maintaining price stability, and,

ii. The need to support the shilling from further depreciation as other Central Banks raised their rates. Notably the Kenyan shilling had depreciated by 4.8% to an all-time low of Kshs 118.5 as of 21st July 2022, from Kshs 113.1 year to date. The depreciation was mainly attributable to increased dollar demand in the oil and energy sectors as the prices of fuel continued to rise. In the short term, we expected the shilling to depreciate even further if the prices of fuel were to continue rising leading to an increased import bill, Kenya being a net importer. As such, we anticipated this to put pressure on the Central Bank to pursue additional policy measures to slow the accelerated depreciation of the shilling.

The Monetary Policy Committee noted that the current account deficit to GDP was estimated at 5.3% in the 12 months to June 2022, 1.0% point higher than the 5.2% recorded in a similar period in 2021. Additionally, exports of goods remained strong, growing by 11.2% compared to similar a period in 2021. Key to note, private sector credit growth came in at 12.3% in June 2022, 4.6% points higher than the 7.7% over the same period in 2021.

Below, we analyze the trends of the macro-economic indicators since the July 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 July 2022	Our Expectation Going forward	CBR Direction (July)	Probable CBR Direction (September)
Government Revenue Collection	• Total revenue collected as at the end of August 2022 amounted to Kshs 284.0 bn, equivalent to 13.3% of the original estimates of Kshs 2,141.6 bn and was 79.6% of prorated estimates of Kshs 356.9 bn. • We note that the government has not met its prorated revenue target for the first two months of the FY'2022/2023 mainly due to; i. The elevated inflationary pressures that have seen consumers cut on spending, and,	• 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 fuel prices continue to rise. Additionally, the persistent supply chain constraints are expected to weigh on the business environment • However, we expect the implementation of the Finance Act 2022 coupled with the dissipation of elections related economic uncertainties to continue supporting the tax revenue collected.	Neutral	Neutral

	ii. The prolonged electioneering period that affected the normal business operations			
Government Borrowing	• Kenya has continued to receive financing from the World Bank and other bilateral lenders such as the International Monetary Fund (IMF). In July the IMF [completed](#) the third review of the 38-month Extended Fund Facility (EFF) and Extended Credit Facility (ECF)-funded program allowing Kenya to access USD 235.6 mn (Kshs 27.9 bn), bringing the total funding to USD 1.2 tn (Kshs 140.5 bn) aimed at boosting Kenya's economic recovery process and to strengthen fiscal sustainability through reforms, • Kenya's Public debt as at May 2022 stood at Kshs 8.6 tn, equivalent to 69.1% of GDP, 19.1% points above the IMF recommended threshold of 50.0% for developing countries, • USD denominated external debt constituted of 67.9% of all external debt as of May 2022 increasing the debt servicing cost at a time when the Kenyan shilling has depreciate 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 59.6% of the actual revenue collected for the month of August 2022 which continues to put pressure on the government to borrow more in an aim to fund the expenditure, and, • 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.	**Negative**	**Negative**
Inflation	• Year on year (y/y) inflation rate for August 2022 came in at 8.5%, from 8.3% recorded in July 2022, while the month on month (m/m) inflation increased by 0.2% points. The increase was mainly driven by a 15.3%, 7.6% and 5.6% increase in the food and non-alcoholic beverages index, transport index and housing, water, electricity, gas and other fuels, respectively. • Key to note, the August 2022 y/y inflation rate was the highest since August 2017.	• We expect inflation rates to remain elevated, on the back of high fuel prices with Kenya registering the highest prices of fuel ever. 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 the fuel prices to continue increasing given the elimination of the petrol subsidy and partial removal of the subsidy on diesel and kerosene, which we believed was unsustainable. Going forward, we expect the 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.	**Negative**	**Negative**

Currency (USD/Kshs)	• Since the last meeting, the Kenyan Shilling has depreciated by 1.4% against the US Dollar to Kshs 120.4 as of 16th September 2022, from Kshs 118.7 on 27th July 2022, mainly attributable to increased dollar demand from commodity and energy sector importers, and, • Forex Reserves decreased by 4.8% to USD 7.4 bn (equivalent to 4.2 months of import cover) as of 16th September 2022 from USD 7.7 bn (equivalent to 4.5 months of import cover) recorded in July 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 • However, the shilling performance and strength is expected to be supported by the sufficient forex reserves, currently at USD 7.4 bn (equivalent to 4.2 months of import cover). The shilling is also expected to be supported by Sufficient diaspora remittances evidenced by a 14.7% y/y increase to USD 3,992.0 mn cumulative remittances as of August 2022, from USD 3,481.0 mn recorded over the same period in 2021	**Negative**	**Negative**
GDP Growth	• Kenyan's economy recorded a 6.8% expansion in Q1'2022, up from the 2.7% growth recorded in Q1'2021, highlighting the continued recovery of the economy given the resumption of most economic activities after lifting of measures which had been put in place to curb the spread of COVID-19. The performance was driven by i. The accommodation and food services sector which recorded the highest growth rate of 56.2% in Q1'2022 compared to the 33.3% contraction recorded in Q1'2021 mainly driven by the relaxation of most COVID – 19 travel and other restrictions which saw activity in the sector increase, and, ii. An 8.1% growth in the transport and storage Sector in Q1'2022 in comparison to the 8.7% contraction recorded in Q1'2021	• 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 the manufacturing sector, • 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 remained below 50.0 since April 2022 signaling a deteriorating business environment in the Kenyan private sector.	**Neutral**	**Neutral**
Private Sector Credit Growth	• The latest data from CBK indicates that private sector credit growth recorded a 12.3% growth in June 2022, 0.8% points higher than the 11.5% growth recorded in April 2022 as demand recovered following the increased economic activities. Key to note, the 12.3% growth is the highest ever recorded since May 2011, when it came in at 11.1%.	• We expect the operating business environment to continue deteriorating evidenced by the continued PMI decline hence curtailing private sector credit growth, • However, we anticipate continued caution on lending especially to the sectors that continue to record slowed growth such as Agriculture and Real Estate, which have seen their gross non-performing loans increase by 6.3% and 5.6% to Kshs 78.5 bn and Kshs 20.4 bn in Q1'2022, from Kshs 19.2 bn and Kshs 74.7 bn in Q4'2021, respectively,	**Neutral**	**Neutral**

		• 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 16th September 2022 coming in at 4.0%, 1.4% points lower than the 5.4% recorded in the period prior to the July 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 598.2 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	**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 August 2022 rose to 8.3%, 6.3% points above the 2.0% target. As such, the United States Federal Bank Monetary Policy Committee, in their September 2022 sitting, decided to tighten the current accommodative policy stance by increasing the rate by 0.75% points. In their most recent sittings, England, Australia, Malaysia and Ghana also increased their rates while China lowered its rate by 0.05% points partly due to the need to support economic recovery. 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	2.25%	2.50%	0.25%
2	China	Bank of China	3.70%	3.65%	(0.05%)
3	England	Bank of England	1.75%	2.25%	0.5%
4	Australia	Reserve Bank of Australia	1.85%	2.35%	0.5%
5	USA	Federal Reserve	2.50%	3.25%	0.75%
6	Ghana	Bank of Ghana	19.00%	22.00%	3.00%

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 7.5% with their decision mainly being 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, highlighting the continued recovery of the economy post pandemic. However, the current business environment is characterized by a deteriorating performance evidenced by the country's PMI which has remained below 50.0 since April 2022 mainly due to elevated inflationary pressures emanating from high global fuel prices and persistent supply chain bottlenecks. This coupled with the political climate, resulted in the government failing to meet its revenue target for the second month of the FY'2022/2023. In light of the above, we believe that risks abound the economic recovery and we do not expect the MPC to increase the CBR with the main aim of supporting the post pandemic recovery.

We however note that there is need to anchor inflation given that the inflation rate for the month of August 2022 rose to 8.5%, from the 8.3% recorded in July 2022, driven by increasing food and fuel prices. In the short term, inflation is expected to remain elevated driven by the high fuel prices now that the government has partially removed the fuel subsidy and plans on completely eliminating it. As other central banks across the globe raise their rates to curb inflationary pressures, we expect Kenya's monetary committee to maintain the CBR mainly because;

a. The operating environment continues to deteriorate, and,

b. Most of the inflationary pressure is external given the persistent supply chain constraints that have seen fuel and other commodity's prices increase.

Even as the MPC ascertains a healthy business environment by maintaining the Central Bank Rate at 7.5%, we expect the committee to continue monitoring the situation and react appropriately, given that its main role is maintaining price stability.