KENYA | MACROECONOMIC UPDATE | MONETARY POLICY | INSIGHTS

## FUNDAMENTALS

# KENYA MPC UPDATE: PEDAL ON THE MEDAL

**Economist**
Churchill Ogutu
+254 711 796 739
churchill.ogutu@ic.africa

# IN BRIEF

- The Central Bank of Kenya (CBK) delivered a higher-than-expected rate hike (75bps -vs- 25bps consensus) at its March 2023 monetary policy committee meeting, taking the policy rate to 9.50%. Belatedly, the policy rate is now ahead of the (ex-post) inflation (Feb-2023: 9.2%).

- The CBK acknowledged that Feb-2023 inflation surprised to the upside (+180bps), mainly driven by the vegetable segment in the food inflation. Although the reaction function is blunt to address the supply-induced inflationary shocks, the MPC emphasized its intent to prevent second-round effects entrenching.

- We expect FX convertibility risk to abate in the near-term. Anecdotal evidence suggests that the FX interbank market has been reactivated, leading to a narrowing between the commercial banks' executed USD rate and the CBK official rate.

- Although the external FX buffer of USD 6.6bn - equivalent to 3.7months of import cover – is a concern, we are bullish on its near-term outlook. We estimate FX reserves at USD 7.9bn (c. 4.5months of import cover) at the end of FY23, bolstered by financing inflows.

- As monetary policy normally acts with 'long and variable lags', we thus expect the 75bps rate hike to slowdown 1Q2023 growth prospects. The previous monetary policy effects (cumulative 125bps in tightening) have started creeping in with private sector credit growth at 11.7% y/y (February 2023); 100bps below the 1Q2023 target

- Domestic borrowing in FY23 is trailing the curve with 67.8% (KES 295.0bn in aggregate terms) achieved hitherto, implying investors will demand a term premium at the remaining primary bond auctions. Coupled with the higher inflationary expectations, this should dial upwards rates in 2Q2023.

## Better late than never?

The Central Bank of Kenya (CBK) delivered a higher-than-expected rate hike (75bps -vs- 25bps consensus) at its March 2023 monetary policy committee meeting, taking the policy rate to 9.50%. Belatedly, the policy rate is now ahead of the (ex-post) inflation (Feb-23: 9.2%). The MPC pointed at the approved new electricity tariff scheduled to take effect from April 1, 2023, coupled with the higher inflationary expectations from its pre-meeting surveys as its proximate cause of concern. Furthermore, the indication is that the FX interbank market has improved, with a slight narrowing in the commercial banks' executed FX rate with the apex bank's official FX rate. Therefore, in the classical sense, we expect the policy rate hike to take pressure off further KES weakening. Notwithstanding, the pedal on the medal stance risks clouding the real sector near-term outlook.

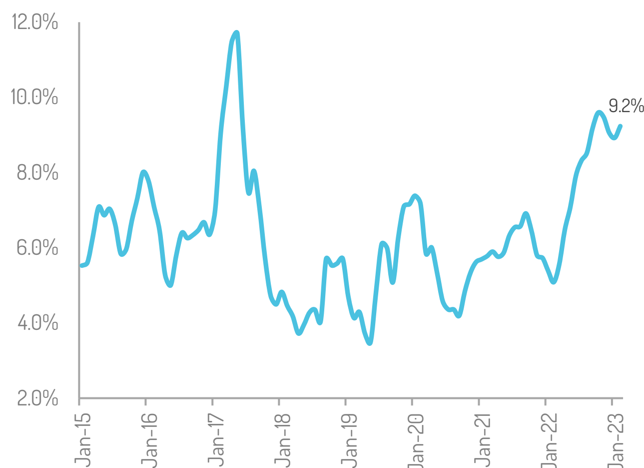
## What 75bps hike can achieve that a 25bps would not

Top of investors' mind is the question; "what does the CBK know that the market does not?" Heading into the March MPC meeting, prices in the cash market (91-Day through 364-Day T-Bills) had jumped an average of 59bps since the last rate hike (November 2022 MPC meeting). This month's primary bond auction – 17-year infrastructure bond with a 13.5-year weighted life – was priced c.61bps higher than the next similar tenured bond. Taking these directional moves to reflect near-term inflationary expectations, the market penciled in the odds of a 25-50bps rate hike in this meeting.

The central bank offered clues behind its hike quantum. The "CEO and Market Perceptions" Surveys conducted ahead of the policy meeting painted a somewhat dim outlook. KES sharp depreciation (6.6% YTD), prolonged drought and shortage of some raw materials has de-anchored inflation expectations. Furthermore, the CBK acknowledged that the Feb-2023 inflation surprised to the upside (+180bps -vs- the 7.40% in-house projection), mainly driven by the vegetable segment in the food inflation. Although the reaction function is blunt to address the supply-induced inflationary shocks, the MPC emphasized its intent to prevent second-round effects from entrenching.

On this note, the proposed end-user electricity tariff, scheduled to take effect on April 1, 2023, was clearly at the MPC's crosshairs. Domestic and small commercial customers consuming > 30kWh monthly, will bear the biggest brunt of the upward adjustment - 15.8% in the remainder of FY23 and 13.3% in FY24 – as the newer electricity end-user tariff kicks in. We thus see negative passthrough effect of the higher electricity prices feeding into higher inflationary expectations, and second-round effects.

### INFLATION




SOURCE: KENYA NATIONAL BUREAU OF STASTICS, CENTRAL BANK OF KENYA

## Easing FX convertibility risk; positive for KES

We expect FX convertibility risk to abate in the near-term. Anecdotal evidence suggests that the FX interbank market has been reactivated, leading to a narrowing between the commercial banks' executed USD rate and the CBK official rate. This has led to a normalization of USDKES volatility in the last two weeks of March, but a premium of c. 2.0% - 5.0% on the commercial banks' rate implies FX price discovery is yet to be fully achieved. We hold the view that the attendant publishing of the Kenya FX Code will anchor enhanced FX interbank market activity going forward.

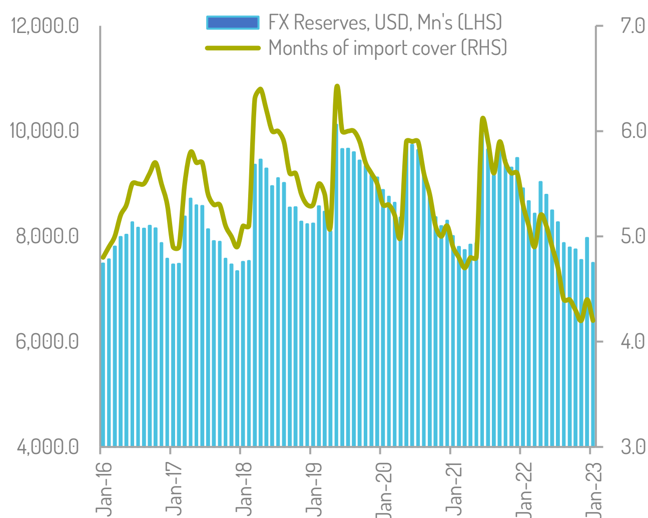
Although the external FX buffer – USD 6.6bn equivalent to 3.7months of import cover – is a concern, we are bullish on its near-term outlook. We estimate FX reserves at USD 7.9bn (c. 4.5months of import cover) at the end of FY23, bolstered by financing inflows. The World Bank is considering a USD 1.0bn Development Policy Operation (DPO) loan with authorities, while there is expectation that the syndicated loan totaling USD 600mn will close out by end April 2023. Together with the IMF disbursement following the programme's fifth review, this should give FX reserves the much-needed boost. However, in as much as there has been a victory lap with the recent signing of the government-to-government oil importation deal, – a 6-month credit deal for domestic Oil Marketing Companies (OMCs) and Saudi Aramco and Abu Dhabi National Oil Company (ADNOC) – the kicking-of-the-can-down-the-road signals pressure on FX reserves in the medium-term.

## Watching an accident in slow motion

In our assessment, there are downside risks to growth. On a more fundamental basis, agriculture sector (25.0% sector weighting) is still reeling from the prolonged drought and may drag lower the 2023 outlook. As such, the CBK estimates 2023 growth will be lower at 5.8%, down from earlier projected 6.0%. The ongoing bi-weekly (Mondays and Thursdays) anti-government demonstrations and protests by the Opposition camp, largely concentrated in lower income Nairobi areas and select cities with high Opposition support, is also another pressure point that may morph into a tail risk.

As monetary policy normally acts with 'long and variable lags', we thus expect the 75bps rate hike to slowdown 1Q2023 growth prospects. The CBK estimates that the policy action takes about 3 - 8 months to filter through the economy. The previous monetary policy effects (cumulative 125bps in tightening) have started creeping in with private sector credit growth at 11.7% y/y (February 2023); 100bps below the 1Q2023 target. Extrapolating this metric, factoring in the latest policy stance, implies a miss on its 13.8% y/y 2023-end target.

**FX RESERVES**




SOURCE: THE CENTRAL BANK OF KENYA

## Term premium to dial rates higher in 2Q 2023

We opine that T-Bills will trend higher by an average of 25bps as the market adjusts to the monetary policy stance. This should take the 91-day T-bill yield above the psychological 10.0% level (currently at 9.9%). The market has telegraphed some liquidity stress as the weighted average KES interbank rate is at a 42-month high of 7.7%. This has, in turn, influenced the reverse repo transactions between the Central Bank and the commercial banks as it injects liquidity into the system.

Worth noting is the sell buyback transactions in March 2023. Although average daily volume (KES 1.7bn) for sell buybacks pales volumes transacted in the vertical repo market (KES 9.1bn), this belies the fact that these transactions are signaling a shift from Available-for-sale to Held-to-Maturity accounting treatment for the underlying securities. Put differently, there is a preference of taking duration risk over interest rate risk, suggesting expectations of higher rates going forward.

We take this argument further. From a fiscal perspective, the announced reduction of net domestic borrowing in FY23 from the initial KES 581.7bn to the revised KES 435bn, dictates that real rates should trend lower in 2Q2023 (final quarter of FY23). But, with domestic borrowing behind the curve with 67.8% (KES 295.0bn in aggregate terms) achieved hitherto, this means that investors will demand term premium at the remaining primary bond auctions. Given the higher inflationary expectations coupled with the unmet domestic borrowing requirements, rates should dial upwards in 2Q2023.

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## For more information contact your IC representative


### Business development & client relations

**Derrick Mensah**
Head, Business Development
+233 24 415 5765
derrick.mensah@ic.africa

**Dora Youri**
Head, Wealth Management
+233 23 355 5366
dora.youri@ic.africa

**Kelvin Quartey**
Analyst, Business Development
+233 57 604 2802
kelvin.quartey@ic.africa

### Corporate Access

**Joanita Hotor**
Corporate access
+233 50 137 6100
Joanita.hotor@ic.africa

### Insights

**Courage Kingsley Martey**
Head, Insights
+233 240 970 832
courage.martey@ic.africa

**Churchill Ogutu**
Economist
+254 711 796 739
churchill.ogutu@ic.africa

**Lydia Adzobu**
Senior Analyst, Financial sector
+233 24 656 8669
Lydia.adzobu@ic.africa

### Investing

**Isaac Adomako Boamah**
Chief Investment Officer
030 225 2623
isaac.boamah@ic.africa

**Obed Odenteh**
Portfolio Manager, Fixed Income
+233 54 707 3464
obed.odenteh@ic.africa

**Timothy Schandorf**
Portfolio Manager, Risk Assets
+233 24 292 2154
Timothy.schandorf@ic.africa

**Herbert Dankyi**
Analyst, Rates
+233 55 710 6971
herbert.dankyi@ic.africa

**Clevert Boateng**
Analyst, Consumer, Technology, Media & Telecommunication
+233 24 789 0452
clevert.boateng@ic.africa

### Operations

**Nana Amoa Ofori**
Chief Operating Officer
+233 24 220 6265
nanaamoa.ofori@ic.africa

**Emmanuel Amoah**
Fund Administrator
+233 20 847 2245
emmanuel.amoah@ic.africa

**Kelly Addai**
Fund Accountant
+233 20 812 0994
kelly.addai@ic.africa

### Trading

**Randy Ackah-Mensah**
Head, Global Markets
+233 24 332 6661
randy.amensah@ic.africa

**Allen Anang**
Equities,Trader
+233 54 084 8441
allen.anang@ic.africa

**Isaac Avedzidah**
Trader, Fixed Income
+233 24 507 7382
isaac.avedzidah@ic.africa



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