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FUNDAMENTALS

KENYA MPC UPDATE: UNDER THE HOOD OF FX RISK

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IN BRIEF

- The Central Bank of Kenya delivered a surprise 200bps rate hike in its December 2023 MPC meeting, taking the CBR to 12.5%. With November 2023 inflation coming in at 6.8%, within the target band of 5.0% ± 2.5%, the policymakers cited FX pressure as major risk to its inflation outlook.

- The hike was surprising against the backdrop of neutral policy stance in the previous two MPC meetings that were held in August and October 2023. Put differently, what does a 200bps rate hike achieve in December 2023 that 100bps successive rate hikes in August and October 2023, or any other iteration, was unable to achieve?

- The CBK attributed 3.0pp of the November 2023 inflation to FX passthrough. We are of the view that the CBK used fuel inflation as a proxy for the FX passthrough as the sub-index contributed 2.9pp to the month's inflation. Electricity prices and regulated fuel pump prices, which went up by an average 40.0% y/y and 28.8% y/y, respectively, cements our view.

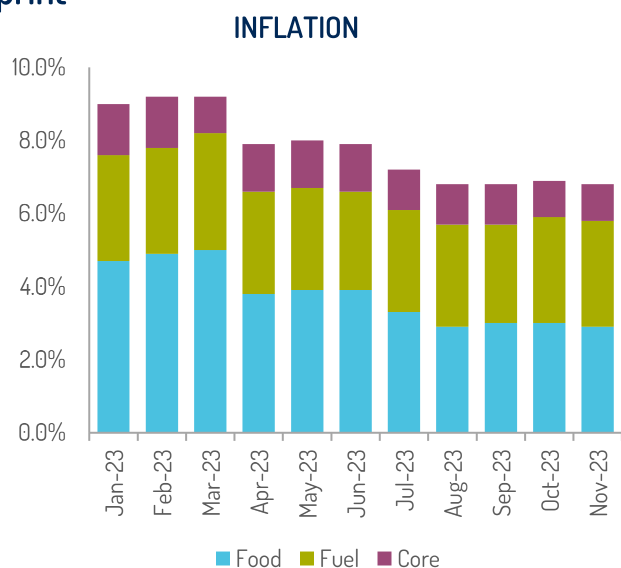
- Our general feeling is that the Governor did not communicate clearly on the targeted 'fair value' of KES. Granted that central bankers adopt Fedspeak as their preferred communication, this oversight left us with many questions. Is CBK telegraphing that as KES hit its 'fair value', the apex bank was not able to anchor KES at this level due to dwindling FX reserves? What does a 200bps achieve in restoring exchange rate stability that other instruments have failed to achieve?

- We believe the triggering of the monetary policy consultation clause (MPCC) is the proximate cause of the rate hike in the latest MPC meeting (and the June 2023 MPC meeting). With average inflation in 2Q2023 at 7.9% and above the upper range of 7.5%, the MPCC was triggered with the jumbo rate hike as a remedial measure. This is the second MPCC trigger in the current IMF programme, the previous one was triggered with the inflation average of 9.4% in 4Q2022.

Surprise rate hike

The Central Bank of Kenya delivered a surprise 200bps rate hike in its December 2023 MPC meeting, taking the CBR to 12.5%. With November 2023 inflation coming in at 6.8%, within the target band of 5.0% ± 2.5%, the policymakers cited FX pressure as a major risk to its inflation outlook. Furthermore, they were mum on whether the jumbo rate hike was unanimous or there was a vote split, although the general tone of the statement was hawkish. The hike was surprising against the backdrop of neutral policy stance in the previous two MPC meetings that were held in August and October 2023. Put differently, what does a 200bps rate hike achieve in December 2023 that 100bps successive rate hikes in August and October 2023, or any other iteration, was unable to achieve? These sorts of questions strengthen our view to look beyond the explicit FX weakness argument as posited by the monetary policymakers. Specifically, we believe that Monetary Policy Consultation Clause (MPCC) considerations were the invisible hand behind the latest decision.

FX passthrough of 3pp in November inflation print



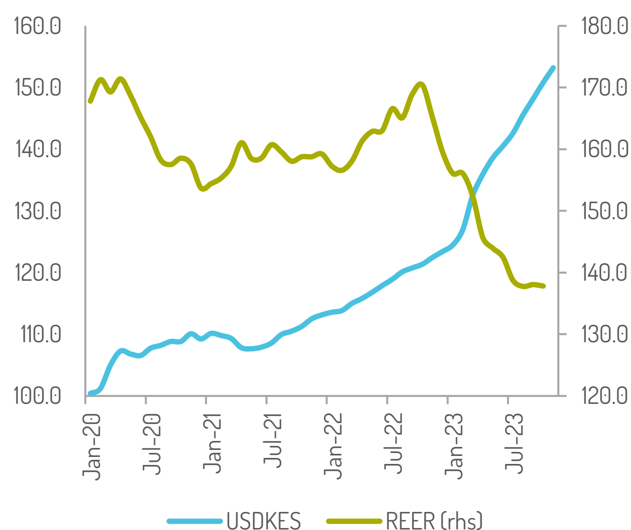
SOURCE: CENTRAL BANK OF KENYA

The November 2023 inflation print (6.8%) prolonged the stickiness that has been entrenched since August 2023. Upward inflation pressure has been acute on transport items and non-vegetable segments. Nevertheless, the outlook remains positive into 1Q2024, largely on favourable base effects and conducive weather conditions that will anchor food inflation. The CBK attributed 3.0pp of the November 2023 inflation to FX passthrough. We are of the view that the CBK used fuel inflation as a proxy for the FX passthrough as the sub-index contributed 2.9pp to the month's inflation. Electricity prices and regulated fuel pump prices, which went up by an average 40.0% y/y and 28.8% y/y, respectively, cements our view.

Whereas FX passthrough has entrenched inflation closer to the upper target, we flag demand compression in the external sector as a potential source of moderation in FX pressures. The current account balance narrowed to -3.9% of GDP in 2Q2023 from -5.1% at the end of 2022 and is expected at -4.1% at the end of the year. This is largely due to narrowing of the merchandize trade balance from a deficit of USD 11.7bn in 2022 to the estimated deficit of USD 9.8bn in 2023. Whereas this looks encouraging from a rear-view mirror, we suspect the MPC is nudging us towards the projected USD 10.6bn merchandise trade deficit in 2024, on further KES weakness. As such, the jumbo rate hike is likely to forestall a ballooning of the merchandize trade deficit. Notwithstanding, we are concerned with the spillover effects of the high proportion of intermediate goods, at c. 70.0% of total imports, to the real sector. Further demand compression implies that the projected 5.9% real GDP growth in 2024 (2023E: 5.5%) by the CBK is ambitious. Unless it is an implicit admission that inflation will trend lower, hence, boosting the real GDP print.

Emphasis on FX risks

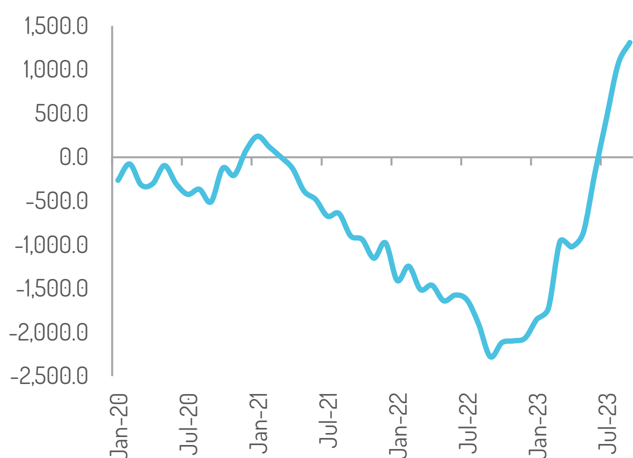
The overarching theme of the December 2023 MPC meeting was the emphasis on FX risks. Although overall YTD KES weakness has been 19.5%, the pace of depreciation has moderated to an average of 1.7% m/m in the 3-month period ending November 2023, down from an average of 2.9% m/m in the 3-month period ending April 2023. We think the ongoing efforts to restore the FX interbank market has somewhat cooled the FX pressures lately despite the Governor admitting a lack of ammunition to prop up the local currency since he took the stint in June 2023. Lifting the lid on USD intervention by the apex bank, the CBK Governor acknowledged that USD 2.8bn (approximately USD 70.0mn per month) was used to prop up the Shilling from 2020 to May 2023.



SOURCE: BLOOMBERG, BRUEGEL

From our assessment of Real Effective Exchange Rate (REER), we note that the overvaluation trend started abating in April 2023, on the back of the currency adjustment following the restoration of the FX interbank market. The monetary authorities doubled down with an FX Code of Conduct and launched an Electronic Matching System, to fully operationalize the FX interbank market. The apex bank further acknowledged using moral suasion on some banks suspected of violating the FX Code of Conduct although did not get into the specifics. We view the recent reforms and the currency adjustment in a positive light to correct the observed overvalued currency.

NET FOREIGN ASSETS HELD BY BANKS, USD MN'S



SOURCE: ICAMMU ESTIMATES

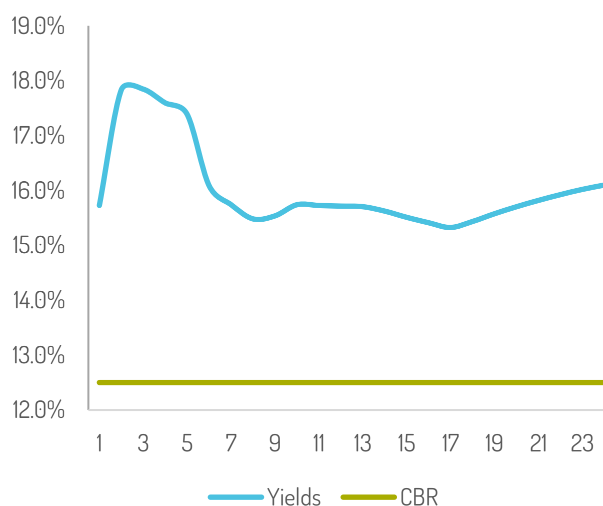
Our general feeling is that the Governor did not communicate clearly on the targeted 'fair value' of KES. Granted that central bankers adopt Fedspeak as their preferred communication, this oversight left us with many questions. Is CBK telegraphing that as KES hit its 'fair value', the apex bank was not able to anchor KES at this level due to dwindling FX reserves? What does a 200bps achieve in restoring exchange rate stability that other instruments have failed to achieve? Aside from these rhetorical questions, one positive theme that we like is the swing in banks' net foreign position from a liability of USD 2.3bn in September 2022 to asset of USD 1.3bn in September 2023; levels last seen in 2Q2008. Proxying banks' net foreign liabilities with foreign currency deposits of USD 9.5bn in September 2023, we estimate foreign assets of USD 10.8bn in banks. With the sledgehammer approach in the latest monetary policy decision, this poses a risk to foreign asset mobilization in the banking sector going forward. Although the focus has been on the overall financial sector stability and toxic assets, we foresee a retracement in the foreign asset accumulation by banks going forward.

IMF's invisible hand

One of the questions we have grappled with is on the timing of the rate hike, with our inflation outlook expected to be within target and on the backdrop of MPC maintaining a neutral stance in August and October 2023 meetings. We believe the triggering of the monetary policy consultation clause (MPCC) is the proximate cause of the rate hike in the latest MPC meeting (and the June 2023 MPC meeting). Kenya reached a staff-level agreement with the IMF last month although the Executive Board approval is expected in January 2024. With average inflation in 2Q2023 at 7.9% and above the upper target range of 7.5%, the MPCC was triggered with the jumbo rate hike as a remedial measure. This is the second MPCC trigger in the current IMF programme as the previous one was triggered with the inflation average of 9.4% in 4Q2022. Interestingly, we observe a developing pattern here. The first MPCC trigger necessitated the "unscheduled" June 2023 MPC meeting that resulted in 100bps rate hike, ahead of Executive Board approval in July 2023. The second MPCC trigger has resulted in a 200bps rate hike in the latest MPC meeting ahead of Executive Board approval in January 2024. *Deja vu* all over again.

The CBK also hinted that the anticipated USD 300mn buyback will be funded by the financing flow from the Trade Development Bank (TDB) that is expected to disburse a similar amount in the first half of this month. We expect the anticipated USD 683.0mn (at current SDRUSD rate) disbursement from the IMF in January 2024, and World Bank Development Policy Operation (DPO) at c. USD1.5bn, due in March 2024, to be FX supportive. Furthermore, there's an expected USD 1.0bn loan from China in 1H2024, but we suspect this will be project-based and is not necessarily for budget support. Essentially, the CBK ruled out FX reserve drawdown to fund the partial buyback and the remainder of the upcoming maturity of KENINT 2024 but will rely on external financing flows. We cheer the projected USD 361.0mn (bear case) balance of payment surplus in 2023, but this hinges on the TDB syndicated loan of at least USD 300.0mn during this month.

YIELD CURVE



SOURCE: NAIROBI SECURITIES EXCHANGE, CENTRAL BANK OF KENYA

UNDERWEIGHT Kenya local rates

We are underweight Kenya local rates as we monitor tangible progress on FX availability. With the latest rate decision, we are less convinced that the authorities will move up the curve, from the short end, in its primary issuance. We believe the short-tenor papers will feature predominantly at the primary auctions, further exacerbating the bumpy curve. The fiscal agent accepted KES 47.2bn, against the offer size of KES 25.0bn, on its TAP Sale of the on-the-run infrastructure bond highlighting the catch-22 situation the government finds itself in as far as domestic borrowing is concerned.

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