KENYA | MACROECONOMIC UPDATE | MONETARY POLICY | INSIGHTS

FUNDAMENTALS

KENYA MPC UPDATE: INTERBANK STRAINS POINT TO AUGUST MPC PAUSE

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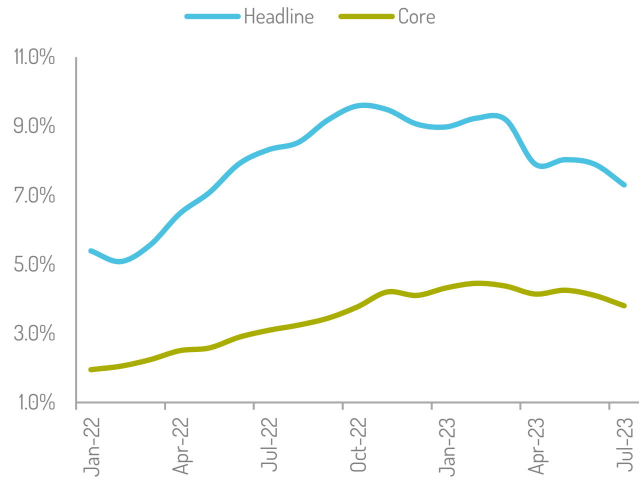
IN BRIEF

- We expect a pause in the upcoming Central Bank of Kenya MPC meeting that is scheduled for this Wednesday 9 August 2023. The "out of calendar" meeting is a doubling down of the emergency MPC meeting that was held in late June; the first policy meeting under the new Governor Dr. Kamau Thugge.
- With central banking psychology biased towards data dependency, we opine that the upcoming MPC meeting gives the policymakers two inflation data sets (June 2023 and July 2023) that were published following the June 2023 emergency MPC meeting.
- Nevertheless, July 2023 inflation at 7.3% eased to target band (5.0% ± 2.5%) for the first time in 14-months. Core inflation decelerated 30bps m/m to 3.80% y/y, which should comfort the policymakers.
- Inflation expectations into the MPC meeting remain de-anchored, exacerbated by the lifting of the conservatory orders that had suspended the implementation of the Finance Act 2023. Although the energy regulator had put into effect the doubling in the fuel VAT as contained in the Finance Act 2023 in its last two price reviews, Pavlovian conditioning signals some higher inflationary bias with the Court of Appeal giving its green light effecting the start of the revenue-raising law.
- Recent developments in the KES interbank market strengthen our view of a neutral policy at the August 2023 MPC meeting. Overnight interbank rate jumped to 17.1% at the end of last week, with interbank spreads widening to 550bps (65bps ahead of the June 2023 emergency MPC meeting).
- Whether the interbank stress has been induced by teething issues with the rolling of the new Central Securities Depository (CSD) system, or whether chaperoned by the CBK to enhance its monetary policy transmission channel, this sets the stage for a neutral policy stance to allow a more orderly interbank market correction.

Out of calendar meeting, an opportune time to test data dependency

We expect a pause in the upcoming Central Bank of Kenya MPC meeting that is scheduled for this Wednesday 9 August 2023. The meeting is "out of calendar" in the sense that it is being held in an even-number month, but this is a doubling down of the emergency MPC meeting that was held in late June; the first policy meeting under the new Governor Dr. Kamau Thugge. As highlighted here, the 100bps hike in the June 2023 emergency MPC meeting was a necessary maneuver ahead of the completion of the fifth review of the IMF programme. This was necessary on account of the runaway inflation that had triggered monetary policy consultation with the multilateral institution following the breach of the metric in the final quarter of 2022. With central banking psychology biased towards data dependency, we opine that the upcoming MPC meeting gives the policymakers two inflation data sets (June 2023 and July 2023) that were published following the June emergency MPC meeting.

INFLATION



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

Inflation back to target band but outlook remains uncertain, pending substantive High Court ruling on the Finance Act 2023

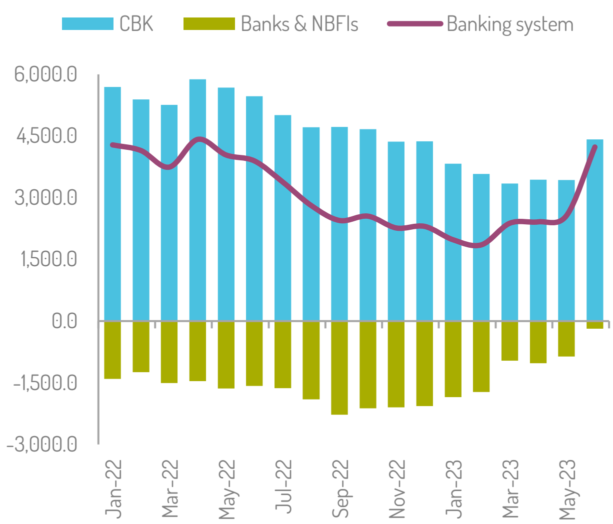
Headline inflation eased to 7.3% in July 2023 and within the target band (5.0% ± 2.5%) for the first time in 14-months. Core inflation decelerated 30bps to 3.8% y/y, which should comfort the policymakers. Similarly, food inflation cooled into single-digit territory of 8.6%, coinciding with the harvest period of select vegetable items. Electricity prices jumped an average 56.2% y/y, following the upward revision of electricity tariff on 1 April 2023. Fuel inflation sustained its upward momentum, printing 14.5% in the review month, in lockstep with the uptick in the underlying fuel pump prices.

Inflation expectations into the MPC meeting remain de-anchored, exacerbated by the lifting of the conservatory orders that had suspended the implementation of the Finance Act 2023. Although the energy regulator had put into effect the doubling in the fuel VAT as contained in the Finance Act 2023 in its last two price reviews, Pavlovian conditioning signals some higher inflationary bias with the Court of Appeal giving its green light effecting the start of the revenue-raising law. That said, the inflation outlook remains less clear-cut, pending the three-judge High Court bench that was appointed by the Chief Justice to give a substantial ruling on the petition that challenged the Finance Act 2023.

FX passthrough may upset the inflation outlook apple cart

The Kenyan Shilling (KES) has weakened 13.8% YTD against the USD, largely with the convergence between the central bank and commercial banks' FX rate. The net foreign liabilities of banks and non-banking financial institutions (NBFI) narrowed to USD 181.8mn in June 2023, a level last recorded in April 2021, and supporting the convergence of the FX rates. We believe the Government-to-Government (G2G) oil importation scheme is the proximate cause of the narrowing in the banks' net foreign liability position. As banks source dollars to meet the payment obligation of this oil credit scheme, this will lead to a buildup in banks' net foreign liabilities. Furthermore, the upcoming final dividend payment by Safaricom may have led to USD accumulation by banks since July 2023. This implies further scope for KES weakness that adds some positive tilt on near-term inflation outlook.

NET FOREIGN ASSETS, USD MN'S

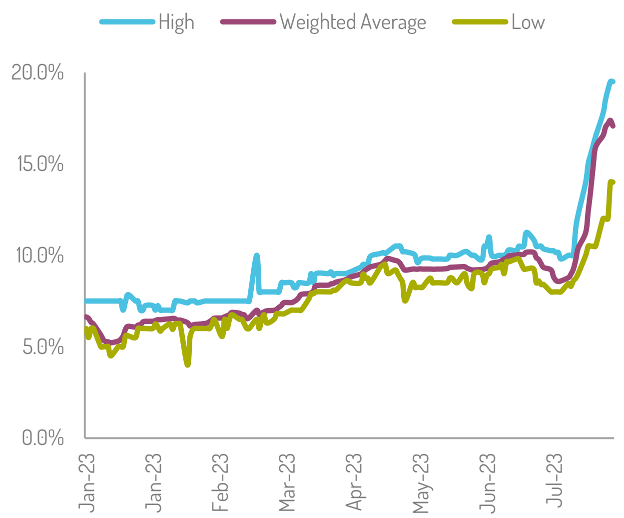


SOURCE: CENTRAL BANK OF KENYA, ICAMMU CALCULATIONS

Interbank vulnerabilities expose monetary policy transmission underbelly

Recent developments in the KES interbank market strengthen our view of a neutral policy at the August MPC meeting. Overnight interbank rate jumped to 17.1% at the end of last week, with interbank spreads widening to 550bps (65bps ahead of the June 2023 emergency MPC meeting). To provide some context; the apex bank recently rolled out its new Central Securities Depository system, dubbed DhowCSD. This is geared to eliminate paper-based processes and enhance liquidity distribution with an enabling of full transfer of collateral for horizontal repo transactions. Anecdotal evidence suggests the suspension of rollovers of Government securities that were maturing on 31st July 2023. Extrapolating this further, we believe that the dearth in open market operations (OMO) in the last two weeks may have been enforced to allow smooth transition to the new Central Securities Depository system. Thus, the cash-starved banks had to meet their Cash Reserve Requirement (CRR) thresholds in the overnight interbank market, as opposed to vertical transactions with the apex bank in OMO, overheating the interbank market.

KES OVERNIGHT INTERBANK MARKET RATES



SOURCE: CENTRAL BANK OF KENYA

There is an argument to be made that the apex bank has chaperoned tightness in the interbank market to enhance its monetary policy transmission channel. In the first three weeks of July 2023, OMO activities were largely skewed towards mopping liquidity in the eight occasions the central bank intervened with average mop-up volume of KES 9.4bn at a weighted average rate of 8.9% (below the CBR rate of 10.50%). Cracks started emerging in the interbank market at the tail end of this period, possibly as the interbank spreads widened to 325bps on 21st July 2023. Further to the interbank spread widening to 550bps as at end of last week, the central bank has acted as the lender of last resort in five occasions in the last two weeks and mirroring strains last witnessed in late October 2015. Also, the outsized rediscounting of T-Bills seemingly by commercial banks puts the final nail on the strained-liquidity coffin, suggesting a more broad-based liquidity concern. Curiously, the central bank injected liquidity via reverse repo on two occasions last week at an average premium of 720bps above the CBR. Whether the interbank stress has been induced by teething issues with the roll-out of the new CSD system, or whether chaperoned by the CBK to enhance its monetary policy transmission channel, this sets the stage for a neutral policy stance to allow a more orderly market correction. A protracted liquidity strain portends to derail private sector credit mediation, which seemingly slowed its momentum in June 2023 with a growth of 12.2% (CBK target: 13.1%).

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