Cytonn Note on the 26th January 2022 Monetary Policy Committee (MPC) Meeting

The Monetary Policy Committee (MPC) is set to meet on Wednesday, 26th January 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 29th November 2021, the committee decided to reconvene in January 2022, while highlighting that they would remain ready to reconvene earlier if necessary. Additionally, the MPC maintained the CBR at 7.00% for the eleventh consecutive time, citing that the accommodative policy stance adopted in March 2020, which saw a cumulative 125 bps cut, was having the intended effects on the economy. The committee noted that inflation remained anchored within the target range of 2.5% - 7.5%, and leading economic indicators continued to show a robust rebound in the economy. This was in line with our expectations as per our MPC Note with our view having been supported by:

i. The MPC taking a wait and see approach as it monitors the recovery of the economy. Kenya's economy recorded a 10.1% growth in Q2'2021, up from the 0.7% growth in Q1'2021 and the 4.7% contraction recorded in Q2'2020. We believed that despite this recovery, the slow vaccine inoculation and the emergence of the new variants would continue to weigh down the recovery of the economy. As such, we were of the view that the MPC would keep monitoring the macro-economic indicators before pursuing any additional policy measures,

ii. We expected the inflation rates to remain stable and within the government's target range of 2.5% -7.5% on account of the stable fuel prices. October's inflation declined to 6.5%, from 6.9% recorded in September, supported by the decline in fuel prices following the re-instatement of the Fuel Subsidy program, and,

iii. The need to support the shilling from further depreciation. The shilling had depreciated by 1.6% to Kshs 112.2 as of 19th November 2021, from Kshs 110.4 recorded in September 2021. We believed that the sufficient forex reserves of USD 8.9 bn (equivalent to 5.4 months of import cover) as of 19th November 2021, would continue to support the shilling from foreign exchange shocks in the short term. As such, this would reduce pressure on the Central Bank to pursue any additional policy measures.

In the November meeting, the Monetary Policy Committee also noted strides made in the implementation of the FY'2021/2022 Government Budget, with an emphasis on the robust Revenue performance attributable to an uptick in economic activities and improvement in business environment. Total revenue collected as of October 2021 amounted to Kshs 598.5 bn, equivalent to 101.1% of the prorated estimates of Kshs 591.9 bn. Further, the Monetary Policy Committee noted that the current account deficit to GDP was estimated at 5.4% in the 12-months to October 2021, a 0.3% point increase from the 5.1% recorded over a similar period in 2020.

Below, we analyze the trends of the macro-economic indicators since the November 2021 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 November 2021	Going forward	Probable CBR Direction (November)	Probable CBR Direction (January)
Government Revenue Collection	• Total revenue collected as at the end of December 2021 amounted to Kshs 926.3 bn, equivalent to 52.2% of the original estimates of Kshs 1.8 tn and is 104.3% of the prorated estimates of Kshs 853.7 bn • The strong revenue performance is mainly attributable to; i. Enhanced compliance enforcement efforts and the implementation of new tax measures that are focused	• We expect the implementation of the Finance Act 2021 which brought changes to the Excise Duty Tax, Income Tax as well as the Value Added Tax to continue to expand the tax base and consequently enhance revenue collection. Additionally, the 7.7% increase in the target Excise Duty for FY'2021/2022 to Kshs 259.6 bn, from Kshs 241.0 bn is expected to further expand the tax base, and,	**Positive**	**Positive**

	on ensuring that that non-compliant taxpayers pay their due taxes, ii. Improved business environment due to relaxation of COVID-19 containment measures such as the lift of nationwide dusk curfew that was lifted on 20th October 2021, and, iii. The widening of the tax base following the implementation of Finance Act 2021 has continued to support the recovery of revenue collection	• The gradual economic recovery and the relaxation of the COVID-19 measures such as lift of dusk curfew is also expected to boost KRA's revenue collection for FY'2021/2022 • KRA has embarked on aggressive revenue collection and compliance efforts which saw them surpass their revenue collection targets by 5.1% in the six months leading to December 2021 having collected Kshs 976.7 bn against a target of Kshs 929.2 bn. These efforts are expected to continue boosting revenue collection.		
Government Borrowing	• The Government, as of 14th January 2022, was 5.5% ahead of its prorated borrowing target of Kshs 367.2 bn having borrowed Kshs 388.3 bn and has domestic maturities worth Kshs 549.3 bn. The government will have to borrow Kshs 49.1 bn monthly to meet its domestic borrowing target of Kshs 658.5 bn in the 2021/2022 fiscal year, • In December 2021, the IMF released USD 258.1 (Kshs 29.2 bn) to Kenya following completion of the Second reviews of the Extended Arrangement under the Extended Fund Facility (EFF)/ Extended Credit Facility (ECF) Arrangement, and, • Kenya's Public debt as at August 2021 stood at Kshs 7.9 tn, with domestic debt coming in at Kshs 3.9 tn (48.8% of total debt stock), while external debt composed of Kshs 4.1 tn (51.2% of total debt stock). The Public debt to GDP ratio came in at 63.9%.	• The Public Debt to GDP ratio as at August 2021 stood at 63.9%, an increase of 0.9% points from 63.0% recorded in July 2021 and remains 13.9% points above the IMF recommended threshold of 50.0% for developing nations which points to debt nearing unsustainable levels. • The government's high borrowing appetite could mean that the country is heading towards levels of distress given the high debt servicing obligations, which will increase due to expiry of the Debt Service Suspension Initiative (DSSI) in December 2021. We therefore believe that with the slow recovery in some sectors such as Agriculture, which is Kenya's largest contributor to the GDP, fiscal consolidation will continue to remain a concern in the medium term, and, • The government has announced plans to issue two Eurobonds in 2022 totalling USD 2.2 bn (247.0 bn) to be used for Budget support, and refinancing the 10-year USD 2.0 bn (Kshs 226.0 bn) bond issued in 2014.	**Negative**	**Negative**
Inflation	• Y/Y inflation for December 2021 came in at 5.7%, from the 5.8% recorded in November, while the m/m inflation increased by 0.9%. The increase was mainly attributable to a 1.7% increase in food & non-alcoholic beverages coupled with a 1.1% increase in transport and housing, water, electricity, gas and other fuels.	• Y/Y inflation eased to 5.7% in December, from the 5.8% recorded in November 2021 and we expect it to remain within the Government's target range of 2.5%-7.5% • However, Global fuel prices have continued to rise, hitting seven year highs on the back of increased demand and persisting supply chain constraints. As such, we believe the viability of the Fuel Subsidy program under the National Treasury remains in question and we could see upward pressure on the inflation basket, with fuel being a major contributor to Kenya's headline inflation.	**Negative**	**Neutral**

Currency (USD/Kshs)	• Since the last meeting, the Kenyan Shilling has depreciated by 0.9% against the US Dollar to Kshs 113.5 as of 20th January 2022, from Kshs 112.4 on 29th November 2021, mainly attributable to increased dollar demand from commodity and energy sector importers, and, • Forex Reserves have remained constant at USD 8.8 bn (equivalent to 5.4 months of import cover) since the last meeting. Forex reserves remain 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	• We project the Kenyan Shilling to remain under pressure in the medium term attributable to increased demand from oil and merchandise traders as they beef up their hard currency positions in anticipation for more trading partners reopening their economies globally, • However, the shilling will be supported by the sufficient forex reserves, currently at USD 8.8 bn (equivalent to 5.4 months of import cover), and the improving diaspora remittances evidenced by a 17.0% y/y increase to an all-time high USD 350.6 mn in December 2021, from USD 299.6 mn recorded over the same period in 2020	**Neutral**	**Neutral**
GDP Growth	• Kenya's economy expanded by 9.9% in Q3'2021, up from the 2.1% contraction recorded in Q3'2020. The performance was driven by; i. Strong rebound in the Accommodation and food sector which recorded a 24.8% growth in Q3'2021 compared to a growth of 9.3% in Q2'2021 and 63.4% contraction recorded in Q2'2021 and in Q3'2020, respectively, ii. A 25.1% growth in the Manufacturing Sector in Q3'2021 in comparison to the 7.0% growth recorded in Q'2021 and the 4.7% contraction recorded in Q2'2020, and, iii. A 64.7% growth in the Education sector as compared to the 17.4% contraction recorded in Q3'2020 iv. A 25.1% growth in the Manufacturing Sector in Q3'2021 in comparison to the 7.0% growth recorded in Q2'2021 and the 4.7% contraction recorded in Q3'2020, and, v. A 1.8% decline in the Agriculture sector, which is Kenya's main contributor to GDP, as compared to a growth of 4.2% in Q3'2020 and decline of 0.9% in Q2'2021	• We expect Kenya's economy to continue growing in tandem with the global economy as most sectors of the economy continue to recover. The lifting of the dawn to dusk curfew that was put in place since March 2020 is expected to boost economic recovery in sectors such as accommodation and food services • Notably, December's PMI increased for the third straight month to 53.7 from 53.0 recorded in November 2021 an evidence of improving business activities in the country, and, • We however believe that risks abound the economic recovery due to existence and emergence of new COVID-19 variants and effects of the electioneering period as the country nears the August 2022 general elections	**Neutral**	**Neutral**
Private Sector Credit Growth	• The latest data from CBK indicates that private sector credit growth recorded a 7.7% growth in the 12 months to September 2021, slightly higher than the 7.6% growth recorded in the 12 months to September 2020 as demand recovered following the increased economic activities	• Private sector credit growth is expected to continue being supported by the improving operating environment in the country, • However, we expect to continue seeing continued caution on lending especially to the sectors that continue to record muted growth such as Agriculture and Real Estate, • Private sector lending will also be impeded by elevated credit risk due to deterioration of business environment as a result of a heated and prolonged	**Neutral**	**Neutral**

		electioneering period as the country nears the August 2022 General election, and, • The increased government borrowing is also expected to continue crowding out the private sector		
Liquidity	• Liquidity levels in the money markets eased, with the average interbank rate on 14th January 2022 coming in at 3.4%, a 1.9% points decrease from the 5.3% recorded during the last meeting on 29th November 2021, supported by government payments	• Liquidity is expected to remain favourable due to: i. High domestic debt maturities that currently stand at Kshs 477.7 bn worth of T-bill maturities and Kshs 71.6 bn worth of T-bond maturities as at 14th January 2022, and, ii. Low Cash Reserve Ratio (CRR) currently at 4.25% from 5.25% previously. Despite the reduction of the CRR, lending to the private sector has remained muted • However, risks abound liquidity should the government decide to restructure its local debt by rolling over some of the maturities	**Positive**	**Positive**

Conclusion

Of the factors that we track, one is negative, four are neutral and two are positive. Notably, most Central Banks around the world have maintained the accommodative stance adopted on the onset of the pandemic in order to spur recovery and economic growth. However, inflation has continued to persist globally driven increasing fuel and energy prices and supply chain constraints. In the United States, y/y inflation peaked at 7.0%, the highest since 1982, and as such the Federal Reserve is expected to tighten the current accommodative policy stance in March 2022. We expect reactionary moves from other Central Banks around the world, in order to stem outflows from their economies as investors seek to benefit from the higher rates in the United States. However, the Central Banks especially in the emerging markets will have to perform tough balancing acts in-order not to curtail their economic growth and post pandemic recovery by increasing their benchmark rates. The table below highlights the policy stance adopted by Central Banks of major economies;

No	Country	Central Bank	Rate in Jan 2021	Current Rate	Margin
1	USA	Federal Reserve	0.00% - 0.25%	0.00% - 0.25%	-
2	Australia	Reserve Bank of Australia	0.10%	0.10%	-
3	Malaysia	Bank Negara Malaysia	1.75%	1.75%	-
4	China	Bank of China	3.85%	3.70%	(0.15%) points
5	England	Bank of England	0.10%	0.25%	0.15% points

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 7.00% with their decision mainly being supported by:

i. We foresee the MPC taking a wait and see approach as they continue to monitor the country's economic recovery, with an emphasis on the need to spur economic growth and not curtail post pandemic recovery. Kenya's economy recorded a 9.3% growth in Q3'2021, up from the 2.1% contraction recorded in Q3'2020 but slightly lower than the 10.1% growth recorded in Q2'2021. We believe that despite this recovery, risks abound economic recovery are the emergence of the new variants and 2022 being an election year. Historically, election years have seen slower economic growth due to political instability. As such, we believe that the

MPC will keep monitoring the macro-economic indicators before pursuing any additional policy measures,

ii. Inflation is expected to remain stable and within the government's target range of 2.5% -7.5% on account of the stable fuel prices. December inflation eased to 5.7%, from 5.8% recorded in November, supported by the stability in fuel which have remained unchanged since October 2021 due to the fuel subsidies under the Petroleum Development fund. However, Global fuel prices have continued to increase, hitting seven year highs on the back of increased demand and persisting supply chain constraints. We believe that the fuel subsidy program by the National Treasury stands at risk of being depleted and is unsustainable, due to the continuous increase in the average landed costs of fuel. We anticipate inflation pressures to remain elevated in the short term driven by the rising food prices and the rise in global fuel prices and,

iii. The need to support the shilling from further depreciation having depreciated by 0.9% to Kshs 113.5 as of 20th January 2022, from Kshs 112.4 recorded on 29th November 2021. We believe that the forex reserve of USD 8.8 bn (equivalent to 5.4 months of import cover) as of 14th January 2022, continue to support the shilling from foreign exchange shocks in the short term. As such, this will reduce pressure on the Central Bank to pursue any additional policy measures.

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