Cytonn Note on the 29th March 2022 Monetary Policy Committee (MPC) Meeting

The Monetary Policy Committee (MPC) is set to meet on Tuesday, 29th March 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 26th January 2022, the committee decided to reconvene in March 2022, while highlighting that they would remain ready to reconvene earlier if necessary. Additionally, the MPC maintained the CBR at 7.00% for the twelfth 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 monitored the recovery of the economy with an emphasis on the need to spur economic growth and not curtail post pandemic recovery. Kenya's economy recorded a 9.9% growth in Q3'2021, up from the 2.1% contraction recorded in Q3'2020. In our view, despite this growth risks abounded the economic recovery on the back of the emergence of new COVID-19 variants and the 2022 elections. As such, we believed 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% supported by the stability in fuel prices evidenced by the unchanged prices since October 2021. December 2021 inflation had eased to 5.7%, from 5.8% recorded in November 2021. We anticipated inflationary 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 believed that the forex reserve of USD 8.8 bn (equivalent to 5.4 months of import cover) as of 14th January 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 January 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 December 2021 amounted to Kshs 926.3 bn, equivalent to 104.3% of the prorated estimates of Kshs 887.8 bn. The Monetary Policy Committee also noted that the current account deficit to GDP was estimated at 5.4% in 2021, a 0.3% point increase from the 5.1% recorded over a similar period in 2020. Additionally, private sector credit growth increased to 8.6% in December 2021, from 8.4% in December 2020.

Below, we analyze the trends of the macro-economic indicators since the January 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 January 2022	Our Expectation Going forward	CBR Direction (January)	Probable CBR Direction (March)
Government Revenue Collection	• Total revenue collected as at the end of February 2022 amounted to Kshs 1,192.8 bn, equivalent to 67.2% of the original estimates of Kshs 1,775.6 bn and was 100.8% of the prorated estimates of Kshs 1,183.7 bn • The strong revenue performance is mainly attributable to;	• 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 revenue collected and consequently enhance revenue collection. Additionally, the 7.7% increase in the target Excise Duty for FY'2021/2022	**Positive**	**Positive**

	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. 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	to Kshs 259.6 bn, from Kshs 241.0 bn is expected to further increase the tax revenue, • The gradual economic recovery and the relaxation of the COVID-19 measures such as the lifting of the dusk to dawn curfew is also expected to boost KRA's revenue collection for FY'2021/2022. However, risks abound the economic recovery on the back of the emerging COVID-19 variants as well as the upcoming 2022 elections which are expected to weigh on the recovery, • KRA has embarked on aggressive revenue collection and compliance efforts which saw them surpass their revenue collection targets by 3.8% in the seven months leading to January 2022 having collected Kshs 1.1 tn against a target of Kshs 1.0 tn. These efforts are expected to continue boosting revenue collection		
Government Borrowing	• The Government, as of 18th March 2022, was 12.2% ahead of its prorated borrowing target of Kshs 483.5 bn having borrowed Kshs 542.4 bn and has domestic maturities worth Kshs 338.9 bn. The government will have to borrow Kshs 35.8 bn monthly to meet its domestic borrowing target of Kshs 661.6 bn in the 2021/2022 fiscal year, • In 2021 alone, Kenya received loans from the IMF and the World Bank totalling USD 1.9 mn (Kshs 210.2 bn) in a bid to support Kenya's COVID-19 recovery process. Kenya's Public debt as at December 2021 stood at Kshs 8.2 tn, with domestic debt coming in at Kshs 4.0 tn (49.1% of total debt stock), while external debt composed of Kshs 4.2 tn (50.9% of total debt stock). The Public debt to GDP ratio came in at 66.2%, and, • Additionally, the recently issued USD 750.0 mn (Kshs 85.8 bn) loan in March 2022 adds into the already ballooning debt and USD denominated external debt which constituted of 67.0% of all external debt as of December 2021. This will further increases the debt servicing cost given that the Kenyan shilling continues to depreciate against the dollar	• The Public Debt to GDP ratio as at December 2021 stood at 66.2%, which is 16.2% points above the IMF recommended threshold of 50.0% for developing nations which points to debt nearing unsustainable levels, • Given the high debt servicing obligations, which will increase due to the expiration of the Debt Service Suspension Initiative (DSSI) in December 2021, the government's high borrowing appetite 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, and, • Also in 2021, the government announced plans to issue two Eurobonds in 2022 subject to favourable market conditions totalling USD 2.2 bn (247.0 bn). The proceeds are meant for budgetary support, and refinancing of the 10-year USD 2.0 bn (Kshs 226.0 bn) bond issued in 2014	**Negative**	**Negative**
Inflation	• Year on year inflation rate for February 2022 came in at 5.1%, from the 5.4% recorded in January, while the m/m inflation increased by 0.4%. The increase was driven by a 0.8% increase in food & non-alcoholic beverages coupled with a 0.7% increase in furnishings, household equipment and routine household maintenance	• Y/Y inflation eased to 5.1% in February, from the 5.4% recorded in January 2022 and we expect it to remain within the Government's target range of 2.5%-7.5%, and, • However, concerns remain high on the widening trade deficit as global fuel prices continue to rise due to supply bottlenecks. Additionally, the geopolitical	**Positive**	**Neutral**

		pressures following the Russian invasion further worsens the situation. Petrol and diesel prices for the period 15th March to 14th April increased by 3.9% and 4.5% to Kshs 134.7 and Kshs 115.6 from Kshs 129.7 and Kshs 110.6. As such, we believe that the increase will cause an upward pressure on the inflation basket, given that fuel is a major contributor to Kenya's headline inflation		
Currency (USD/Kshs)	• Since the last meeting, the Kenyan Shilling has depreciated by 0.8% against the US Dollar to an all-time low of Kshs 114.4 as of 22nd March 2022, from Kshs 113.5 on 26th January 2022, mainly attributable to increased dollar demand from commodity and energy sector importers, and, • Forex Reserves declined by 8.4% to USD 8.0 (equivalent to 4.9 months of import cover) as of 18th March 2022 from USD 8.7 (equivalent to 5.3 months of import cover) recorded in January 2021. 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 4.5-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, and, • However, the shilling will be supported by the sufficient forex reserves, currently at USD 8.0 bn (equivalent to 4.9 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 improving diaspora remittances evidenced by a 23.5% y/y increase to USD 321.5 mn in February 2022, from USD 260.3 mn recorded over the same period in 2021.	**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.	• We expect Kenya's economy to continue growing, albeit at a gradual pace, in tandem with the global economy as most sectors of the economy continue to recover. The lifting of all COVID-19 related restrictions is expected to boost economic recovery in sectors such as accommodation and food services as well as hospitality and tourism, which were hard hit by the pandemic • Notably, February's PMI increased to 52.9 following a nine-month low of 47.6 recorded in January 2022, pointing towards a strengthened business environment in the country on the back of continued economic recovery as COVID-19 cases continue to decline, and, • 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 8.6% growth in December 2021, 0.2% points higher than the 8.4% growth	• We expect the improving operating environment in the country to continue supporting private sector credit growth,	**Neutral**	**Neutral**

	recorded in December 2020 as demand recovered following the increased economic activities	• However, we anticipate continued caution on lending especially to the sectors that continue to record muted growth such as Agriculture and Real Estate, • 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.		
Liquidity	• Liquidity levels in the money markets remained relatively stable, with the average interbank rate as of 21st March 2022 coming in at 4.8%, as was recorded during the last meeting on 26th January 2022, supported by tax remittances which offset government payments	• Liquidity is expected to remain favourable due to: i. High domestic debt maturities that currently stand at Kshs 271.0 bn worth of T-bill maturities and Kshs 68.0 bn worth of T-bond maturities as at 18th March 2022, and, ii. Low Cash Reserve Ratio (CRR) currently at 4.25% from 5.25% previously. We however note that despite the reduction of the CRR, growth in the private sector credit has remained muted.	**Neutral**	**Positive**

Conclusion

Of the seven factors that we track, one is negative, four are neutral and two are positive. Notably, some of the Central Banks of developed economies around the world have raised their central bank rates, given the persistent increase in inflation owing to rising fuel and energy prices, as well as supply chain constraints. For instance, in the United States, their y/y inflation for the month of February peaked at 7.9%, 5.9% points above the 2.0% target, marking a 40-year high. As such, the United States Federal Bank Monetary Policy Committee, in their recent sitting in February 2022, decided to tighten the current accommodative policy stance by increasing the rate by 0.25% points. In their most recent sittings in February and March 2022, England and China also increased their rates by 0.4% points and 0.25% points, respectively, while Australia and Malaysia maintained their rates. 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 March 2021	Current Rate	Margins
1	USA	Federal Reserve	0.00% - 0.25%	0.25% - 0.5%	0.25% points
2	Australia	Reserve Bank of Australia	0.10%	0.10%	Unchanged
3	Malaysia	Bank Negara Malaysia	1.75%	1.75%	Unchanged
4	China	Bank of China	3.375%	3.625%	0.25% points
5	England	Bank of England	0.10%	0.5%	0.4% 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 anticipate the MPC taking a wait-and-see approach as it continues to monitor the country's economic recovery, with a focus on the need to stimulate economic growth rather than curtail post-pandemic recovery. Kenya's economy recorded a 9.9% 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. Additionally, there has been impressive performance in revenue collections of Kshs 1.2 tn during the first eight months of the current fiscal year, which was equivalent to 100.8% of the prorated revenue collection target, pointing towards improved economic environment. We however believe that risks abound the economic recovery on the back of the emergence of new COVID-19 variants and rising political pressures ahead of the August 2022 elections. As such, we believe that the MPC will keep monitoring the macro-economic indicators before pursuing any additional policy measures. Additionally, given the Russian geo – political risks, we expect the MPC to monitor how the country might be affected and react appropriately,

ii. Inflation is expected to increase but remain within the government's target range of 2.5% - 7.5% driven by the increase in fuel prices with prices of super petrol and diesel having increased by 3.9% and 4.5% to Kshs 134.7 and Kshs 115.6 from Kshs 129.7 and Kshs 110.6. February inflation eased to 5.1%, from 5.4% recorded in January, supported by the stability in fuel which had remained unchanged since October 2021 due to the fuel subsidies under the Petroleum Development fund. However, given the persistent supply constraints which have been worsened by the Russian invasion, we expect the inflation rate to increase in the short term as food and fuel prices continue to rise. Additionally, we believe that the fuel subsidy program by the National Treasury stands at risk of being depleted and is unsustainable, as evidenced by the increased compensation amounts which further increase the possibility of depletion. Further, concerns remain high should the Russian invasion persist, as food and fuel prices will continue to increase. We expect the MPC to monitor the situation and react accordingly, given that its main role is maintaining price stability, and,

iii. The need to support the shilling from further depreciation having depreciated by 0.8% to an all-time low of Kshs 114.4 as of 22nd March 2022, from Kshs 113.5 recorded on 26th January 2022. 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 if the prices of fuel continue to rise but will be supported by foreign reserves and improving diaspora remittances evidenced by a 23.5% y/y increase to USD 321.5 mn in February 2022, from USD 260.3 mn recorded over the same period in 2021. As such, this will reduce pressure on the Central Bank to pursue any additional policy measures. Key to note, however, is that forex reserves have been dwindling since the year begun having declined by 3.3% to USD 8.0 bn (equivalent to 4.9 months of import cover) as of 18th March 2022, from USD 8.3 bn (equivalent to 5.1 months of import cover) in January 2021 and diaspora remittances have also declined by 9.0% to USD 321.5 mn in February 2022, from USD 350.6 mn in December 2021.