Cytonn FY'2021 Currency and Interest Rates Review Note

In FY'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 six sittings held during the year. The yields on government securities in the secondary market were on an upward trajectory, with the FTSE bond index declining by 2.2% to close at Kshs 96.1, from Kshs 98.3 recorded at the end of 2020, bringing the YTD performance to a 2.0% decline. The Kenyan Shilling depreciated against the US Dollar by 3.6% in FY'2021, to close at Kshs 113.1, from Kshs 109.2 in FY'2020, the lowest it has ever been. The depreciation was partly attributable to increased dollar demand from merchandise and energy sector importers amidst supply bottlenecks. In this note, we shall look at the performance of the Kenyan shilling and the Interest Rates in FY'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

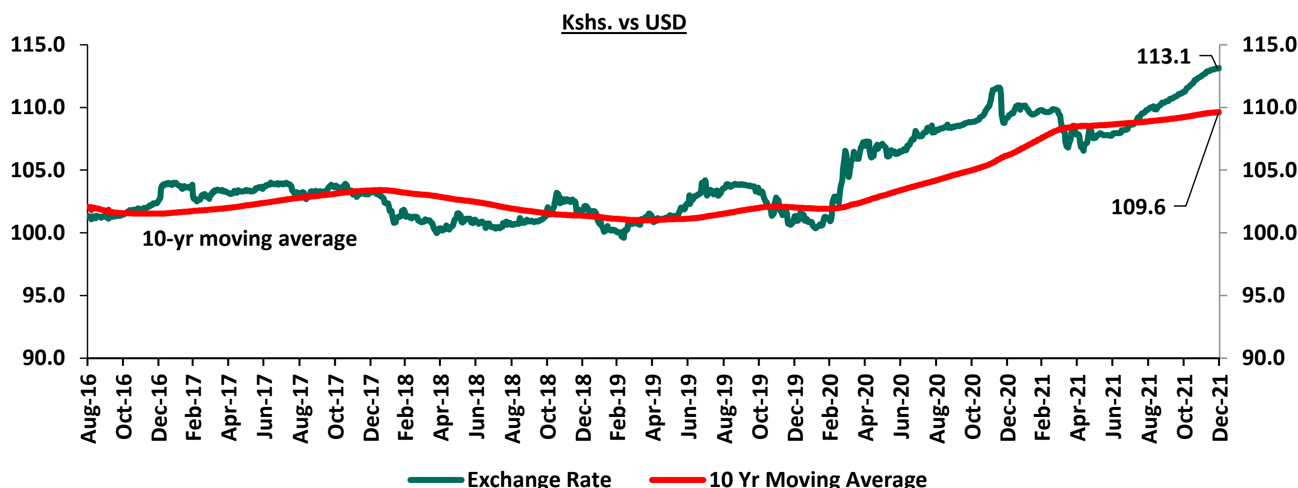
The Kenyan Shilling depreciated against the US Dollar by 3.6% in FY'2021, to close at Kshs 113.1, from Kshs 109.2 in FY'2020. The depreciation was mainly driven by the following factors;

a) Rising uncertainties in the global market due to the emergence of new COVID-19 variants, which saw investors continue to prefer holding their investments in dollars and other hard currencies and commodities,
b) Increased global crude oil prices that led to increased dollar demand from oil and energy importers who had to increase the amounts they pay for oil imports and hence depleting dollar supply in the market,
c) Increased dollar demand as economies reopened leading to shortage of dollars in the Kenyan market,
d) Widening of the current account deficit which stood at 5.2% of GDP in the 12-months to November 2021 compared to 4.7% within the same period in 2020. The expansion is partly attributable to a robust increase in merchandise imports by 26.5% to Kshs 498.0 bn, from Kshs 393.8 bn in Q3'2020, compared to a 7.9% increase in merchandise exports to Kshs 176.2 bn, from Kshs 163.3 bn recorded in a similar period in 2020, and,
e) The aggressively growing government debt, with Kenya's public debt having increased at a 10-year CAGR of 17.7% to Kshs 7.8 tn in July 2021, from Kshs 1.5 tn in July 2011 thus putting pressure on forex reserves to repay some of the public debt.

However, the shilling continued to be supported by;

i. Sufficient Forex reserves, which stood at USD 8.8 bn (equivalent to 5.4-months of import cover) as at 31st December, 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 972.6 mn IMF disbursement and the USD 130.0 mn World Bank loan financing received in June, 2021, and,
ii. Improving diaspora remittances evidenced by a 17.0% y/y increase to USD 350.6 mn in December 2021, from USD 299.6 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	2021 Expectations at Beginning of Year	Outlook - Beginning of Year	2021 Experience	Effect
Balance of Payments	• We expected relative stability in the business environment in 2021 supported by the easing of the lockdown measures by Kenya's trading partners as well as continued support from the tea, coffee and horticulture exports due to the normalized demand in Kenya's export markets as the corona-virus restrictions continued to ease in many countries. We however noted that risks abounded in the medium term driven by the possibility of higher oil imports bill	**Neutral**	• According to Kenya National Bureau of Statistics (KNBS), Kenya's balance of payments improved in Q3'2021, coming in at a deficit of Kshs 34.4 bn, from a deficit of Kshs 103.9 bn in Q3'2020. The improvement was attributable to an 11.9% increase in the stock of gross official reserve to Kshs 1,064.2 bn, from Kshs 951.0 bn in Q3'2020. The decline was however weighed down by a 27.4% expansion of current account balance to Kshs 184.6 bn, from Kshs 145.0 bn in Q3'2020,	**Neutral**
Government Debt	• We expected the government to come under pressure to borrow despite them being 11.1% ahead of their domestic borrowing target as at the end of 2020 given that banks had high exposure in government securities. Additionally, we expected more pressure to emanate from the expectations of KRA not achieving the revenue targets and the government having had a net external financing target of Kshs 347.0 bn to finance the budget deficit	**Negative**	• As at the end of December 2021, the Government was 5.9% ahead of its prorated borrowing target of Kshs 341.9 bn having borrowed Kshs 362.1 bn and has domestic maturities worth Kshs 592.1 bn. On external debt front, debt borrowed as of June 2021, amounted to Kshs 4.0 tn which is 32.8% of GDP with 66.9% in USD denomination, an indication that the shilling is expected to experience pressure due to repayment of foreign-denominated debt	Negative
Forex Reserves	• The Country's forex reserves, as at the close of 2020, stood at USD 7.8 bn (equivalent to 4.8-months of import cover), which was above the statutory requirement of maintaining at least 4.0-months of import cover, and the EAC	**Neutral**	• As at 31st December 2021, forex reserves, stood at USD 8.8 bn (equivalent to 5.4-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-	**Neutral**

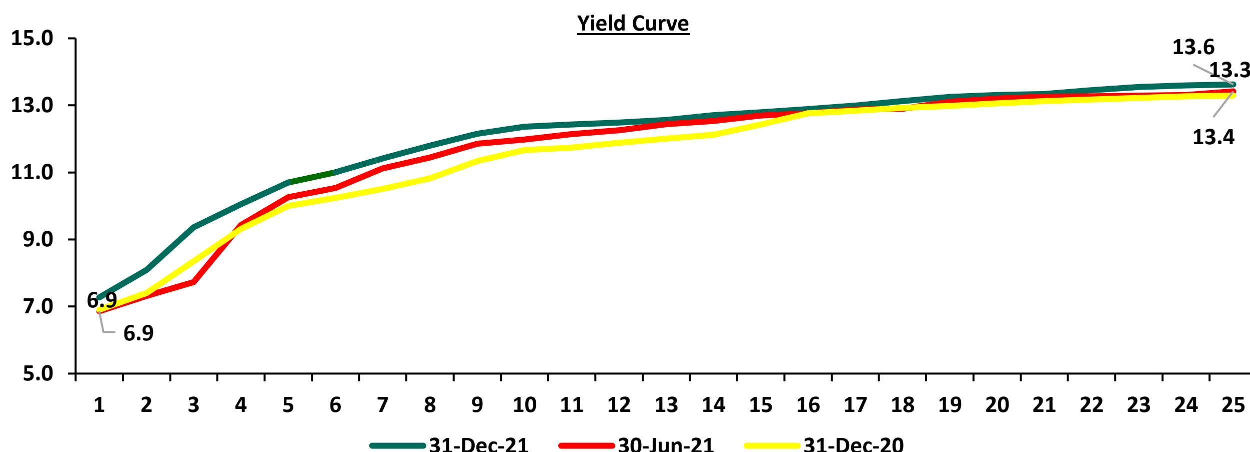
	region's convergence criteria of 4.5-months of import cover, • On the downside, Kenya's forex reserves had been dwindling due to subdued inflows from diaspora remittances and exports. Despite this, we expected the same to be supported by the reopening of economies across the globe which would allow the flow of currency though the global economy		months of import cover. However, Kenya's forex reserves have been declining due to subdued inflows from exports and repayment of debts	
Monetary Policy	• we expected the MPC to maintain the Central Bank Rate (CBR) at 7.00%, with their decision mainly being supported by Stable Inflation which was projected to remain within the 2.5%-7.5% target range despite the increases in fuel prices and the need to support the economy by adopting an accommodative stance and pumping money into the economy	**Neutral**	• In 2021, the MPC maintained the CBR at 7.00% citing that the accommodative policy stance was having the intended effects on the economy and inflation rates remained within the government's target range	**Neutral**

From the currency drivers, 2 are negative (Government Debt and Balance of Payment), and 2 are neutral (Forex Reserves and Monetary policies) in line with our outlook at the beginning of the year.

Section II: Kenya's Interest Rate Environment

In FY'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 to reject expensive bids in the primary market and as such, kept the interest rates low. However, the high inflation rates during the year exerted upward pressure on interest rates as investors attached a higher premium to compensate for inflation risk. Notably, liquidity levels tightened as evidenced by the increase in the average interbank rate to 4.7% in 2021, from 3.7% in 2020, partly due to government remittances which offset payments.

During the year, the rates on government papers remained relatively stable despite the projected high budget deficit to GDP of 11.4%. Yields on government securities in the secondary market experienced upward pressure, partly attributable to the increased government borrowing and partly due to the increasing inflation seen in 2021. Consequently, the FTSE bond index declined by 2.2% to close at Kshs 96.1, from Kshs 98.3 recorded at the end of 2020, bringing the YTD performance to a 2.0% decline.



Underlying factors affecting the Interest Rate environment:

Driver	2021 Expectations at Beginning of Year	Outlook - Beginning of Year	2021 Experience	Effect
Fiscal Policies	• We expected the increased pressure on the government to meet its budget deficit of 8.7% of GDP for FY'2020/2021 to have an upward effect on the interest rates	**Negative**	• In 2021, the government's borrowing appetite continued, having borrowed domestically Kshs 362.1 bn against their target of Kshs 341.9 bn for the FY'2021/2022, to relieve the burden of debt maturities	**Negative**
Monetary Policy	• We expected inflation rates to remain stable and within the projected target of 2.5%-7.5%. However, we believed that if inflation continued to rise, there could be some pressure on the MPC to maintain price stability. As such, the yields on government securities were likely to adjust further upwards as investors would attach higher premium to meet their required real rate of return	**Neutral**	• The interest rate environment remained stable during the year, with the MPC retaining the CBR at 7.00%. Notably, commercial banks' lending rates marginally increased to 12.1% in October 2021, from 12.0% seen in October 2020	**Neutral**
Liquidity	• We expected liquidity to continue being supported by the Low Cash Reserve Ratio (CRR) which stood at 4.25% from 5.25% previously • We further noted that lending to businesses and individuals remained muted on the back of elevated risk levels as the effects of the Coronavirus continued to be felt in the economy and ahead of the 2022 August election. As such more money was expected to flow into government securities, which would provide some relief on government yields due to decreased credit competition from the private sector	**Positive**	• During the year, liquidity levels tightened but remained favorable supported by government maturities and closing at an average interbank rate of 4.7% in 2021 from an average of 3.7% in 2020	**Positive**

From the interest rates drivers, 1 is positive (Liquidity), 1 is neutral (Monetary Policy) and 1 is negative (Fiscal Policy) in line with our outlook at the beginning of the year.

Section V: Conclusion

In 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 3.6% in 2021, to close at Kshs 113.1, from Kshs 109.2 in 2020, 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. Additionally, the increased global crude oil prices led to increased dollar demand from oil and energy importers causing further depreciation of the shilling.

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 sufficient forex reserves and the improving diaspora remittances. In the interest rate environment, we expect the rise in the yield curve to be sustained in 2022, mainly driven by increased borrowing appetite by the government with the aim of plugging in the fiscal deficit, which is projected to come in at Kshs 1.4 tn in the FY'2021/22 equivalent to 11.4% of the GDP. The increased borrowing will results in slight

upward pressures in the yield curve thus destabilizing the interest rate environment. Despite this, we expect the interest rate environment to remain relatively stable in the country owing to the support from concessional multilateral loans from IMF reducing the government's cash crunch.

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