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Cytonn Note on the 29th March 2023 Monetary Policy Committee (MPC) Meeting

The Monetary Policy Committee (MPC) is set to meet on Wednesday, 29th March 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 Monday, 30th January 2023, the committee decided to reconvene in March 2023, while highlighting that they were ready to reconvene earlier if necessary. Additionally, the MPC maintained the Central Bank Rate at 8.75% in their January sitting, citing that the effect of the interest hike to 8.75% in November 2022 was still transmitting into the Kenyan economy, coupled with easing inflationary pressures in major economies such as the U.S, China and Europe, and a decline in global commodity prices. Driven by the reasons aforementioned, the committee concluded that maintaining the monetary policy at 8.75% was appropriate as they continue to monitor inflation trends within the economy. This was against our expectations of a 25.0 bps hike to 9.00% as per our MPC note with our view having been supported by:

i. The need to continue cooling down inflationary pressures to the government's target range of 2.5%-7.5%, with inflation for the months of November and December 2022 easing to 9.5% and 9.1%, respectively, majorly attributed to decline in global fuel and food prices, the main contributors to headline inflation. Additionally, we expected inflation to remain elevated in the short term driven by the high fuel prices that despite declining, still remained above the pre-pandemic levels. We also expected inflationary pressures to remain high on the back of high food prices, due to the erratic weather patterns in the country. As such, we expected the MPC to raise the CBR as it continued to monitor the situation and react accordingly, as per its mandate to maintain price stability, and,

ii. The need to support the shilling from further depreciation as other Central Banks raised their rates. Notably the Kenyan shilling depreciated by 9.0% during 2022, and to an all-time low of Kshs 124.2 as of 25th January 2023, from Kshs 123.4 recorded in the beginning of 2023, representing a 0.7% depreciation prior to the January meeting. The depreciation was mainly attributable to increased dollar demand in the oil and energy sectors as a result of high fuel prices. In the short term, we expected the shilling to depreciate even further if the prices of fuel continued to rise leading to an increased import bill, with Kenya being a net fuel importer. Key to note, forex reserves also remained under pressure despite the financing facility by the IMF, coming in at USD 7.4 bn as at 20th January 2023, representing 4.1 months of import cover, only 0.1 months above the statutory requirement of 4.0 months.

The Monetary Policy Committee noted progress towards the achievement of the FY'2022/2023 Government Budget in its January meeting, with an emphasis on the strong tax revenue collection, reflecting enhanced tax administration efforts and increased economic activity. Total revenue collected as at the end of December 2022 amounted to Kshs 987.9 bn, equivalent to 92.3% of the prorated estimates of Kshs 1,070.8 bn, with tax revenues amounting to Kshs 952.6 bn, equivalent to 92.0% of the prorated estimates of Kshs 1,036.0 bn. Further, the Monetary Policy Committee noted that the proposed FY'2022/23 Supplementary Budget was a commendable austerity measure in rationalizing expenditure to achieve the intended fiscal consolidation, a key objective of the current administration. The Monetary Policy Committee also noted that the current account deficit to GDP was estimated at 4.9% in 2022, a 0.5% points lower than the 5.4% recorded over a similar period in 2021, attributable to improved receipts on exports and resilient remittances. Additionally, exports of goods remained strong, growing by 10.9% in 2022 compared to 2021 while imports grew by 5.8% during the period. Key to note, private sector credit growth came in at 12.5% in 2022, compared to the 8.6% recorded in 2021 with the increased number of loan applications and approvals reflecting improved economic activities across key sectors of the economy.

Below, we analyze the trends of the macro-economic indicators since the January MPC meeting, and how they are likely to affect the MPC decision on the direction of the CBR:

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Indicators	Experience since the last MPC meeting in January 2023	Our Expectation Going forward	CBR Direction (January)	Probable CBR Direction (March)
Government Revenue Collection	• Total revenue collected for the first eight months of FY'2022/2023, ending 28th February 2023 amounted to Kshs 1,281.3 bn, equivalent to 59.8% of the original estimates of Kshs 2,141.6 bn for FY'2022/2023 and was 89.7% of the prorated estimates of Kshs 1,427.7 bn, • We note that the government has not met its prorated revenue target for the first eight months of the FY'2022/2023 mainly due to the deteriorated macroeconomic environment evidenced by the decline in the average Purchasing Managers Index (PMI) to 49.2 in the first eight months to February 2023 from 51.3 in a similar period in FY'2022/2023, coupled with a slowdown in economic growth to 4.7% in Q3'2022 from 9.3% recorded in a similar period last year.	• 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. Additionally, the persistent supply chain constraints are expected to weigh on the business environment, • However, we expect the implementation of the Finance Act 2022, coupled with how fast the new regime implements initiatives to achieve its tax collection targets such as the Exercise Duty Regulations 2023, reduce the Value Added Tax (VAT) and Corporate Income Tax gap to 19.8% and 30.0% from 38.9% and 32.2% respectively, • Additional measures that can yield higher tax collection targets include expand the tax base to include the informal sector targeting 2,800 SMEs, and integrate KRA tax system with telecommunication companies.	**Neutral**	**Neutral**
Government Borrowing	• The government, as at 23rd March 2023, was 20.4% ahead of its prorated borrowing target of Kshs 314.2 having borrowed Kshs 378.2 bn of the total borrowing target of Kshs 425.1 bn as per the revised domestic borrowing target for FY'2022/2023. The government has domestic maturities worth Kshs 659.2 bn and will have to borrow Kshs 220.6 bn monthly to meet the upcoming domestic maturities and the budget deficit in the FY'2022/2023, • Kenya has continued to receive financing from the World Bank and other bilateral lenders such as the International Monetary Fund (IMF). In 2022, Kenya received a total of USD 750 mn (Kshs 80.9 bn) under the Development Policy Operation (DPO) from the World Bank and USD 1.7 tn (Kshs 204.0 bn) from the IMF under the 38-month Extended Fund Facility (EFF) and Extended Credit Facility (ECF)-funding program aimed at boosting Kenya's economic recovery process and to strengthen fiscal sustainability through reforms, • Kenya's Public debt as at October 2022 stood at Kshs 8.7 tn, equivalent to 62.3% of GDP, 12.3% points above	• Kenya's rising debt sustainability remains a significant concern with the government's borrowing appetite remaining high given the subdued economic environment coupled with an ever present fiscal deficit, projected at 5.7% of GDP in FY'2022/23. Additionally, the rising debt servicing costs represented 54.2% of the actual revenue collected as the end of February 2023 which continues to put pressure on the government to borrow more in an aim to fund the servicing, • 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 June 2024. This has since raised need to finance it with the government having been phased out on the two Eurobonds that it had announced to issue by June 2022 on the back of increasing interest rates in the Eurobond markets making borrowing more expensive, and, • The initial plans to reduce expenditure for the FY'2022/23 by Kshs 300.0 bn, are yet to materialize with the total	**Negative**	**Negative**

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	the IMF recommended threshold of 50.0% for developing countries, • USD denominated external debt constituted of 69.3% of all external debt as of October 2022 leading to an increase in the debt servicing cost at a time when the Kenyan shilling has depreciated against the dollar to an all-time low	gross budget for FY'2022/23 increasing by 0.4% to Kshs 3,373.3 bn from Kshs 3,358.6 bn. This was initially expected to reduce the current fiscal deficit for FY'2022/2023 by 34.8% to Kshs 562.5 bn from Kshs 862.5 bn. Additionally, the current administration's efforts to boost tax collection such as the draft regulations for the Excise Duty Regulations 2023 will help reduce the budget deficit to 4.3% as targeted in the FY2023/24 Draft Policy Statement.		
Inflation	• Year on year (y/y) inflation rate for February 2023 came in at 9.2%, an increase from 9.0% recorded in January 2023, while the month on month (m/m) inflation increased by 0.2% points. The increase was mainly driven by a 13.3% and 7.6% increase in the food and non-alcoholic beverages index and water, electricity, gas and other fuel index in February 2023 when compared to 12.8% and 7.3% increases in January 2023, respectively, • Notably, Kenya's inflation increased to 9.2%, reversing the easing trend witnessed from November when inflation eased to 9.0% in January 2023, from a 5-Yr peak of 9.6% recorded in October 2022, pointing towards soaring inflationary pressures with regard to food prices, underpinned by supply chain bottlenecks, • Additionally, the Monetary Policy Committee maintained the Central Bank Rate to 8.75% in their January 2023 meeting to allow the effect of the November 2022 interest hike to be fully felt in the economy following ease in inflationary pressures as witnessed in November 2022, December 2022 and January 2023. Despite the monetary stance, we still believe that the inflationary pressures are due to external shocks, driving the high food and fuel prices and a decline is largely pegged on how soon global supply chains stabilize.	• We expect inflation rates to remain elevated in the short term arising from high fuel prices due the partial removal of fuel subsidies by the current regime. Further, we expect the current administration to completely do away with the fuel subsidies in the coming months as they are unsustainable, inflating the import bill. Notably, despite the global fuel prices dropping by 35.5% to USD 75.9 per barrel as of 16th March 2023, from a peak of USD 117.7 per barrel recorded on 1st June 2022 and the decline in landing costs, super petrol price increased by Kshs 2.0 while prices of Diesel and Petrol remained unchanged. This was significantly weighed down by the partial removal of fuel subsidies. As such, we expect the cost of production to remain high as fuel is a major input to many businesses, • Additionally, we expect food prices to remain elevated in the short term, given the uneven weather patterns and drought experienced in 2022 that have reduced the country's food security. However, the agricultural sector is expected to be supported by the recent fiscal policies such as subsidizing costs of crucial farm inputs such as fertilizers, and ongoing importation of duty-free rice, maize and sugar. As a result, these measures will lower the cost of farming and result in a drop in food prices, respectively.	**Negative**	**Negative**

Currency (USD/Kshs)	• Since the last meeting, the Kenyan Shilling has depreciated by 5.3% against the US Dollar to Kshs 131.0 as at 23rd March 2023, from Kshs 124.4 recorded on 30th January 2023 mainly attributable to increased dollar demand from commodity and energy sector importers, and, • Forex Reserves declined by 6.4% to USD 6.6 bn (equivalent to 3.7 months of import cover) as of 23rd March 2023 from USD 7.0 bn (equivalent to 3.9 months of import cover) recorded in 27th January 2023. Notably, the forex reserves are below the statutory requirement of maintaining at least 4.0 months of import cover as well the EAC region's convergence criteria of 4.5 months of import cover.	• 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 is expected to be weighed down further by the depleted forex reserves, currently at USD 6.6 bn (equivalent to 3.7 months of import cover) and below the statutory requirement of 4.0 months of import cover. Moreover, diaspora remittance has declined by 3.8% y/y to USD 309.2 mn in February 2023, from USD 321.5 mn recorded in February 2022, • We also expect that the recent interest hikes in developed economies, such as the interest hike by the U.S Fed to a range of 4.75%-5.00%, from a range of 4.50%-4.75%, as well as, the European union to 3.50% from 3.00% to exert downward pressure on the value of the Kenyan currency	**Negative**	**Negative**
GDP Growth	• Kenyan's economy recorded a 4.7% growth in Q3'2022, lower than the 9.3% growth recorded in Q3'2021, pointing towards a slower economic growth. The performance was driven by i. Accommodation and food services sector which recorded the highest growth rate of 22.9% in Q3'2022, however slower than the 127.5% growth recorded in Q3'2021, remained resilient during the quarter mainly driven by relaxation of COVID-19 travel restrictions that has seen increased visitor arrivals through the Jomo Kenyatta and Moi International airports, ii. The subdued growth in the agricultural sector which is a main contributor to the country's GDP, with Agriculture, Forestry and Fishing activities recording a decline of 0.6% in Q3'2022 compared to a growth of 0.6% in Q3'2021, due to unfavorable weather conditions which has undermined agricultural production. Notably, agriculture production was further worsened by expensive farm inputs necessitating the government to subsidize fertilizers	• We expect Kenya's GDP to continue growing at a slower pace in tandem with the global economy amid fears of a global recession. However, the economy will be supported by recovery in sectors like accommodation and food services sector, as well as recent fiscal policies such as subsidizing costs of crucial farm inputs such as fertilizer are expected to support growth in the agriculture sector, which remains as Kenya's largest contributor to GDP, • However, risks lie on the downside, given the elevated inflationary pressures which have continued to weigh on the business environment, as well as the expensive agricultural inputs that remain elevated above pre-pandemic levels impeding agricultural output • Notably, the country's PMI for the month of February dropped 46.6, the first in six months to fall below the 50.0 threshold, pointing towards a deterioration of business environment in the Kenyan private sector. Nonetheless, optimism regarding growth prospects for the Kenyan and global economy remained high as per the CBK's CEOs survey-January 2023. This was attributed to declining concerns surrounding global inflationary pressures, recessionary fears and geopolitical tensions	**Neutral**	**Neutral**

Private Sector Credit Growth	• The latest data from CBK indicates that private sector credit growth continues to recover having grown by 12.5% y/y growth in December 2022, 3.9% points higher than the 8.6% growth recorded in the same period in 2021 as demand recovered following the increased economic activities	• We expect the general business environment to remain subdued in the short term mainly as a result of elevated inflationary pressures consequently pushing the prices of commodities hence curtailing private sector credit growth, • We anticipate the adoption of the risk based pricing model in the banking sector to continue to unlock access to credit to individuals and businesses who were not captured by the previous frame works 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 the infrastructure bond IFB1/2023/017 hitting an all-time high of 14.4%, effectively edging out majority of the corporate bonds currently in the trading in market	**Neutral**	**Neutral**
Liquidity	• Liquidity levels in the money markets tightened, with the average interbank rate for the period ending 24th March 2023 coming in at 7.2%, 0.9% points higher than the 6.2% recorded in the period prior to the January 2023 meeting, partly attributable to tax remittances that offset government payments	• The first three months of 2023 have experienced tightened liquidity, with the interbank rate reaching a high of 7.4% as at 24th March 2023, the highest it has been since 22nd October 2019. • However we expect liquidity is expected to be supported by: i. High domestic debt maturities that currently stand at Kshs 444.8 bn worth of T-bill maturities and Kshs 214.4 bn worth of T-bond maturities for FY'2022/2023, and, ii. Low Cash Reserve Ratio (CRR) currently at 4.25% from 5.25% previously which continues to support private sector credit growth	**Positive**	**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 central bank rates, given the elevated inflation rates. In the United States, the y/y inflation for the month of February 2023 eased to 6.0% from 6.4% in January 2023, but remained 4.0% points above the 2.0% target. As a result on 22nd March 2023, the United States Federal Bank Monetary Policy Committee opted for a 25.0 bps interest rate hike, to the range of 4.75%-5.00%, from 4.50%-4.75% in a bid to lower inflation, despite the banking sector stability concerns. Additionally, in their most recent sittings England, Australia and Ghana also increased their rates while Malaysia and China maintained their rates. We expect continuous 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 and other countries. 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;

Cytonn Report: Monetary Policy stances around the globe					
No	**Country**	**Central Bank**	**Previous Rate**	**Current Rate**	**Change (% Points)**
1	Malaysia	Bank Negara Malaysia	2.75%	2.75%	Unchanged
2	China	Bank of China	3.65%	3.65%	Unchanged
3	England	Bank of England	3.50%	4.00%	0.50%
4	Australia	Reserve Bank of Australia	3.35%	3.60%	0.25%
5	USA	Federal Reserve	4.50% - 4.75%	4.75% - 5.00%	0.25%
6	Ghana	Bank of Ghana	27.00%	28.00%	1.00%
7	Canada	Bank of Canada	4.25%	4.50%	0.25%
8	South Africa	South Africa Reserve bank	7.00%	7.25%	0.25%
9	Euro Area	European Central bank	3.00%	3.50%	0.50%

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 increase the Central Bank Rate (CBR) by 25 bps to 9.00% from the current rate of 8.75% with their decision mainly being supported by:

1. The need to bring down inflation to the government's target range of 2.5%-7.5%. Inflation for the month of February increased to 9.2%, a reversal from the easing in inflation pressures experienced in the months of November, December and January 2023. Going forward, inflation is expected to remain elevated in the short term driven by the high fuel and food prices. Additionally, we expect the fuel prices to rise as the current administration plans to completely do away with the fuel subsidy program and adjust the domestic fuel prices to ease pressure on expenditure. Further, we expect food prices to remain elevated in the short term, due to the erratic weather patterns and as the measures being taken by the current administration to address food security concerns take effect. As such, we expect the MPC to increase the CBR as it seeks to anchor inflation, given that its main role is maintaining price stability, and,
2. The need to support the shilling from further depreciation as other Central Banks raise their rates. Year to date, the Kenyan shilling has depreciated by 6.4% to an all-time low of Kshs 131.3 as at 24th March 2023, from Kshs 113.1 recorded at the beginning of 2023, adding to the 9.0% depreciation recorded in 2022. The depreciation is mainly attributable to increased dollar demand in the oil and energy sectors as a result of high fuel prices. The high crude oil prices have inflated Kenya's import bill and as a result, petroleum products imports have continued to weigh heavily on the country's import bill, and accounted for 27.6% of the total import bill in Q3'2022, up from 25.6% in Q2'2022 and much higher than 15.2% recorded in Q3'2021. Moreover the interest rates hikes in developed economies with USA and the Euro Area increasing their rates to the range of 4.75%-5.00% and 3.50%, respectively in March 2023 is expected to significantly put pressure on the Kenyan shilling. Key to note, forex reserves have been under pressure coming in at USD 6.6 bn as at 23rd March 2023, representing 3.7 months of import cover, below the statutory requirement of maintaining at least 4.0-months of import. As such, this put pressure on the Central Bank to pursue additional policy measures to slow the accelerated depreciation of the shilling.

Notably, despite the macroeconomic indicators being inclined towards an increase in the Central Bank Rate with focus on easing inflation while supporting the Kenyan currency, the committee must be cautious as the country's economic growth has been declining. This is evidenced by Kenya's economy recording a 4.7% growth in Q3'2022 pointing towards slower economic growth as compared to the 5.2% and 9.3% expansion rates recorded in Q2'2022 and Q3'2021, respectively. As such, an increase in the Central Bank Rate (CBR)

to 9.00% from the current 8.75% is expected to unleash further negative impacts on the local economy amid a deteriorated local business environment and continued global shocks.

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