Cytonn Note on the 30th May 2022 Monetary Policy Committee (MPC) Meeting

The Monetary Policy Committee (MPC) is set to meet on Monday, 30th May 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 Tuesday 29th March 2022, the committee decided to reconvene in May 2022, while highlighting that they would remain ready to reconvene earlier if necessary. Additionally, the MPC maintained the CBR at 7.00% for the thirteenth 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. February inflation eased to 5.1%, from 5.4% recorded in January 2022. 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 0.8% 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 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 8.0 bn (equivalent to 4.9 months of import cover) as of 18th March 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 March 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 1.54 tn, equivalent to 102.0% of the prorated estimates of Kshs 1.50 tn. On the other hand, the Monetary Policy Committee also noted that the current account deficit to GDP was estimated at 5.6% in February 2022, a 0.4% point increase from 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. Additionally, private sector credit growth was slower at 9.1% in February 2022, as compared to 9.6% in February 2021. Notably, the private sector growth increased by 0.5% points in February 2022 from 8.6% recorded in December 2021.

Below, we analyze the trends of the macro-economic indicators since the March 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 March 2022	Our Expectation Going forward	CBR Direction (March)	Probable CBR Direction (May)
Government Revenue Collection	• Total revenue collected as at the end of April 2022 amounted to Kshs 1,536.8 bn, equivalent to 85.0% of the original estimates of Kshs 1,808.3 bn and was	• We expect the continued implementation of the Finance Act 2021 which brought changes to the Excise Duty Tax, Income Tax as well as the Value Added Tax to	**Positive**	**Positive**

	102.0% of the prorated estimates of Kshs 1,506.9 bn • The strong revenue performance is 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. Improved business environment due to relaxation of COVID-19 containment measures locally and globally, and, iii. The widening of the tax base following the implementation of Finance Act 2021 has continued to support the recovery of revenue collection	continue to expand the tax revenue collected and consequently enhance revenue collection. Additionally, we expect the proposed changes under the Finance Bill 2022 to further widen the scope of Revenue Collection, with proposed changes such as increasing Digital Service Tax to 3.0% from 1.5% in FY'2021/2022 expected to further increase the tax revenue, • The sustained 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, and, • KRA has embarked on aggressive revenue collection and compliance efforts which saw them surpass their revenue collection targets by 2.0% in the ten months leading to April 2022 having collected Kshs 1.54 tn against a target of Kshs 1.51 tn. These efforts are expected to continue boosting revenue collection.		
Government Borrowing	• The Government, as of 20th May 2022, was 4.6% ahead of its prorated borrowing target of Kshs 600.2 bn having borrowed Kshs 627.9 bn and has domestic maturities worth Kshs 664.0 bn. The government will have to borrow Kshs 27.1 bn monthly to meet its domestic borrowing target of Kshs 664.0 bn in the 2021/2022 fiscal year, • Kenya has continued to receive financing from the World Bank and other bilateral lenders such the International Monetary Fund (IMF) in a bid to support Kenya's COVID-19 recovery process. In March 2022, the World Bank, advanced Kshs 750.0 mn (Kshs 85.8 bn) to help strengthen fiscal sustainability through reforms. This adds to the loans received from the IMF and the World Bank totalling USD 1.9 bn (Kshs 210.2 bn). Kenya's Public debt as at March 2022 stood at Kshs 8.4 tn, with domestic debt coming in at Kshs 4.2 tn (49.9% of total debt stock), while external debt composed of Kshs 4.2 tn (50.1% of total debt stock). The Public debt to GDP ratio came in at 67.8%, and, • Kenya's debt continues to balloon, especially USD denominated external debt which constituted of 67.0% of all external debt as of December 2021. This will further increase the debt servicing cost given that the Kenyan shilling continues to depreciate against the dollar	• The Public Debt to GDP ratio as at March 2022 stood at 67.8%, which is 17.8% 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. This has however been temporarily shelved by the government due to increase interest rates in the Eurobond markets which will make borrowing at this time more expensive. Year to date,	Negative	Negative

		Kenyan Eurobonds' rates have increased by an average of 5.3% points to 11.9% on average from 6.6% at the beginning of the year.		
Inflation	• Year on year inflation rate for April 2022 came in at 6.5%, from the 5.6% recorded in March 2022, while the m/m inflation increased by 1.7%. The increase was mainly driven by a 3.0% increase in food & non-alcoholic beverages coupled with a 2.8% increase in the transport index following the surge in global oil prices	• We expect it to remain within the Government's target range of 2.5%-7.5% in the short term, • However, concerns remain high on the widening trade deficit as global fuel prices continue to rise due to supply bottlenecks. Additionally, the geopolitical pressures following the Russia – Ukraine conflict further worsens the situation, • Super petrol, diesel and kerosene prices 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, from Kshs 144.6 per litre, Kshs 125.5 per litre and Kshs 113.4, respectively for the period 15th May 2022 to 14th June 2022. 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.	**Neutral**	**Neutral**
Currency (USD/Kshs)	• Since the last meeting, the Kenyan Shilling has depreciated by 1.4% against the US Dollar to an all-time low of Kshs 116.5 as of 23rd May 2022, from Kshs 114.8 on 29th March 2022, mainly attributable to increased dollar demand from commodity and energy sector importers, and, • Forex Reserves increased by 5.8% to USD 8.3 bn (equivalent to 4.9 months of import cover) as of 19th May 2022 from USD 7.8 bn (equivalent to 4.7 months of import cover) recorded in March 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 4.5-months of import cover.	• We project 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 8.3 bn (equivalent to 4.9 months of import cover) which will be boosted by; i) the recently issued USD 750.0 mn (Kshs 85.8 bn) loan in March 2022 from the World Bank, ii) the expected USD 244.0 mn from the International Monetary Fund (IMF), and, iii) the improving diaspora remittances evidenced by a 18.6% y/y increase to USD 355.0 mn in April 2022, from USD 299.3 mn recorded over the same period in 2021.	**Neutral**	**Negative**
GDP Growth	• Kenya's economy expanded by 7.5% in 2021, up from the 0.3% contraction	• We expect Kenya's economy to continue growing, albeit at a gradual pace, in tandem with the global economy as most	**Neutral**	**Neutral**

	recorded in 2020. The performance was driven by; i. Strong rebound in the Accommodation and food sector which recorded a 52.5% growth in 2021 compared a 47.7% contraction recorded in 2020, ii. A 21.4% growth in the Education in 2021 in comparison to the 9.3% contraction recorded in 2020, and, iii. A 7.9% growth in the wholesale and retail trade sector as compared to the 0.5% contraction recorded in 2020, iv. A 6.9% growth in the Manufacturing Sector in 2021 in comparison to the 0.4% contraction recorded in 2020.	sectors of the economy continue to recover. The lifting of all COVID-19 related restrictions is expected to continue 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, • However, April's PMI declined to 49.5 from 50.5 recorded in March 2022, marking an 11-month low, pointing towards a deteriorating business environment in the country on the back of an increase in input costs, marking an eight – year high and a decline in output on the back of persistent supply chain constraints which led to increased cost pressures, and, • We also 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.		
Private Sector Credit Growth	• The latest data from CBK indicates that private sector credit growth recorded a 10.9% growth in March 2022, 1.8% points higher than the 9.1% growth recorded in February 2022 as demand recovered following the increased economic activities. Key to note, the 10.9% growth is the highest ever recorded since May 2011, when it came in at 11.1%.	• We expect the improving operating environment in the country to continue supporting private sector credit growth, • 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.	**Neutral**	**Neutral**
Liquidity	• Liquidity levels in the money markets eased slightly, with the average interbank rate since the last meeting on 29th March 2022 coming in at 4.6%, a 0.2% decline from 4.8%, as was recorded in the period prior to the March 2022 meeting, supported by tax remittances which offset government payments	• Liquidity is expected to remain favourable due to: i. High domestic debt maturities for FY'2021/2022 that currently stand at Kshs 105.4 bn worth of T-bill maturities and Kshs 68.0 bn worth of T-bond maturities as at 20th May 2022, and, ii. Low Cash Reserve Ratio (CRR) currently at 4.25% from 5.25% previously. As a result, Private sector credit has grown at an average of 9.6% in the three months of 2022, as compared to 8.9% in the first three months in 2021.	**Neutral**	**Positive**

Conclusion

Of the seven factors that we track, two are negative, three are neutral and two are positive. Notably, there has been sustained activity of the Central Banks of developed economies around the world in a bid to raise 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, the United States Federal Bank Monetary Policy Committee, increased its benchmark interest rates by 0.5% points to a range of 0.75% - 1.00%. Key to note the 0.5% points increase is the largest since 2000 and is in an attempt to curtail inflation, with the y/y inflation for the month of April, peaked at 8.3%, 6.3% points above the 2.0% target. Similarly, The Australia Central Bank raised its cash rate by 0.25% points to 0.35% in May 2022, the first hike in over a decade. This also follows burgeoning inflation that has reached 5.1%, above the Australian Central Bank's target of 2.0% - 3.0%. In England, the Bank of England increased its bench mark interest rates by 0.25% points to 1.0%, while China and Malaysia maintained their rates. Closer to home, the Bank of Ghana increased the benchmark lending rates by 2.0% points to 19.0%, from 17.0% mainly informed by the surging inflation that hit 23.6% in April 2022, well above the Bank of Ghana's target range of 6.0%-10.0%. We expect continued 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	Malaysia	Bank Negara Malaysia	1.75%	1.75%	Unchanged
2	China	Bank of China	3.70%	3.70%	Unchanged
3	England	Bank of England	0.75%	1.00%	0.25% points
4	Australia	Reserve Bank of Australia	0.10%	0.35%	0.25% points
5	USA	Federal Reserve	0.00% - 0.25%	0.75% - 1.00%	0.5% points
6	Ghana	Bank of Ghana	17.00%	19.00%	2.0% 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 7.5% growth in 2021, up from the 0.3% contraction recorded in 2020. Additionally, there has been impressive performance in revenue collections of Kshs 1.5 tn during the first ten months of the current fiscal year, which was equivalent to 102.0% 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 Russia – Ukraine 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 Super petrol, diesel and kerosene prices increasing 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. April inflation increased to 6.5%, from 5.6% recorded in March, supported by the stability in fuel due to the fuel subsidies under the Petroleum Development fund. However, given the persistent supply constraints which have been worsened by the Russia - Ukraine conflict, 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 geo-political tensions 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 1.4% to an all-time low of Kshs 116.5 as of 23rd May 2022, from Kshs 114.8 recorded on 29th March 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 18.6% y/y increase to USD 355.0 mn in April 2022, from USD 299.3 mn recorded over the same period in 2021. As such, this will reduce pressure on the Central Bank to pursue any additional policy measures. The shilling has received support from Forex reserves which have remained stable and adequate since the year at Kshs 8.3 bn (equivalent to 4.9 months of import cover) as of 20th May 2022, as was recorded in January 2022.