Cytonn Note on the 9th August 2023 Monetary Policy Committee (MPC) Meeting

The Monetary Policy Committee (MPC) is set to meet on Wednesday, 9th August 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 26th June 2023, the committee noted that they would closely monitor the impact of the policy measures taken, while highlighting that they were ready to reconvene earlier if necessary. Additionally, the MPC decided to raise the Central Bank Rate by 100.0 bps to 10.5% from the previous 9.5%, 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.

The Monetary Policy Committee noted that the ongoing implementation of the FY2022/23 Government Budget, particularly the performance in tax revenue collection, would continue to reinforce fiscal consolidation. Notably, the total revenue collected as at the end of FY'2022/23 amounted to Kshs 2,044.6 bn, equivalent to 95.3% of the revised estimates of Kshs 2,145.4 bn, with tax revenues amounting to Kshs 1,962.0 bn, equivalent to 94.3% of the revised estimates of Kshs 2,079.8 bn. Additionally, the Monetary Policy Committee noted that the leading economic indicators pointed to a strong performance of the Kenyan economy in the H1'2023 mainly driven by the activities in the services sector and the recovery of the Agricultural sector. The committee further noted that goods exports remained strong, with a year-on-year growth rate of 5.5% in the 12 months to May 2023. Notably, receipts from tea and manufacturing goods exports increased on the back of improved prices due to demand from the traditional market. Additionally, imports decreased by 2.3% in the 12 months to May 2023, compared to the 20.4% growth recorded in a similar period last year, due to the completion of projects, which led to lower imports of infrastructural related equipment's. Remittances in the 12 months to May 2023 amounted to USD 3,977.0 mn, representing a 0.1% gain compared to a similar period last year. However, the current account deficit is projected at 4.8% of GDP in 2023, up from the estimate of 5.1% of GDP in 2022. Notably, private sector credit growth stood at 13.2% in both April and May 2023, compared to 11.7% in February 2023, with the number of loan applications and approvals remaining strong, highlighting increased demand and resilient economic activities.

Below, we analyze the trends of the macro-economic indicators since the June 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 June 2023	Our Expectation Going forward	CBR Direction (June)	Probable CBR Direction (August)
Government Revenue Collection	• Total revenue collected as at the end of June 2023 amounted to Kshs 2,044.6 bn, equivalent to 95.3% of the revised estimates of Kshs 2,145.4 bn for FY'2022/2023, • We note that the government has not been able to meet its prorated revenue targets for the FY'2022/2023, partly attributable to the deteriorated macroeconomic environment in the country as evidenced by the Purchasing Managers Index (PMI), which has for the last 6 months to July 2023 remained below the 50.0 no change threshold, with the July 2023 PMI coming in at 45.5. The July 2023 inflation rate stood at 7.3%, however, the inflation rate had remained elevated and above the CBK target	• 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 and electricity prices, coupled with the sustained depreciation of the shilling against the dollar, which continue to put pressure on the economic environment • However, with the implementation of the Finance Act 2023, the government will have a broader tax base which will lead to increased tax revenue collection. Among the key provisions in the Act are increase of the VAT on Petroleum from 16.0% to 8.0%, introduction of a higher personal income tax rate of 35.0% on the income of individuals earning above	Neutral	Neutral

	range of 2.5% - 7.5% for the last 13 months to June 2023.	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, given the subdued general business environment, which is underpinned by the depreciation of the Kenyan shilling, tightened liquidity in the money market, and elevated inflationary pressures, we expect the subdued business environment to weigh down tax revenue given that consumers have cut back on their spending due to a reduction in disposable income.		
Government Borrowing	• The government, as at 31st July 2023, was 2.7% ahead of its prorated net domestic borrowing target of Kshs 48.3 having a net borrowing position of Kshs 49.6 bn of the domestic net borrowing target of Kshs 586.5 bn in the FY'2023/2024. The government has domestic maturities worth Kshs 721.2 bn and will have to borrow Kshs 115.3 bn monthly to meet the upcoming domestic maturities and finance the budget deficit in FY'2023/2024. • Kenya has continued to receive financing from the World Bank and other bilateral lenders, such as the International Monetary Fund (IMF). The World Bank approved a USD 1.0 bn (Kshs 138.6 bn) loan on May 2023 under the Development Policy Operation (DPO) to provide low cost budget financing. Additionally, the government of Kenya was able to secure a commercial loan of USD 500.0 million (Kshs 69.6 billion) from a syndicate of global banks to ease its financial distress • Recently, the IMF announced that it had completed a fifth review of the 38-month Extended Fund Facility (EFF) and Extended Credit Facility (ECF) financing for Kenya allowing for an immediate disbursement of USD 415.4 mn (Kshs 58.9 bn), inclusive of USD 110.3 mn (Kshs 15.6 bn) from an augmentation of access. The board also approved Kenya's request for a 20-month arrangement under the	• Kenya's rising debt sustainability remains a significant concern, with the government's borrowing appetite remaining high mainly due to an ever-present fiscal deficit, which came in at 5.8% of GDP in FY'2022/23 and the government projects a deficit of 4.4% of GDP in FY'2023/24. Additionally, according to Fitch ratings, Kenya's external debt service costs is expected to rise sharply by 53.6% to USD 4.3 bn in FY'2023/2024 up from USD 2.8 bn that was spent on debt service in the previous year, FY'2022/2023. The high debt servicing cost is mainly due to the USD 2.0 bn Eurobond maturing in June 2024. As a result of the expected continuation of the global tightening cycle, Kenya is likely to face headwinds in servicing the Eurobond since the government plans to refinance the Eurobond in external markets. • The total borrowing for the FY'2023/24 is set to reduce by 12.9% to Kshs 718.0 bn, from Kshs 824.0 bn, in FY'2022/23 budget estimates. Additionally, the government has reduced its appetite for foreign debt, projecting to borrow Kshs 131.5 bn in foreign debt in the FY'2023/24, a 66.8% decrease from 395.8 billion in the FY'2022/23. The move is expected to lower the cost of debt servicing, given that foreign debt has been ballooning as a result of the Kenya shilling's sustained depreciation against major currencies. However, risk lies due to the sustained	**Negative**	**Negative**

	Resilience and Sustainability Facility (RSF), amounting to USD 551.4 mn (Kshs 78.1 bn) in a bid to build resilience against the impacts of climate change and attract additional private investment towards climate-related initiatives. The disbursement brings the total amount disbursed under the EFF and ECF arrangements to USD 2,056.6 mn (Kshs 291.2 bn) • Kenya's Public debt as at April 2023 stood at Kshs 9.6 tn, equivalent to 66.3% of GDP, 13.3% points above the IMF recommended threshold of 50.0% for developing countries, • USD denominated external debt constituted of 66.8% of all external debt as of April 2023 leading to an increase in the debt servicing cost at a time when the Kenyan shilling continues to depreciated against the dollar to an all-time low.	depreciation of the Kenyan shilling against US dollar given that a larger proportion of external debt is denominated in US dollars.		
Inflation	• Year on year (y/y) inflation rate in the month of July 2023 eased to 7.3% marking the first time in 14 months that the inflation has fall within the CBK target range of 2.5%-7.5%. However, the month on month (m/m) inflation increased marginally by 0.1% points. • The overall easing of the headline inflation in the month of July 2023 came on the back of tight monetary policy following the Monetary Policy Committee (MPC) move to raise the Central Bank Rate by 100.0 bps to 10.5% in June 2023 from 9.5% in May 2023, a move aimed to anchor inflation.	• Despite the easing of year-on-year inflation, the risk of an elevation of inflation above the CBK target range remains high following the effectuation of the Finance Act 2023, which provisions a double increase in VAT on petroleum products to 16.0% from 8.0%. With fuel being a major input in most businesses, the cost of production is expected to remain elevated. • Additionally, the sustained depreciation of the Kenyan shilling against major currencies is also expected to underpin inflationary pressures in the country as manufacturers pass on the high cost of importation to consumers through hikes in consumer prices in order to maintain their margins	**Positive**	**Negative**
Currency (USD/Kshs)	• The pressure on the Kenya Shilling continues to endure, with the shilling having depreciated by 1.7% against the US Dollar to Kshs 142.8 as at 3rd August 2023, from Kshs 140.4 recorded on 26th June 2023 mainly due to persistently high dollar demand from importers, especially in the oil and energy sector. • Forex Reserves declined by 1.3% to USD 7.4 bn (equivalent to 4.0 months of import cover) as of 27th July 2023 from USD 7.5 bn (equivalent to 4.1 months of import cover) recorded as at 29th June 2023. As such, the forex reserves remain at risk of dropping below the statutory requirement of	• 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 are expected to be weighed down by the dwindling forex reserves which are under pressure on the back of high government debt servicing given that 66.8% of Kenya's external debt is US Dollar denominated as of April 2023. • We also expect the shilling to remain under pressure on the back of the ever present current account deficit, which came at 2.3% of GDP in Q1'2023 from	**Negative**	**Negative**

	maintaining at least 4.0 months of import cover. Additionally, the reserves remain below the EAC region's convergence criteria of 4.5 months of import cover	4.2% recorded in a similar period last year		
GDP Growth	• Kenyan's economy recorded a 5.3% growth in Q1'2023, lower than the 6.2% growth recorded in Q1'2022, pointing towards a slower economic growth. The performance was driven by; i. he positive growth recorded in all sectors, with the Accommodation and Food Service Sector recording the highest growth rate of 21.5% in Q1'2023, albeit lower than the 40.1% growth recorded in Q1'2022. The sector's performance continues to be cushioned by rising tourism activities, as evidenced by increased visitor arrivals through the Jomo Kenyatta and Moi International airports, increasing by 50.0% to 337,937 in Q1'2023, up from 225,321 recorded in Q1'2022. ii. The rebound of agricultural sector, with the sector recording a growth of 5.8% compared to a contraction of 1.7% in Q1'2022. This is after a consecutive contraction of four quarters. The positive growth recorded during the quarter was mainly attributable to the sufficient rainfall experienced in the quarter under review, which resulted in increased agricultural production. However, the sectoral contribution of the Agriculture sector, declined the most by 4.9% points to 18.5% in Q1'2023, from the 23.4% GDP contribution in Q1'2023	• We expect the economy to grow at a slower pace given the subdued general business environment in the country, mainly as a result of sustained shilling depreciation, which continues to raise the cost of importation and consequently leads to a high cost of production. • Additionally, the rising cost of credit on the back of rising interest rates hampers private sector access to credit, which is expected to lower economic activity in the country and in turn lead to slow economic growth. • However, we expect economic growth to be supported by the agricultural sector which continue recuperate, supported by fiscal policies such as subsidizing the costs of crucial farm inputs such as fertilizers. • Notably, the country's PMI for the month of July 2023 recorded a greater slump to 45.5, marking the sixth consecutive month (since June 2023) that the index has recorded below the 50 no change threshold, pointing towards a deterioration of the business environment in the Kenyan private sector. However, according to CEO's survey-May 2023 report, optimism regarding growth prospects for the Kenyan economy improved due to the easing of the inflation rate and the expected increase in agricultural production. On the global economy, respondents had subdued optimism attributable to the lingering war in Ukraine and interest rate hikes in advanced economies.	**Neutral**	**Neutral**
Private Sector Credit Growth	• The latest data from CBK indicates that private sector credit growth continues to recover having grown by 13.2% in May 2023, 1.7% points higher than the 11.5% growth recorded in the	• We anticipate continued adoption of the risk-based pricing model in the banking sector to continue to unlock access to credit for individuals and businesses who were not captured by	**Positive**	**Neutral**

	same period in 2022, as the number of loan applications remains strong, indicating increased demand and improvement of economic activities	the previous framework 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 July T-Bonds coming in at 16.6%, effectively edging out the majority of the corporate bonds currently trading in the market. • Additionally, banks have started adjusting their lending rates in line with the increase in the CBR rate to 10.5% from the previous 9.5%, which is expected to slow down private sector credit demand.		
Liquidity	• Liquidity levels in the money markets tightened, with the average interbank rate in the month of July 2023 increasing by 1.1% points to 10.7% from the 9.6% recorded in June 2023, partly attributable to tax remittances that offset government payments.	• The month of July recorded an occasional tightening of liquidity in the money market on the back of continued high demand for cash by the government. So far in the month of August 2023, the interbank rate has recorded a 5-year high of 17.4% as of August 3, 2023. • However, we expect liquidity to be supported by: i. High domestic debt maturities that currently stand at Kshs 547.8 bn worth of T-bill maturities and Kshs 173.4 bn worth of T-bond maturities for FY'2023/2024, 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 rates with the aim of anchoring inflation within their target ranges. In the United States, the y/y inflation for the month of June 2023 eased to 3.0% from 4.1% in May 2023, but remained 1.0% points above the 2.0% target. As a result, on July 26, 2023, the United States Federal Reserve Monetary Policy Committee opted for a 25.0 bps interest rate hike, to the range of 5.25%-5.50%, from 5.00%-5.25% in a bid to anchor inflation. Additionally, in their most recent sittings, England, Ghana, Canada, and the Euro Area also increased their rates, while Malaysia, Australia, and South Africa 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 the post-pandemic recovery by raising their benchmark rates. The table below highlights the policy stance adopted by the 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	3.00%	3.00%	Unchanged
2	China	Bank of China	3.65%	3.55%	(0.10%)
3	England	Bank of England	5.00%	5.25%	0.25%
4	Australia	Reserve Bank of Australia	4.10%	4.10%	Unchanged
5	USA	Federal Reserve	5.00% - 5.25%	5.25% - 5.50%	0.25%
6	Ghana	Bank of Ghana	29.5%	30.0%	0.50%
7	Canada	Bank of Canada	4.50%	5.00%	0.50%
8	South Africa	South Africa Reserve bank	8.25%	8.25%	Unchanged
9	Euro Area	European Central bank	4.00%	4.25%	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 10.50% with their decision mainly being supported by:

i. The ease in y/y inflation in July 2023 to 7.3% from 7.9% recorded in June 2023 marks the first time in 14 months that inflation has fallen within the CBK target range of 2.5%-7.5%. However, the risk lies on the back of elevated fuel prices following the increase in VAT on petroleum products to 16.0% from 8.0%. 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. The Purchasing Managers Index (PMI) has for the last 6 months remained below the 50.0 no change threshold, with the July 2023 PMI recording dropping to 45.5 from 47.8 recorded in June 2023 and indication of greater deterioration in the business environment. An additional hike in the CBR rate might curtail economic growth given the current macroeconomic and business environment, which cannot accommodate further hikes.

Notably, despite the positive growth in all sectorial contributors to the GDP in Q1'2023, the overall economic growth slowed down, coming in at 5.3% compared to the 6.2% growth recorded in Q1'2022. As such, a further increase in the Central Bank Rate (CBR) is expected to unleash further negative impacts on the local economy amid a deteriorated local business environment.