Q3’2021 Currency and Interest Rates Review Note

In Q3’2021, the Interest Rates environment remained relatively stable, with the Monetary Policy Committee (MPC) having maintained the Central Bank Rate at 7.00% in the two sittings held during the quarter. Yields on government securities in the secondary market remained relatively stable, with the FTSE bond index declining marginally by 0.2% to close at Kshs 96.8, from Kshs 97.0 recorded in Q2’2021, bringing the YTD performance to a 1.4% decline. The Kenyan Shilling depreciated against the US Dollar by 2.4% in Q3’2021, to close at Kshs 110.5, from Kshs 107.9 in Q2’2021, marking a 9-month low. The depreciation was partly attributable to increased import activities by local traders as well as increased dollar demand from merchandise and energy sector importers amidst strained supply chains. In this note, we shall look at the performance of the Kenyan shilling and the Interest Rates in Q3’2021, covering the following;

i. Performance of the Kenyan Shilling,
ii. Kenya’s Interest Rate Environment, and,
iii. Conclusion.

Section I: Performance of the Kenyan Shilling

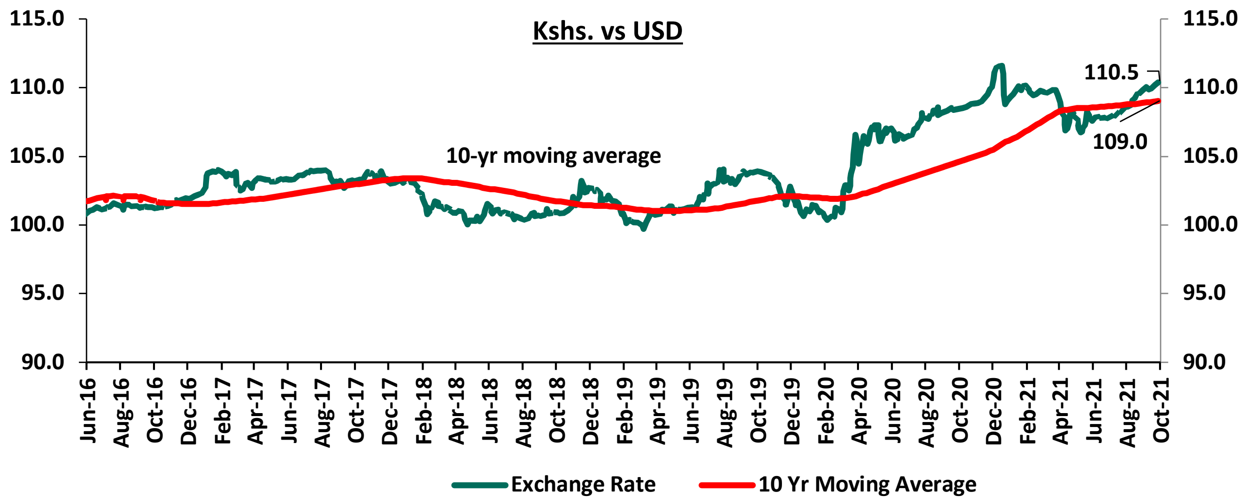
The Kenyan Shilling depreciated against the US Dollar by 2.4% in Q3’2021, to close at Kshs 110.5, from Kshs 107.9 in Q2’2021, marking a 9-month low. On an YTD basis, the Kenyan Shilling depreciated against the US Dollar by 1.2%. The depreciation was mainly driven by the following factors;

a) Rising uncertainties in the global market due to the Coronavirus pandemic, which has seen investors continue to prefer holding their investments in dollars and other hard currencies and commodities,
b) Increased demand from merchandise traders as they beef up their hard currency positions in anticipation for more trading partners reopening their economies globally, and,
c) Rising global crude oil prices on the back of supply constraints at a time when demand is picking up with the easing of COVID-19 restrictions and reopening of economies.

However, the shilling continued to be supported by;

i. The Forex reserves, which stood at USD 9.4 bn (equivalent to 5.8-months of import cover) as at 30th September, which is above the statutory requirement of maintaining at least 4.0-months of import cover, and the EAC region’s convergence criteria of 4.5-months of import cover. In addition, the reserves were boosted by the USD 1.0 bn proceeds from the 12-year Eurobond issued in July, 2021 coupled with the USD 407.0 mn IMF disbursement and the USD 130.0 mn World Bank loan financing received in June, 2021, and,
ii. Improving diaspora remittances evidenced by an 18.8% y/y increase to USD 309.8 mn in September 2021, from USD 260.7 mn recorded over the same period in 2020, which has continued to cushion the shilling against further depreciation.

Below is a graph showing performance of the Kenyan Shilling against the US Dollar:



Underlying Factors affecting Currency Performance:

Driver	Q3'2021 Experience and Outlook Going Forward	Outlook in H1'2021	Current Outlook
Balance of Payments	• According to Kenya National Bureau of Statistics, Kenya's balance of payments deteriorated in Q1'2021, coming in at a deficit of Kshs 59.4 bn, from a deficit of Kshs 47.4 bn in Q1'2020. The deterioration was due to the 16.6% increase in the Current Account Balance to Kshs 142.0 bn in Q1'2021, from Kshs 121.7 bn in Q1'2020, due to merchandise trade deficit and lower inflows from the services sector. Exports increased by 6.2% to Kshs 190.9 mn in Q1'2021 from Kshs 179.7 mn recorded in Q1'2020, and, • We expect gradual improvement in the export sector as Kenya's trading partners continue to reopen. However, the high import bill is expected to weigh down on the Current Account balance due to an increase in merchandise trade deficit attributable to the increase in global fuel prices, persistent disruptions in supply chains and logistical bottlenecks.	**Positive**	**Neutral**
Government Debt	• As at the end of September 2021, the Government was 63.4% ahead of its prorated borrowing target of Kshs 164.6 bn having borrowed Kshs 269.1 bn and has domestic maturities worth Kshs 760.8 bn. On external debt front, debt borrowed as of May 2021, amounted to Kshs 3.7 tn which is 33.7% of GDP with 65.2% in USD denomination, an indication that the shilling is expected to experience pressure due to repayment of foreign-denominated debt, and, • We expect the high debt burden to continue exposing the shilling to exchange rate shocks and will, in turn, exert pressure on the shilling to weaken during the repayment period. Additionally, the debt service to revenue ratio of 65.8% will mean that the government will have to borrow locally to settle external debt, exerting more pressure on the shilling.	**Negative**	**Negative**
Forex Reserves	• As at 30th September 2021, forex reserves, stood at USD 9.4 bn (equivalent to 5.8-months of import cover), which is above the statutory requirement of maintaining at least 4.0-months of import cover, and the EAC region's convergence criteria of 4.5-months of import cover, • In our view, forex reserves will continue to be supported by; debt relief from other institutions, increasing diaspora remittance inflows, continued investor capital inflows with hope for an economic recovery and increasing exports as the key trading partners continue to re-open their economies, and,	**Neutral**	**Neutral**

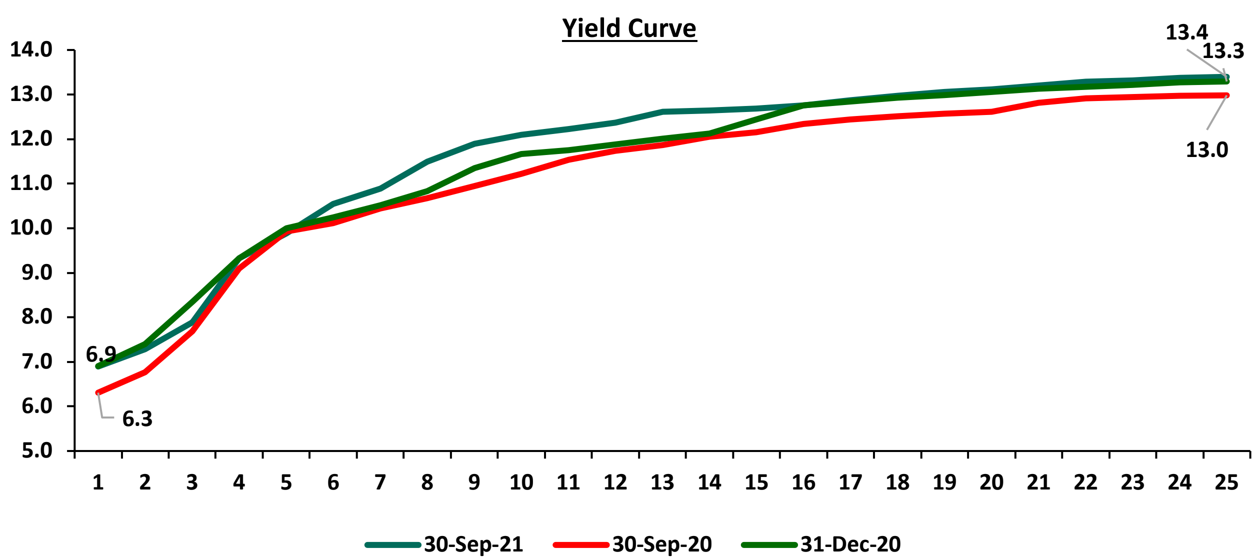
	• However, the elevated debt levels witnessed in the country are likely to put forex reserves under pressure as most of it will be used to finance the debts.		
Monetary Policy	• The Monetary Policy Committee is expected to continue adopting an accommodative stance after maintaining the CBR at 7.00% in the two meetings during the quarter. There is pressure on inflation due to the high fuel prices but it expected to remain within the government's target of 2.5% - 7.5%. Notably, October inflation rate of 6.5% after normalizing from 6.9% in September which had reported the highest rate since September 2017 and is above the midpoint of the government's target, and, • We expect the shilling to remain under pressure as the demand for the dollar increases as a result of the decline in domestic investment activities as Kenya's financial and capital assets become less appealing to investors on account of their lower real rate of return.	**Neutral**	**Neutral**

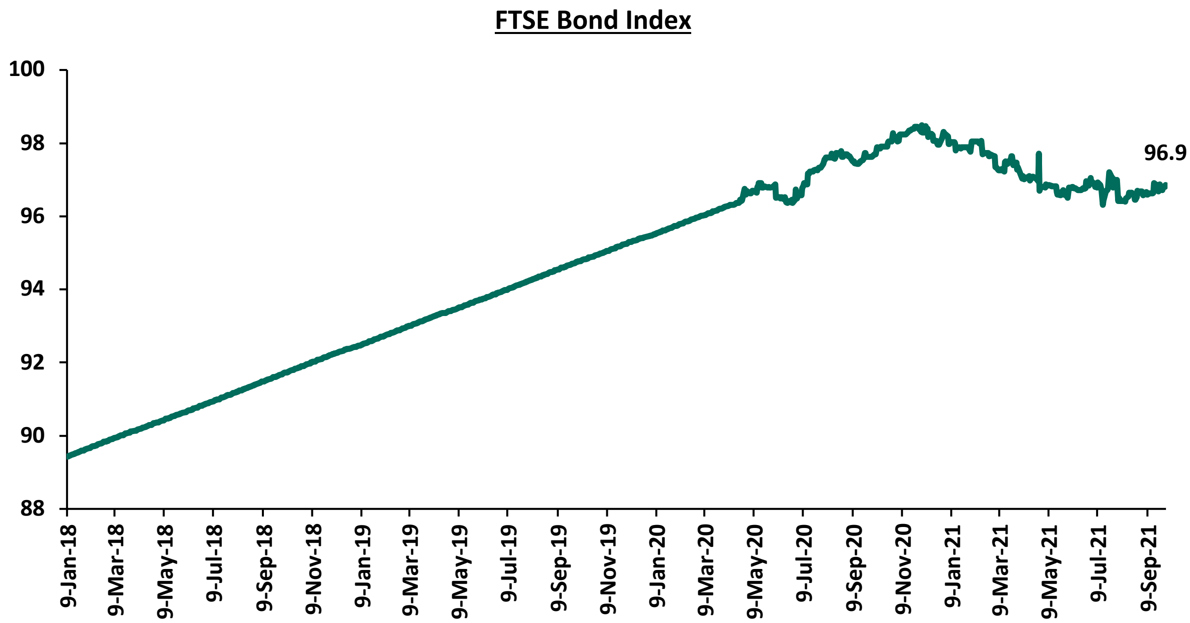
From the currency drivers, 1 is negative (Government Debt), and 3 are neutral (Balance of Payment, Forex Reserves and Monetary policies) with changes in Balance of Payments which was positive and is now neutral.

Section II: Kenya's Interest Rate Environment

In Q3'2021, the interest rates in Kenya remained stable and the MPC continued to play a huge role, having retained the CBR at 7.00%. Additionally, the Government continued rejecting expensive bids in the primary market and as such, kept the interest rates low. However, the rising inflation rates during the quarter continued to put upward pressure on interest rates as investors attach a higher premium to meet their required real rate of return. Notably, liquidity in the money market remained relatively stable, with the average interbank rate increasing marginally by 0.1% points to 4.9%, from 4.8% recorded the previous quarter.

During the quarter, the rates on government papers remained relatively stable despite the projected high budget deficit to GDP of 7.5%. Yields on government securities in the secondary market remained relatively stable, with the FTSE bond index declining marginally by 0.2% to close at Kshs 96.8, from Kshs 97.0 recorded in Q2'2021, bringing the YTD performance to a 1.4% decline.;





Underlying factors affecting the Interest Rate environment:

Driver	Q3'2021 Experience and Outlook Going Forward	Outlook in H1'2021	Current Outlook
Fiscal Policies	• In the first quarter of FY'2021/22 fiscal year, government's borrowing appetite continued, having borrowed domestically Kshs 306.8 bn against their target of Kshs 252.1 bn, to relieve the burden of debt maturities, and, • We believe that despite the projected high budget deficit of 7.5%, the strong revenue performance coupled with monetary support from the IMF and World Bank will mean that the interest rate environment may continue stabilizing since the government will not be desperate for cash.	**Negative**	**Neutral**
Monetary Policy	• The interest rate environment has remained stable during the quarter, with the MPC retaining the CBR at 7.00%. Notably, commercial banks' lending rates marginally increased to 12.1% in August, from 12.0% seen in June 2021, and, • Kenya's inflation rate is expected to remain within the Government's target range of 2.5%-7.5%. However, we believe that if inflation continues to rise, the MPC will be under pressure in the short term to maintain price stability. As such, the yields on government securities are likely to adjust upwards as investors attach a higher premium to meet their required real rate of return.	**Neutral**	**Neutral**
Liquidity	• During the quarter, liquidity in the money market remained relatively stable, with the average interbank rate increasing marginally by 0.1% points to 4.9%, from 4.8% recorded the previous quarter, and, • Liquidity is expected to continue being supported by the Low Cash Reserve Ratio (CRR) of 4.25%. Additionally, the high domestic debt maturities that currently stand at Kshs 620.9 bn worth of T-Bill maturities and Kshs 84.3 bn worth of T-Bond maturities will continue to support the ample liquidity in the money market, and as such, the interest rates environment will continue to remain relatively stable.	**Neutral**	**Positive**

From the interest rates drivers, 1 is positive (Liquidity), and 2 are neutral (Fiscal Policy and Monetary policy) with changes in Fiscal Policies which was negative and is now neutral and liquidity which was neutral and is now positive.

Section V: Conclusion

In Q3’2021, the Interest Rates environment remained relatively stable supported by the ample liquidity in the money market coupled with the accommodative monetary policy. On the other hand, the Kenyan Shilling depreciated against the US Dollar by 2.4% in Q3’2021, to close at Kshs 110.5, from Kshs 107.9 in Q2’2021, attributable to increased demand from merchandise traders as they beefed up their hard currency positions in anticipation for more trading partners reopening their economies globally, coupled with rising global crude oil prices on the back of supply constraints.

We expect the Kenyan shilling to remain under pressure due to the high import bill and the rising uncertainties in the global market as investors continue to prefer holding their investments in dollars. However, the shilling will be supported by high forex reserves and the improving diaspora remittances. In the interest rate environment, we expect the rise in the yield curve to be sustained in the coming quarter, mainly driven by increased borrowing appetite by the government coupled with investors’ hunt for higher yields.