Currency Outlook, & Cytonn Weekly #19/2022

Focus of the Week

In 2022, the Kenyan shilling has continued with the depreciation trend experienced in 2021 and 2020, with the Kenyan shilling depreciating by 2.6% against the US Dollar (USD) to Kshs 116.1 as of 13th May 2022, from Kshs 113.1 recorded on 3rd January 2022. Key to note, this the lowest the Kenyan shilling has ever traded against the USD. The poor performance of the shilling is mainly attributable to the increased dollar demand by energy and general importers, with Kenya largely being a net importer. Global oil prices have also increased during the year, attributable to the persisting supply chain constraints following the COVID-19 pandemic, worsened by the current global geopolitical tensions following the Russia-Ukraine conflict, coupled with the reopening of economies globally, which has seen demand outpace fuel supply, further inflating the country's import bill and consequently weakening the shilling. Additionally, Kenya has seen affirmation of its Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'B+' with a Negative Outlook by Fitch Ratings, unchanged from the last review in 2021 as a result of the currency depreciation, increasing inflation and the risks arising from the upcoming August 2022 general elections. As a result, this week we shall be focusing in detail the factors that are expected to drive the performance of the Kenya shilling and thereafter give our outlook for 2022.

We have previously released Currency outlook in 2020 and 2021 as summarized below;

?. In May 2021, we released the Currency and Interest Rates Outlook – 2021 when Kenya had seen its sovereign rating downgraded by all the major rating agencies; Standard & Poor's , Fitch Rating and Moody's. The lowering of the credit rating was mainly on the back of Kenya's high fiscal deficit coupled with the economic shocks occasioned by the challenges brought about from the impact of the COVID-19 pandemic. Our outlook was a 0.6% appreciation on account of gradual improvement in the export sector as Kenya's trading partners continued to reopen their economies and stable forex reserves on the back of increasing diaspora remittance inflows, continued investor capital inflows and debt relief from other institutions.

a. In our Currency and Interest Rates Outlook topical which was covered in May 2020, our outlook on the currency was a 5.5% depreciation by the end of 2020, driven by the reduced exports earning due to the lockdown measures put in place by Kenya's trade partners coupled with the high fiscal deficit seen during the period.

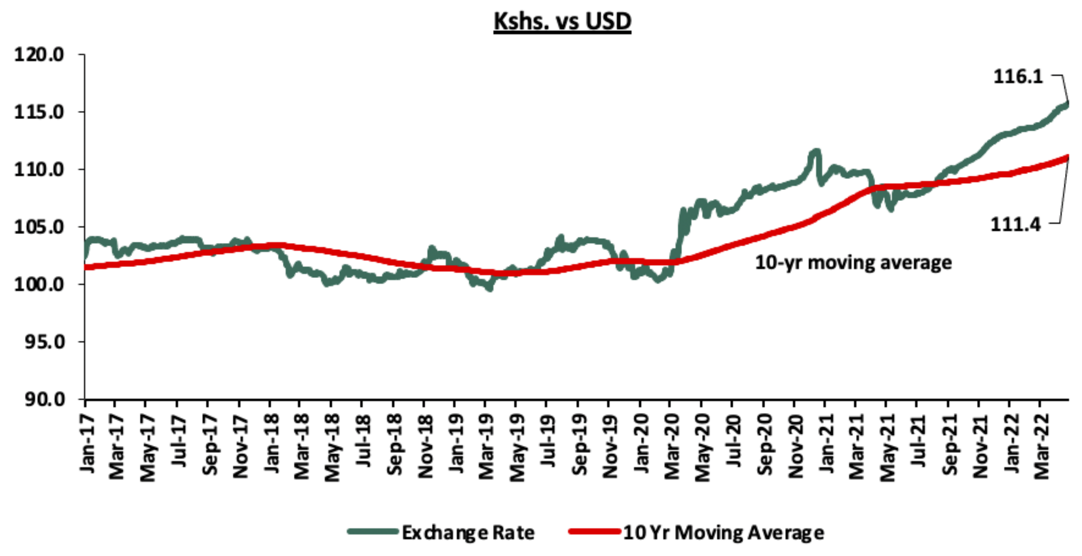
With the shilling having depreciated by 2.6% on a YTD basis, we saw the need to revisit the topic on currency outlook, in order to shed some light on how the shilling is expected to behave in 2022. In this topical, we shall be focusing in detail the factors that are expected to drive the performance of the Kenya shilling and thereafter give our outlook for 2022 based on these factors. We shall cover the following:

i. Historical Performance of the Kenyan Shilling,
ii. Factors behind current currency performance,
iii. Currency Performance Outlook, and,

iv. Conclusion and Our View Going Forward

Section I: Historical Performance of the Kenyan Shilling

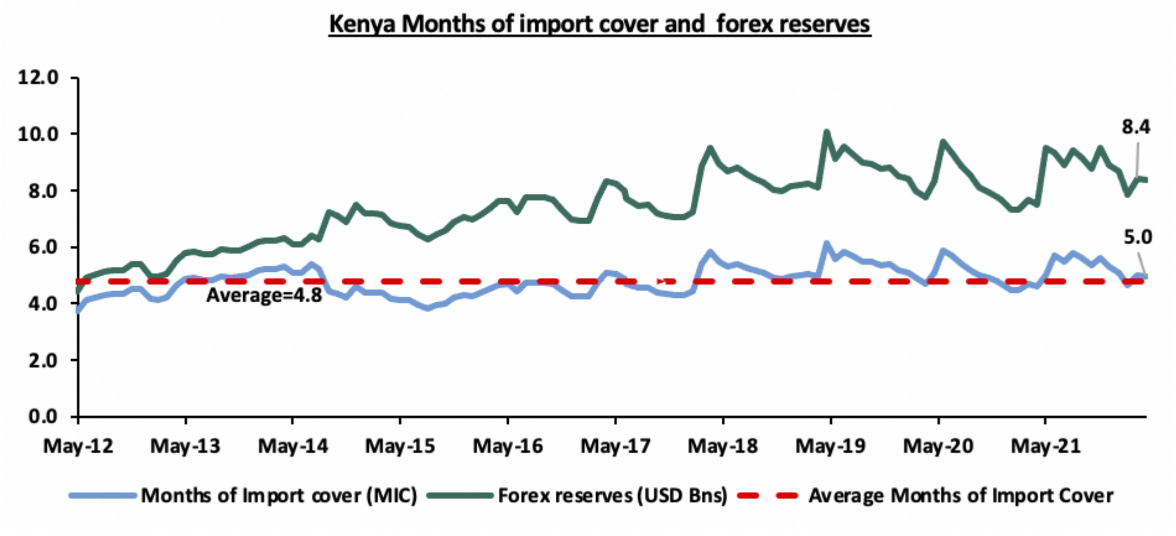
In the period 2017-2019, the Kenyan shilling remained relatively stable against the USD trading within the range of Kshs 99.4 – Kshs 104.2. However, the economic shocks occasioned by the COVID-19 pandemic in 2020 caused volatility of the shilling leading to a depreciation of 7.7% in 2020 and a further 3.6% in 2021. On a YTD basis, the shilling has depreciated by 2.6% against the USD, to close at Kshs 116.1, from Kshs 113.1 recorded on 3rd January 2022. The depreciation in 2022 is attributable to the rising global crude oil prices on the back of supply constraints and geopolitical pressures at a time when demand is picking up with the easing of COVID-19 restrictions and as economies reopen. The chart below illustrates the performance of the Kshs against the USD over the last 5 years;



Source: Central Bank of Kenya

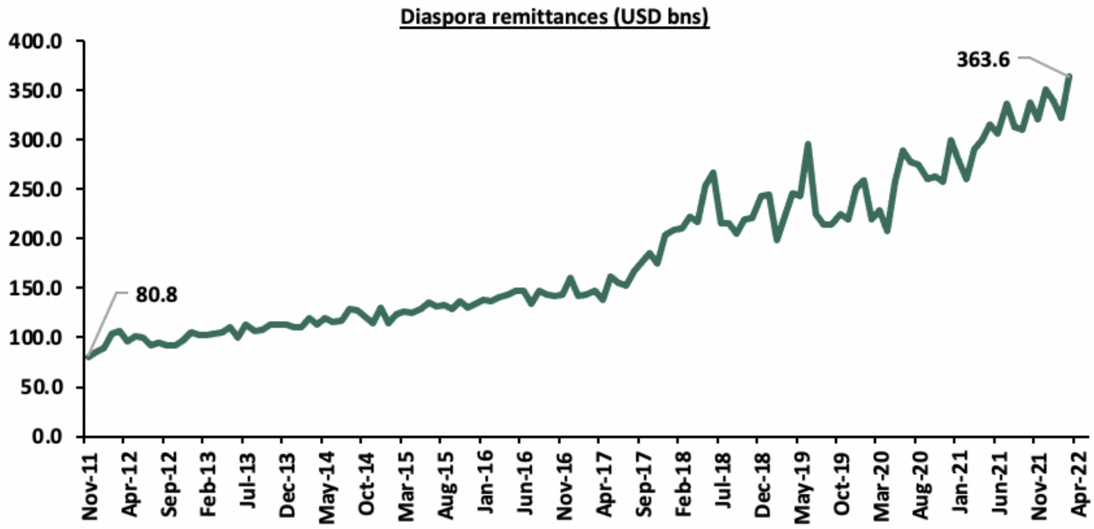
Below are some of the factors that have been supporting the shilling:

i**. Forex reserves** held by the Central bank which are **above** the statutory requirement of 4.0-months of import cover, having grown by a 10-Year CAGR of 6.6% to USD 8.4 bn, equivalent to 5.0 months of import cover in May 2022, from USD 3.9 bn, equivalent to 3.4 months of import cover in May 2012. The chart below shows the trend of the evolution of the forex reserves:



Source: Central Bank of Kenya

ii. Strong diaspora remittances, which have grown by a 10-year CAGR of 13.1% to USD 363.6 mn, in March 2022 from USD 106.2 mn recorded in March 2012 attributable to the increasing Kenyan population in the diaspora and advancing technology that makes transfer of money easier. Key to note, these are the highest diaspora remittances, ever recorded. The chart below shows the trend of the evolution of the Diaspora Remittances:



Source: Central Bank of Kenya

iii. Increase in value of some of the country's principal exports such as horticulture exports which have grown by a 4-year CAGR of 7.1% to Kshs 165.7 bn in December 2021, from Kshs 83.3 bn recorded in December 2011. The Current account deficit as a percentage of the Gross Domestic product (GDP), has also continued to narrow, to a deficit of 5.5% in FY'2021, from a deficit of 7.0% in FY'2017,

iv. Improved investment into the country as measured by the Foreign Direct Investments (FDI) flows into the country, which had grown significantly by a 4-year CAGR of 16.4% to USD 1.1 bn in 2019, from USD 0.6 bn in 2015. However in 2020, FDI flows into the country declined by 34.7% to USD 0.7 bn mainly attributable to muted investor activity during the COVID-19 peak and tightened ownership rules that required companies such as those in the technology sector to have a 30.0% local ownership, and,

v. Inflows from the Multilateral lenders for various loan facilities such as the recent USD 244.0 mn (Kshs 26.9 bn) from the IMF advanced to the country in April 2022 to boost COVID-19 recovery efforts, coupled with the USD 750.0 mn (Kshs 80.9 bn) received from the World Bank in March 2022.

Despite these factors, the shilling has been put under pressure mainly by increasing global oil prices leading to a high dollar demand from energy and oil suppliers, which outweighs supply, and a growing import bill, that has grown by a 10-year CAGR of 7.2% to Kshs 2.6 tn in December 2021, from Kshs 1.3 tn in December 2011.

Section II: Factors behind current currency performance

In 2022, the shilling has recorded an YTD depreciation of 2.6% against the USD, after a 3.6% and 7.7% depreciation in 2021 and 2020, respectively. The shilling has been recording all-time lows against the USD since 9th November 2021. In this section, we will analyze the key factors behind the performance of the Kenyan Shilling in 2022:

I. **Increasing global oil prices**

Kenya remains to be a net importer of crude oil, which accounted for the second largest share of imports, at 17.8% of total imports as of December 2021. The increasing global oil prices have increased the demand for dollars from oil and energy importers who have to increase the amounts they pay for oil imports and hence depleting dollar supply in the market. As a result, this has continued to exert downward pressure on the shilling. On a YTD basis, the Murban Oil that Kenya imports has increased by 34.5% to USD 105.5 per barrel, from USD 78.4 per barrel recorded on 3rd January 2022, mainly attributable to existing supply chain bottle necks, that were worsened by the Russia-Ukraine conflict that has seen demand of oil outweigh supply. Prices of crude oil are expected to remain relatively high in the near term and as such will continue to exert downward pressure on the shilling.

II**. Shortage of the USD following continued reopening of economies**

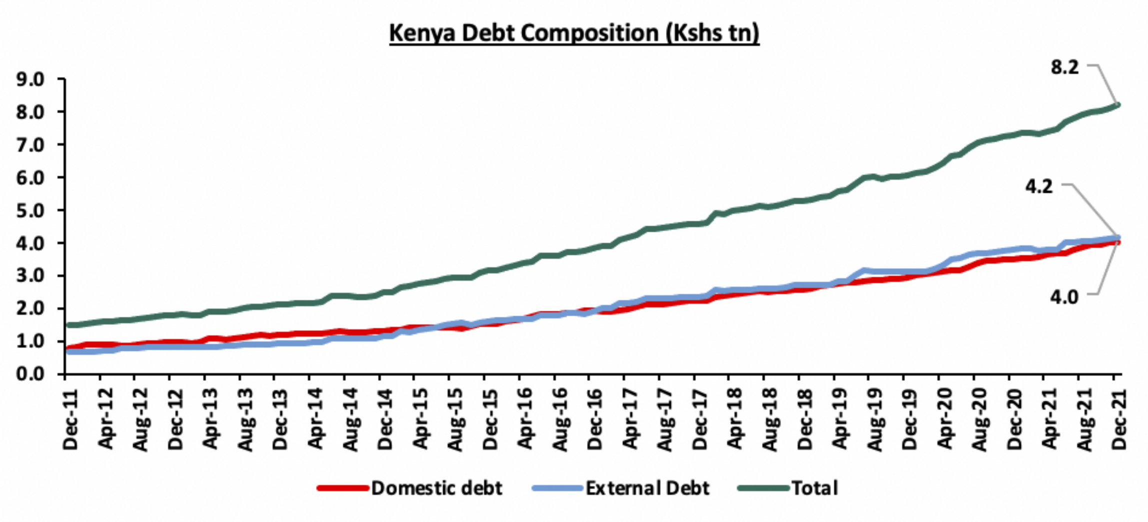
Following the peak of COVID-19 pandemic in 2020, most global economies went on a slowdown due to restrictions and lockdowns that curbed economic growth. However, in 2021, following the discovery of vaccines, vaccine accessibility and vaccine inoculation, most economies have continued to rebuild hence increasing the global demand for the USD for global trade. Further, interest rate hikes by the United States' Federal Reserve during the Q1'2022 to curb inflation has seen redirection of dollar flows to the United States and away from emerging and developing markets.

iii**. Balance of payments**

According to the 2022 Economic Survey released by the Kenya National Bureau of Statistics (KNBS), Kenya's current account deficit expanded by 30.1% in FY'2021, to Kshs 663.8 bn, from Kshs 510.1 bn recorded in FY'2020. This was attributed to a robust increase in merchandise imports by 30.9% to Kshs 2.6 tn in FY'2021, from Kshs 1.6 bn in FY'2020 as compared to a 15.5% increase in merchandise exports to Kshs 743.7 bn, from Kshs 643.9 bn in FY'2020. Though the exports gradually increased in FY'2021 on account of increase in value of exports of horticulture, coffee and tea, which recorded increase of 21.8%, 17.5% and 0.4%, respectively, the more aggressive growth in imports is still worrying and continues to put pressure on the shilling. Moreover, the high fuel prices currently witnessed in the country are likely to increase the import bill. We believe that this high import bill will continue weighing on the improving current account balance and as such, we expect the shilling to continue destabilizing against other currencies.

iv. **Government debt**

Kenya's public debt has continued to grow aggressively, increasing at a 10-year CAGR of 18.6% to Kshs 8.2 tn in December 2021, from Kshs 1.5 tn in December 2011. Out of the current loan stock, external debt has grown at a faster 10-year CAGR of 19.7% to Kshs 4.2 tn in December 2021, from 0.7 tn in December 2021 as compared to domestic debt, which has grown at a 10-year CAGR of 17.5% to Kshs 4.0 tn in December 2021, from Kshs 0.8 tn in December 2011. The rising external debt, whose composition is currently 67.0% USD denominated, has continued to weigh down on the shilling as the government through the CBK has to continually dig into its forex reserves for external debt servicing. In addition, demand for hard dollars to meet debt-servicing requirements is bound to increase upon formal expiry of the Debt Servicing Suspension Initiative (DSSI) in December 2021. Currently, Kenya's debt stands at Kshs 8.2 tn, of which Kshs 4.0 tn is external debt as highlighted in the chart below:



v. **Forex Reserves**

Kenya's Forex Reserves have remained adequate and above the CBK's statutory requirement of at least 4.0 months of import cover, with the forex reserves as at 13th May 2021 at USD 8.4 bn (5 months import cover), an increase of 6.4%, from USD 7.9 bn (4.8 months import cover) in May 2021. The improvement in the forex reserves can be attributed to increased inflows from key sectors such as tourism, coupled with inflows of USD 750.0 mn World Bank received in March 2022 and the USD 244.0 mn expected to be received from the International Monetary Fund as part of the Extended Fund Facility (EFF) and Extended Credit Facility (EFF). However, the reserves have come under increasing pressure partly due to debt service obligations and release of dollars into the market to act as buffers against volatility of the shilling..

Going forward, the elevated debt levels witnessed in the country are likely to put forex reserves under pressure as a significant amount will be used to repay the debts. As a consequence, the Kenyan shilling will be exposed to foreign exchange volatility causing it to weaken. However, we expect the reserves to be supported by increasing diaspora remittance inflows, continued investor capital inflows and increasing exports following increased activities with the key trading partners.

vi**. Monetary Policy**

The Central Bank Rate (CBR) was revised down to 7.00% from 8.25% in January 2020 to support the local economy. Despite this, the yields on government securities have remained high and attractive. Inflation rates have also remained relatively stable and within the government's target of 2.5% - 7.5%. This is mainly attributable to the application of fuel subsidies under the Petroleum Development Fund that have shielded the fuel prices in Kenya against the full impact of rising global fuel prices. As such, we do not expect the CBK to increase the rates in the short term given the government's commitment to sustain the fuel subsidy and protect citizenry against the rising cost of living.

Section III: Currency Performance Outlook

Driver	Outlook	Effect on the currency

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Balance of Payments	· We expect gradual improvement in the export sector from perennial export products like Horticulture, tea and coffee as the increase due to the increase in their global prices. However, the high import bill is expected to weigh down on the Current Account balance due to an increase in merchandise trade deficit attributable to the increase in global fuel prices, persistent disruptions in supply chains and logistical bottlenecks.	**Neutral**
Government Debt	· We expect the government to borrow aggressively to plug in the high fiscal deficit, which is projected at 7.5% of GDP for the FY'2021/22 budget. In addition, Kenya's debt to GDP ratio came in at an estimated 66.2% as of December 2021, 16.2% points above the IMF recommended threshold of 50.0% for developing nations. Slow revenue growth coupled with weak fiscal consolidation places the country at risk of debt distress, and, · The high debt burden especially external debt will continue to expose the shilling to exchange rate shocks and will, in turn, emanate pressure on the shilling to weaken during the repayment period.	**Negative**
Forex Reserves	· Elevated debt levels witnessed in the country are likely to put forex reserves under pressure as most of it will be used to finance the external debt. Further, the expiry of the Debt Service Suspension Initiative in December 2021 is set to increase amounts due and put the shilling under more pressure, and, · In our view, forex reserves will continue to be supported by; debt relief from institutions such as the IMF, increasing diaspora remittance inflows, continued investor capital inflows with hope for an economic recovery and increasing exports as the key trading partners continue to re-open their economies	**Neutral**
Monetary Policy	· Inflation rates have remained within the government's target of 2.5% - 7.5% despite the high fuel prices and as such, we do not expect the CBK to increase the rates as the Central Bank is mainly focused on reviving the economy, and, · Domestic investment activities have declined as Kenya's financial and capital assets have become less appealing to investors on account of the lower real rate of return.	**Neutral**

From the above currency drivers, 1 is negative (Government Debt), while 3 are neutral (Balance of Payment, Monetary Policy, Forex reserves) indicating that currency remain uncertain with a bias towards further depreciation in the short term.

Section IV: Conclusion and Our View Going Forward

Based on the factors discussed above and factoring in the effects of the current geopolitical tensions arising from the Russia-Ukraine tensions, **we expect the Kenyan shilling to remain within a range of Kshs 115.1 and Kshs 119.1 against the USD in the medium term based on the Purchasing Power Parity (PPP) and Interest Rate Parity (IRP) approach respectively, with a bias of a 4.7% depreciation on account of:**

?. High global oil prices which continue to lead to high costs of oil imports,
i. Persisting supply chain bottle neck constraints that continue to increase the costs of imports, and,
ii. Ever present current account deficit due to an imbalance between imports and exports.

In our view, the current pressure on the shilling is unlikely to reduce in the near term, and is a cause of concern. Continuous depreciation of the shilling is set to have a negative effect on the economy as the import bill will continue to be inflated, with the additional costs likely to be passed on to consumers hence elevating the current inflation levels. In as much as most of the factors contributing to depreciation of the shilling during the year are external, we are of the opinion that there actionable steps that can be taken by the Government to mitigate further depreciation of the shilling. These include;

?. **Building an export driven economy** - This can be achieved by formulating and implementing robust export oriented policies and manufacturing to increase exports, thus improving the current account while at the same time reducing overreliance on imports to preserve our foreign exchange reserves. Exports should also undergo value addition before leaving the country in order to increase purchase value and competitiveness. This will go a long way to stabilize the exchange rate,

i. **Reducing the mix of commercial loans which attract high interest rates** - The Kenyan government should move towards reducing the share of commercial borrowing as compared to concessional borrowing so as to reduce amounts paid in debt service. Reduced debt service amounts would greatly help to bring down demand for the greenback and stabilize the exchange rate,

ii. **Diversification of the economy to avoid over-reliance on agriculture and tourism** - Kenya's brand, location and skilled workforce uniquely positions the country to be a financial hub, but we will have to fundamentally rethink our capital markets infrastructure and regulatory frameworks. We have seen Mauritius, which is primarily a financial hub, benefit greatly from the diversification of their economy. Mauritius has a developed mixed economy hinged on different sectors such as manufacturing, financial services which have been increasing their share of GDP and has constantly been diversifying from agriculture and tourism unlike earlier years,

iii. **Capital Markets Authority to encourage local capital formation rather than foreign capital, which has to be repatriated** - The current Capital markets structure in Kenya is foreign investors and capital dominated and as such, companies have to repatriate profits and dividends in dollars continues to starve the market's dollars and further weakens the shilling, and,

iv. **Work with the private sector to maximize Kenyans living abroad investments in the country** - Despite the fact that the remittances have reached historic highs, there is potential for much more to come into the country if we develop, promote and implement an active diaspora investment strategy and engagement.