Cytonn Note on the 27th July 2022 Monetary Policy Committee (MPC) Meeting

The Monetary Policy Committee (MPC) is set to meet on Wednesday, 27th July 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 Monday 30th May 2022, the committee decided to reconvene in July 2022, while highlighting that they would remain ready to reconvene earlier if necessary. Additionally, for the first time since April 2020, the MPC increased the Central Bank Rate by 50.0 bps to 7.5% from 7.0%, citing that there was a scope for tightening of the monetary policy given the high rate of inflation which was expected to remain elevated due to increased global commodity prices and supply chain disruptions. 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 against 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 continued to monitor economic recovery with an emphasis on stimulating economic growth rather than curtailing post-pandemic recovery. Kenya's economy recorded a 7.5% growth in 2021, up from the 0.3% contraction recorded in 2020. In our view, risks abounded the economic recovery despite the growth, on the back of the elevated geopolitical pressures, the emergence of new COVID-19 variants and the August 2022 elections. As such, we believed that the MPC would keep monitoring the macro-economic indicators before pursuing any additional policy measures,
ii. We anticipated inflation rates to increase but remain within the government's target range of 2.5% -7.5% driven by the increase in fuel prices in May, with Super petrol, diesel and kerosene prices having increased by 3.8%, 4.4% and 4.9% to Kshs 150.1 per litre, Kshs 131.0 per litre and Kshs 118.9 per litre. Notably, inflation for the month of April increased to 6.5%, from 5.6% recorded in March, And,
iii. The need to support the shilling from further depreciation having depreciated by 1.4% to Kshs 116.5 as of 23rd May 2022, from Kshs 114.8 recorded on 29th March 2022. The depreciation was mainly attributable to increased dollar demand in the oil and energy sectors as the prices of fuel continued to rise. We believed that the forex reserve of USD 8.3 bn (equivalent to 4.9 months of import cover) as of 20th May 2022, 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.

The Monetary Policy Committee noted progress towards the achievement of the FY'2021/2022 Government Budget in its May meeting, with an emphasis on the robust revenue performance attributable to an increase in economic activity and an improvement in the business environment. Total revenue collected as of April 2022 amounted to Kshs 1.5 tn, equivalent to 102.0% of the prorated estimates of Kshs 1.5 tn. The Monetary Policy Committee also noted that the current account deficit to GDP was estimated at 5.1% in April 2022, a 1.0%-point lower than the 5.2% recorded over a similar period in 2021, and was estimated to increase further to 5.9% by end of 2022 on account of the increase in fuel prices. Key to note, private sector credit growth came in at 11.5% in April 2022, 4.7% points higher than the 6.8% over the same period in 2021.

Below, we analyze the trends of the macro-economic indicators since the May 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 May 2022	Our Expectation Going forward	CBR Direction (May)	Probable CBR Direction (July)

Government Revenue Collection	• Total revenue collected in FY'2021/2022 amounted to Kshs 2.03 tn, against the revised target of Kshs 1.98 tn, representing an out-performance rate of 2.8%. The Kenya Revenue Authority (KRA) surpassed its revenue collection target despite the challenges posed by the COVID-19 pandemic on the business environment. Overall, revenues grew by 21.7% in FY'2021/2022 to Kshs 2.0 tn from Kshs 1.7 tn in FY'2020/2021. • The strong revenue performance was mainly attributable to; i. Enhanced compliance enforcement efforts and the implementation of new tax measures that are focused on ensuring that that non-compliant taxpayers pay their due taxes, ii. Introduction of new taxes such as digital services tax, minimum tax and voluntary tax disclosure as KRA bid to expand sources of revenue, and, iii. Employment of technological strategies to assist seal revenue loopholes.	• The revenue collection target for FY'2022/2023 is Kshs 2.4 tn, an 20.0%% increase from Kshs 2.0 tn in FY'2021/2022, and, • We expect the continued economic recovery coupled with implementation of the Finance Act 2022 which brought changes to the Excise Duty Tax, Value Added Tax and Income Tax to continue supporting the tax revenue collected. However, risks abound the economic recovery on the back of increased inflationary pressures, resurgence of COVID-19 infections, as well as the upcoming August 2022 elections which might have a negative effect on the economy.	**Positive**	**Positive**
Government Borrowing	• The government target borrowing for FY'2022/2023 decreased by 7.2% to Kshs 862.4 bn from Kshs 929.7 bn in FY'2021/2022, in a bid to reduce Kenya's public debt burden and has domestic maturities worth Kshs 834.7 bn, • Kenya has continued to receive financing from the World Bank and other bilateral lenders such as the International Monetary Fund (IMF). Notably, 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 nations • Key to note, Kenya's debt continues to increase, especially USD denominated external debt which constituted of 67.9% of all external debt as of May 2022. This further increases the debt servicing cost given that the Kenyan shilling continues to depreciate against the dollar	• Kenya's rising debt sustainability remains a key concern given the rising debt levels and servicing costs, which have continued to increase due to the expiration of the Debt Service Suspension Initiative (DSSI) in December 2021. Notably, the government's borrowing appetite remains high and may indicate that the country is on the verge of financial distress. As a result, we believe that fiscal consolidation will remain a concern in the medium term, given the slow recovery in some sectors, such as agriculture, Kenya's largest contributor to GDP. Additionally, the resurgence of COVID-19 infections as well as the rising inflationary pressures may further increase the need for borrowing as the government seeks to boost the economy, 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 announced plans to issue two Eurobonds in 2022 subject to favorable market conditions totaling USD 2.2 bn (247.0 bn). This has	**Negative**	**Negative**

		however been temporarily shelved by the government due to increase interest rates in the Eurobond markets which has made borrowing time more expensive.		
Inflation	• Year on year (y/y) inflation rate for June 2022 came in at 7.9%, from the 7.1% recorded in May 2022, while the month on month (m/m) inflation increased by 0.8% points. The increase was mainly driven by a 1.2%, 1.5% and 0.9% increase in the food and non-alcoholic beverages index, household and equipment as well as the transport index, respectively. The June 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, • Notably, fuel prices remained unchanged for the period 15th July to 14th August 2022 attributable to the fuel subsidy program under the Petroleum Development Levy which resulted in subsidies of Kshs 50.7 on Super Petrol, Kshs 53.7 on Diesel and Kshs 53.2 on Kerosene during the month, • Going forward, we still maintain our view that the fuel subsidy programme remains unsustainable and will still be depleted should the average landed costs of fuel continue to rise. This will continue to exert pressure on the inflation basket, given that fuel is a major contributor to Kenya's headline inflation.	**Negative**	**Negative**
Currency (USD/Kshs)	• Since the last meeting, the Kenyan Shilling has depreciated by 1.3% against the US Dollar to Kshs 118.3 as of 15th July 2022, from Kshs 116.7 on 30th May 2022, mainly attributable to increased dollar demand from commodity and energy sector importers, and, • Forex Reserves decreased by 2.7% to USD 8.0 bn (equivalent to 4.6 months of import cover) as of 14th July 2022 from USD 8.2 bn (equivalent to 4.9 months of import cover) recorded in May 2022. However, 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 4.5months of import cover.	• We expect the Kenyan Shilling to remain under significant 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, • We note that the shilling has been recording historical lows on a daily basis since the last MPC meeting • However, the shilling performance and strength is expected to be supported by the sufficient forex reserves, currently at USD 8.0 bn (equivalent to 4.6 months of import cover) which will be boosted by the recently issued USD 750.0 mn (Kshs 85.8 bn) loan in March 2022 from the World Bank, and the expected USD 235.6 mn (Kshs 27.9 bn) from the IMF. Additionally, the improving diaspora remittances evidenced by a 7.6% y/y increase to USD 339.7 mn in May 2022, from USD 315.8 mn recorded over the same period in 2021 will also boost the shilling	**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, ii. A 21.1% growth in the Mining and quarrying Sector in Q1'2022 in comparison to the 16.4% growth recorded in Q1'2021, iii. A 8.1% growth in the transport and storage Sector in Q1'2022 in comparison to the 8.7% contraction recorded in Q1'2021, and, iv. Gradual growth recorded in the manufacturing sector as it reported a growth of 3.7% in Q1'2022 compared to a 2.1% growth in a similar period of review in 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, mining and quarrying as well as manufacturing sectors. On the downside, concerns remain elevated on increasing global oil prices and the upcoming August elections, • Notably, June's 2022 PMI declined for the third consecutive time to 46.8, from 48.2 recorded in May 2022 signaling a further deterioration in the business environment in the Kenyan private sector. Notably, this was the lowest reading since April 2021, when the index came in at 41.5. The decline was largely attributable to rise in input costs occasioned by the increased fuel prices, supply constraints as well as a weakening of the local currency. We 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 an 11.5% growth in April 2022, 0.6% points higher than the 10.9% growth recorded in March 2022 as demand recovered following the increased economic activities. Key to note, the 11.5% growth is the highest ever recorded since May 2011, when it came in at 11.1%.	• We expect continued deterioration of the operating business environment in the country evidence 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, • We also expect private sector credit growth to be weighed down by increased uncertainty on the back of the rising political temperatures ahead of the upcoming August 2022 elections, and, • Additionally, the increased government borrowing is expected to continue crowding out the private sector in the short term.	**Neutral**	**Negative**

Liquidity	• Liquidity levels in the money markets tightened, with the average interbank rate as of 15th July 2022 coming in at 5.3%, a 0.5% points increase from 4.8% recorded in the period prior to the May 2022 meeting, partly attributable to tax remittances that offset government payments	• Liquidity is expected to remain favorable due to: i. High domestic debt maturities that currently stand at Kshs 590.7 bn worth of T-bill maturities and Kshs 244.0 bn worth of T-bond maturities as at 15th July 2022, and, ii. Low Cash Reserve Ratio (CRR) currently at 4.25% from 5.25% previously. As a result, private sector credit growth recorded a 11.5% growth in April 2022, 0.6% points higher than the 10.9% growth recorded in March 2022 as demand recovered following the increased economic activities	**Positive**	**Positive**

Conclusion

Of the seven factors that we track, four are negative, one is neutral and two are positive. Notably, most of the Central Banks of developed economies around the world have raised their central bank rates, given the persistent increase in inflation rates owing to rising fuel and energy prices, stemming from supply chain constraints. For instance, in the United States, the y/y inflation for the month of June 2022 rose to 9.1%, 7.1% points above the 2.0% target, marking the fastest increase since 1984. As such, the United States Federal Bank Monetary Policy Committee, in their June 2022 sitting, decided to tighten the current accommodative policy stance by increasing the rate by 0.75% points. In their most recent sittings in June and July 2022, England, Australia and Malaysia also increased their rates by 0.25% points, 1.0% points and 0.5% points, respectively, while China maintained its rate. 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. 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	Rate in May 2022	Current Rate	Margins
1	Malaysia	Bank Negara Malaysia	1.75%	2.25%	0.5% points
2	China	Bank of China	3.70%	3.70%	Unchanged
3	England	Bank of England	1.00%	1.25%	0.25% points
4	Australia	Reserve Bank of Australia	0.35%	1.35%	1.0% points
5	USA	Federal Reserve	0.75% - 1.00%	1.50% - 1.75%	0.75% points
6	Ghana	Bank of Ghana	19.00%	19.00%	Unchanged

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 raise the Central Bank Rate (CBR) by 25.0 bps with their decision mainly being supported by:

i. We anticipate the MPC to raise the Central Bank Rate (CBR) by 25.0 bps to 7.75%, from the current 7.50%, with a focus on the need to curb the increasing inflation rate. Key to note, inflation for the month of June 2022 rose to 7.9%, from the 7.1% recorded in May 2022, driven by increasing food and fuel prices. Going forward, inflation is expected to remain elevated in the short term driven by the high fuel prices with super petrol, diesel and kerosene retailing at Kshs 159.1 per litre, Kshs 140.0 per litre and Kshs 127.9 per litre, the highest prices ever. Given the persistent supply chain constraints which have been worsened by the existent geopolitical pressures, we expect the inflation rate to increase in the short term as food and fuel prices continue to rise. Concerns also remain high on the sustainability of the fuel subsidy program which has continued to cushion Kenyans against an even higher cost of living, as the landed cost of fuel continues to rise, leading to increased compensation amounts. As such, we expect the MPC to raise the CBR as it continues 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 raise their rates. Notably the Kenyan shilling has 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 is mainly attributable to increased dollar demand in the oil and energy sectors as the prices of fuel continue to rise. In the short term, we expect the shilling to depreciate even further should the prices of fuel continue to rise leading to an increased import bill, Kenya being a net importer. Key to note, forex reserves have also been dwindling since the last sitting having declined by 2.7% to USD 8.0 bn (equivalent to 4.6 months of import cover) as of 15th July 2022, from USD 8.2 bn (equivalent to 4.9 months of import cover) in May 2022. Additionally, diaspora remittances declined by 4.3% to USD 339.7 mn in May 2022, from USD 355.0 mn in April 2022. As such, this might put pressure on the Central Bank to pursue additional policy measures to slow the accelerated depreciation of the shilling.

However, we expect this to curtail the economic growth, given that the economy has not yet fully recovered from the effects of the pandemic. Notably, Kenya's economy recorded a 6.8% expansion in Q1'2022, up from the 2.7% growth recorded in Q1'2021. Additionally, there has been impressive performance in total revenue collection which came in at Kshs 2.03 tn, against the revised target of Kshs 1.98 tn, representing an out-performance rate of 2.8%. This represented a 21.7% revenue growth in FY'2021/2022 to Kshs 2.0 tn, from Kshs 1.7 tn in FY'2020/2021, pointing towards improved economic environment. The increase in the Central Bank Rate coupled with the resurgence of COVID-19 infections and the heated political environment, are expected to slow down the economic recovery.