Economic presentation on Kenya and the DRC

13 July 2023

Themes

- Stubborn inflation
- High interest rates
- Global funding squeeze
- Fiscal consolidation
- Depreciating currencies

Global macro environment

Further rate hikes expected from major central banks

Figure 1: US Fed rate, %

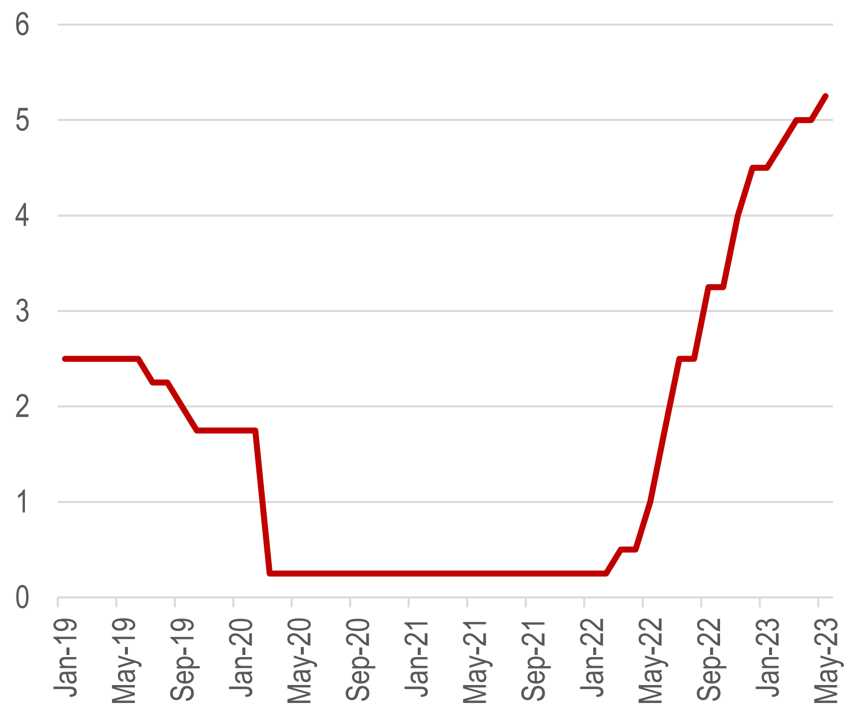
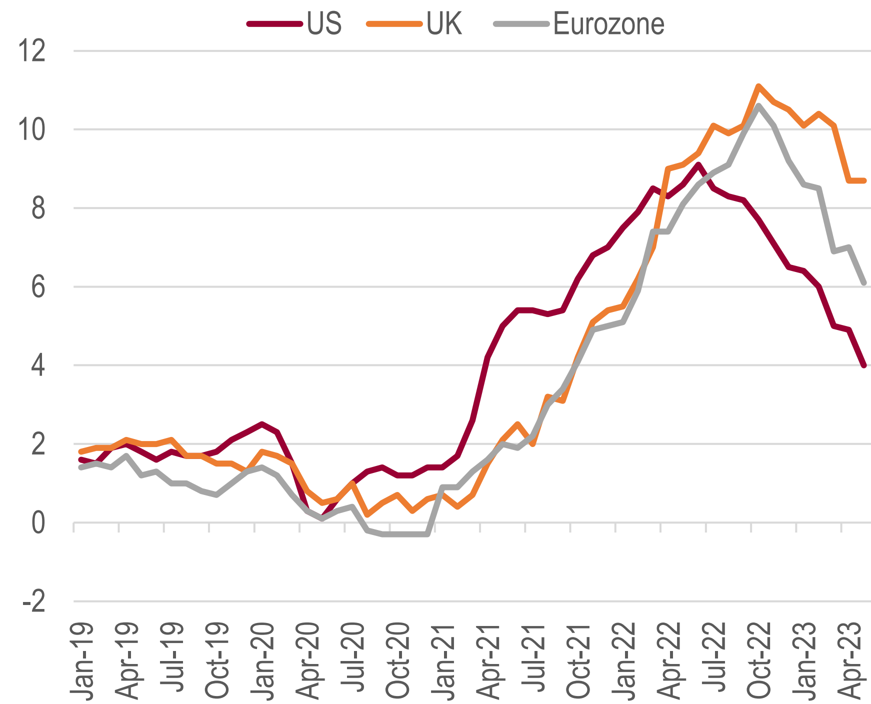


Figure 2: Inflation, % YoY

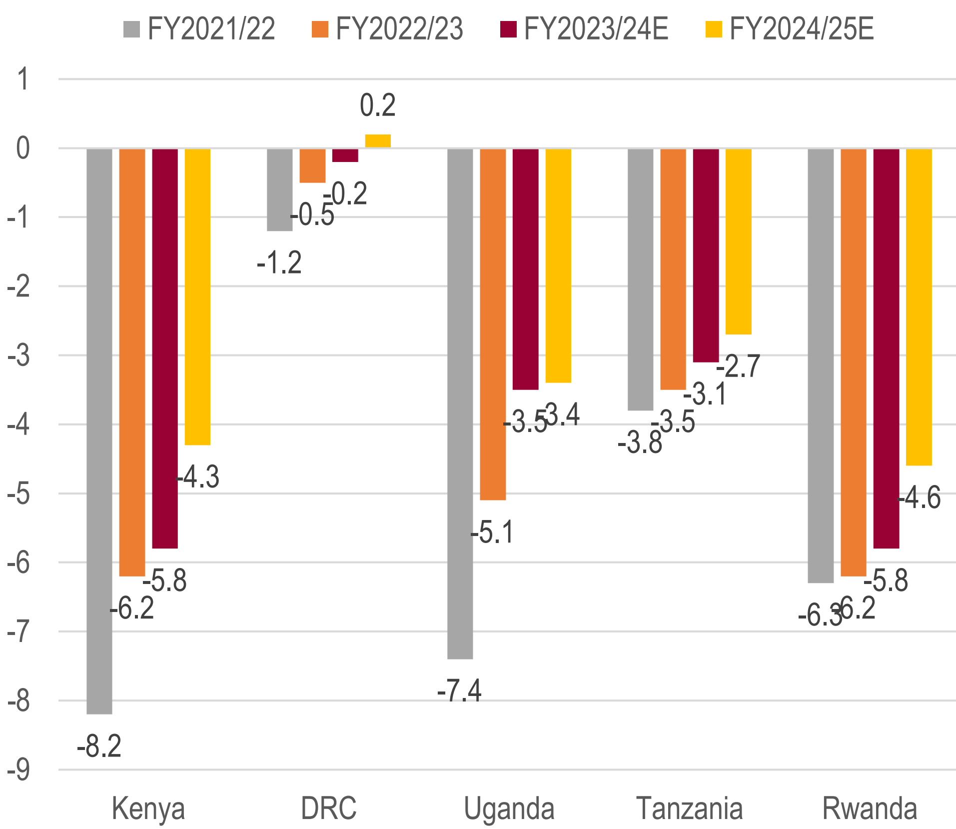


- The world's major central bankers have indicated that further tightening of monetary policy is likely, to counter inflation which remains above their targets.
- Higher interest rates in the world's major economies, implies foreign capital inflows into emerging and developing economies will remain subdued.

East Africa – fastest growing region in the world

Governments bringing down their budget deficits

Figure 3: Budget deficit, % of GDP



- The government budgets proposed by most of the member states of the East African Community in June, indicated fiscal consolidation, implying continued focus on reducing the budget deficit. This policy is intended to rebuild fiscal buffers that have been eroded.
- In a global economy facing several headwinds, we believe mid-to-high-single-digit real GDP growth goes a long way towards mitigating the risks from macroeconomic imbalances. East Africa is the fastest growing region in the world; we expect it to grow at 5.7% in 2023,
- We believe the region's robust real GDP growth will help mobilise the government revenue required to reduce negative budget deficit/GDP balances, and in so doing, lower public debt/GDP over the medium term.

Kenya: GDP growth vulnerable to tight policy

Higher tax burden and interest rates may subdue growth

Figure 4: Kenya: real GDP growth, % YoY

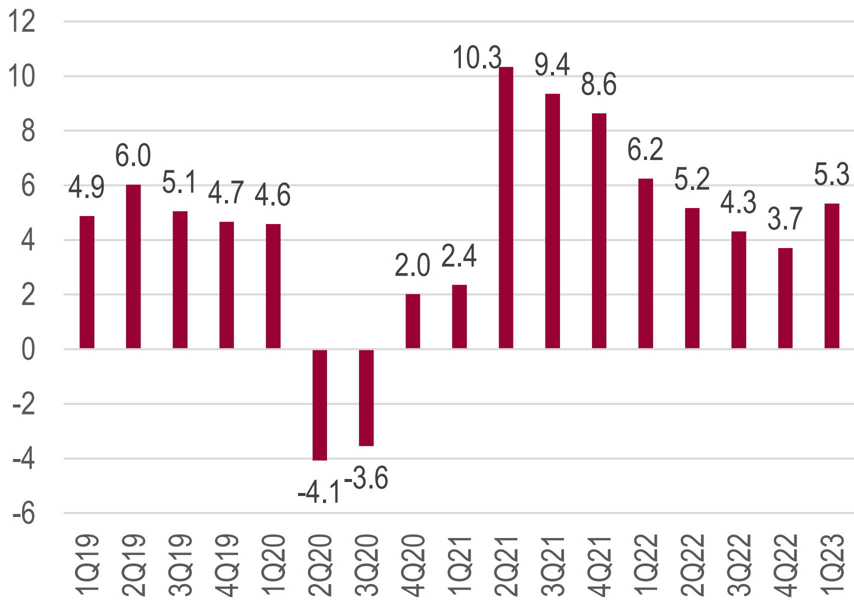
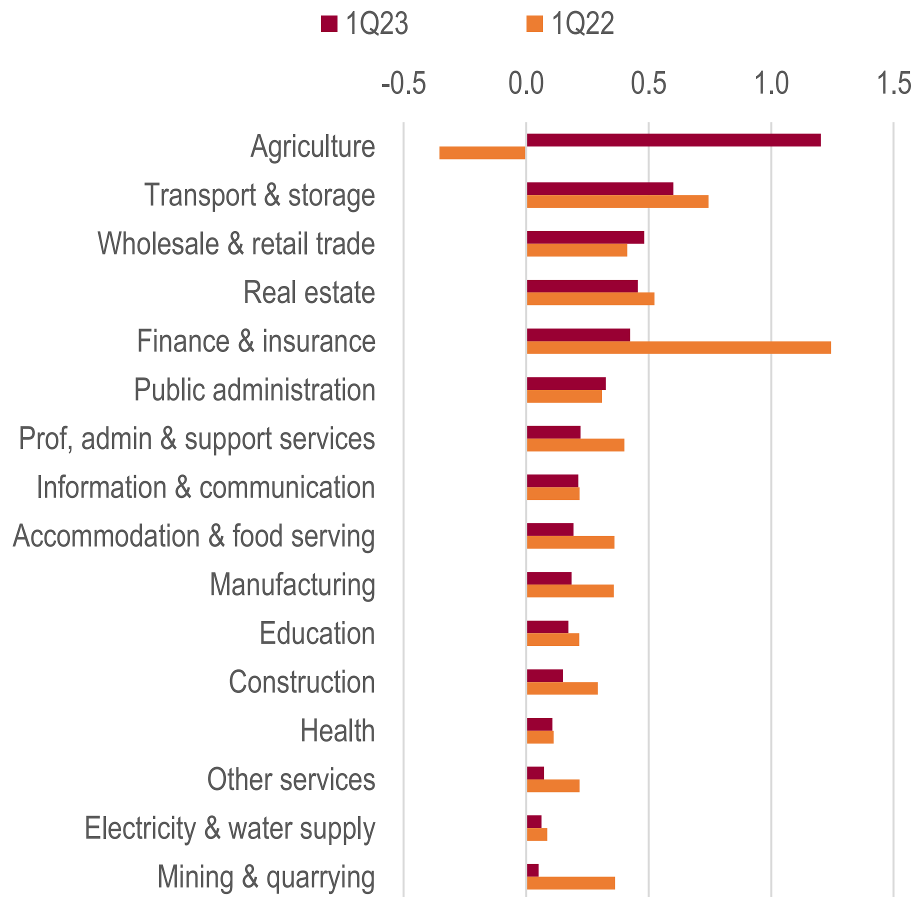


Figure 5: Kenya: contribution to real GDP growth, ppts



- **Agriculture recovers.** After contracting for five quarters, the agriculture sector grew by a strong 5.8% YoY in 1Q23 and was the biggest contributor to real GDP growth of 5.3% YoY.
- We forecast growth of 5.0% for 2023, a moderate increase from 4.8% in 2022 that will be driven by agriculture's recovery.

Kenya: inflation and interest rates

Sticky inflation, elevated interest rates

Figure 6: Kenya: inflation, % YoY

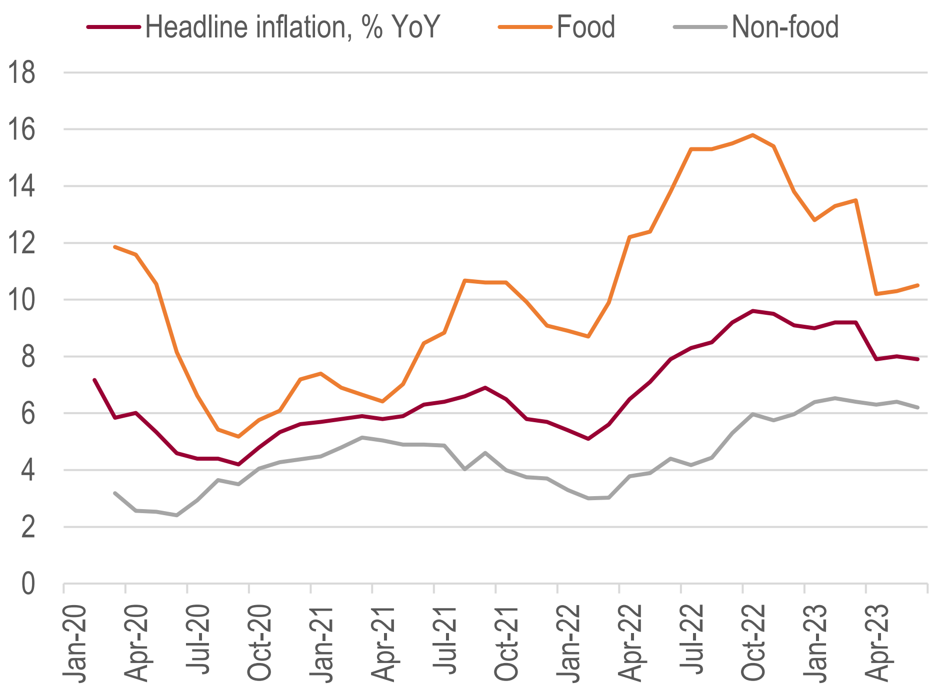
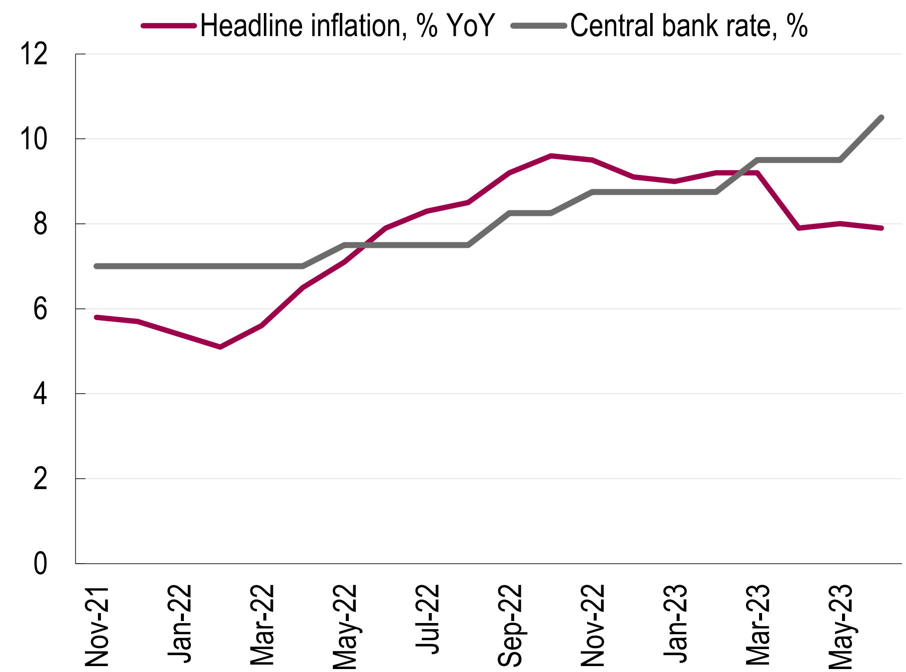


Figure 7: Kenya: inflation vs interest rates

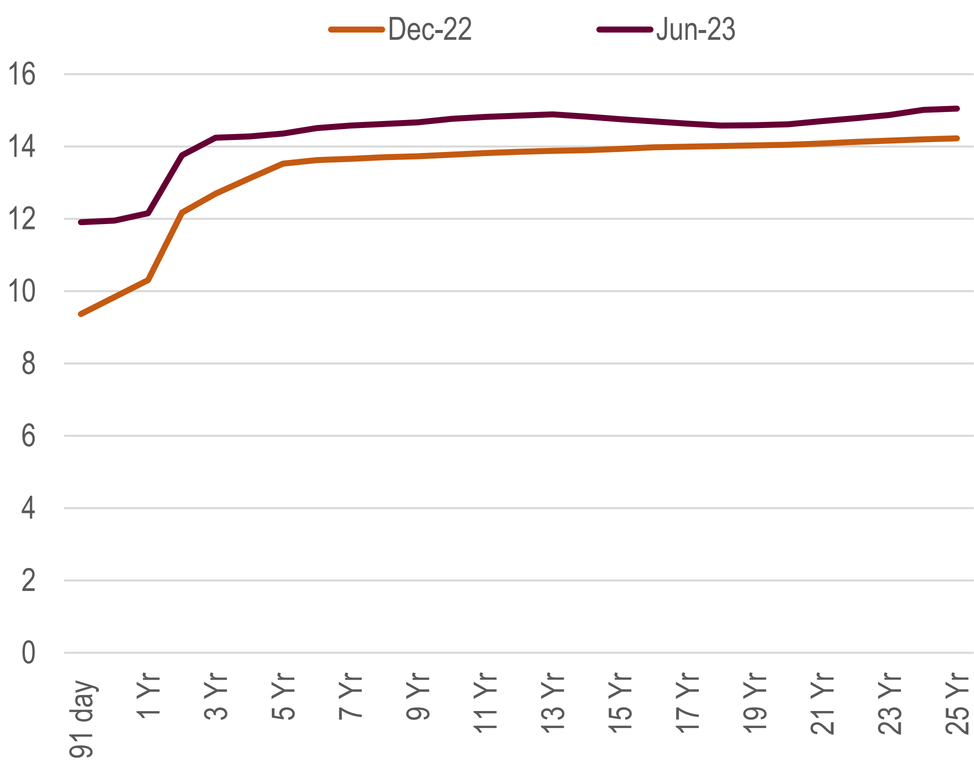


- Inflation has been flat at 7.9-8.0% since April, indicating that it is sticky. We expect inflation to remain close to the upper band of the 2.5-7.5% target over the short term. Food inflation is persistent, We note that month-on-month food inflation remains elevated, at over 1.0% in May and June. This implies food price increases are still strong.
- The MPC hiked the policy rate by 100bpts to 10.5% on 26 June, at an early MPC meeting. More US Fed rate hikes to come and a vulnerable Kenyan shilling imply upside risk to the CBR. We think there is scope for another 50-100bpts hike of the CBR in the second half of 2023.

Kenya: increase in thje yield curve

Higher yields on Treasury bills and bonds imply higher borrowing costs for the government

Figure 8: Kenya: yield curve for Treasury bills and bonds, %



- We believe Kenya's CBR is now better aligned with interest rates on the short end of the yield curve. The interest rate on the 91-day Treasury is 12.0% in July, up from 8.3% a year earlier. .

Kenya: weaker external position

Slowdown in foreign financial inflows

Figure 9: Kenya: Official foreign reserves

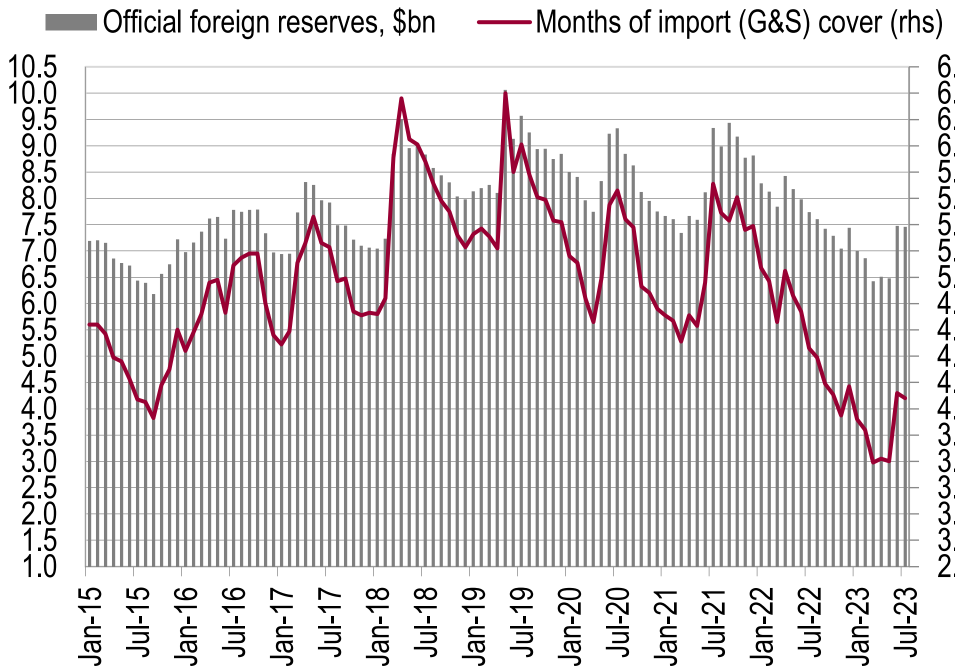
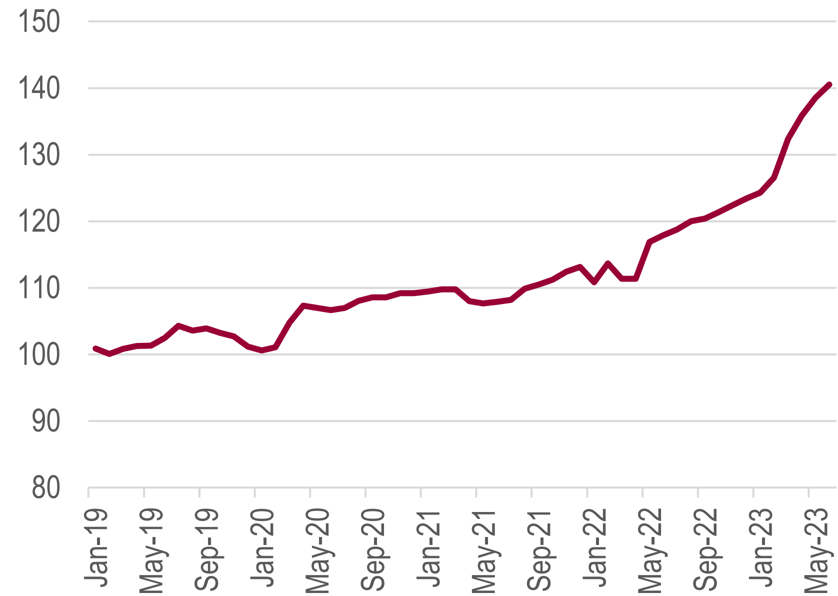


Figure 10: Kenya: exchange rate – KES/$1

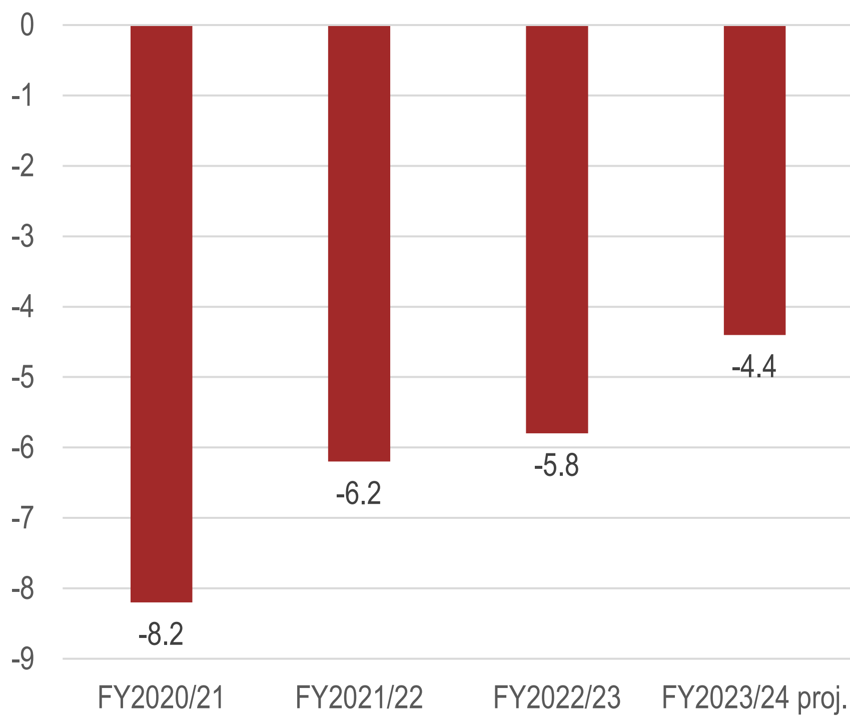


- Foreign exchange reserves dropped below 4 months of import cover in January. However, the inflow of the World Bank loan in June put reserves back over 4 months.
- The narrowing of the current account deficit in 1Q23 was not enough to counter the impact of declining foreign financial inflows.
- The Kenyan shilling has depreciated by 14% against the US dollar, in the year to date, to KES140.6/$1 on 3 July.
- The foreign financing that the government has committed over the short term, including disbursements from the IMF, and funding from bilateral partners. This should help support the exchange rate.

Kenya: fiscal consolidation

Mobilising additional government revenue

Figure 11: Kenya: budget deficit, % of GDP



- The government adopted a fiscal consolidation policy in 2021. This implies reducing its budget deficit, with the intention of slowing the buildup of debt that is at high risk of debt distress. Kenya's public debt has since fallen to an estimated 5.8% of GDP in FY2022/23.
- The government plans on further reducing the budget deficit to 4.4% of GDP in FY2023/24, from 5.8% in FY2022/24. The government's plan on bringing it down further to 3.6% by FY2025/26.
- This implies a slowdown in government borrowing over the medium term, which may help moderate interest rates.

DRC – GDP growth driven by the extractive economy

Growth in the extractive economy is stabilising

Figure 13: DRC – copper production, thousands of metric tons

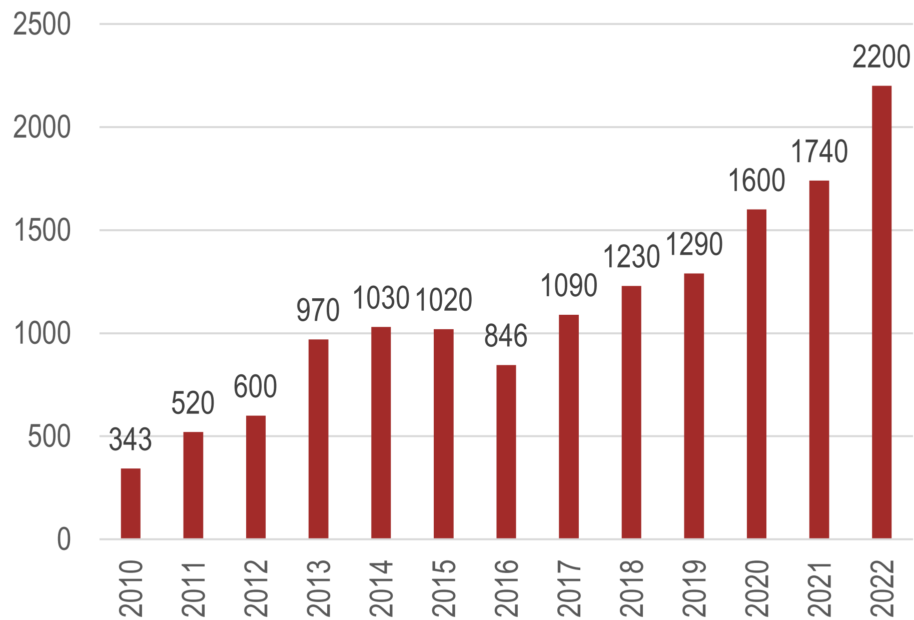
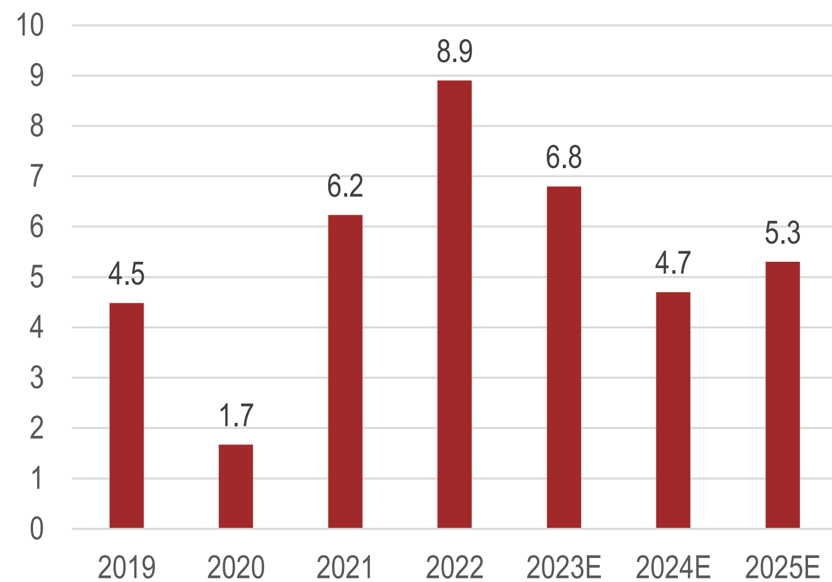


Figure 14: DRC – real GDP growth

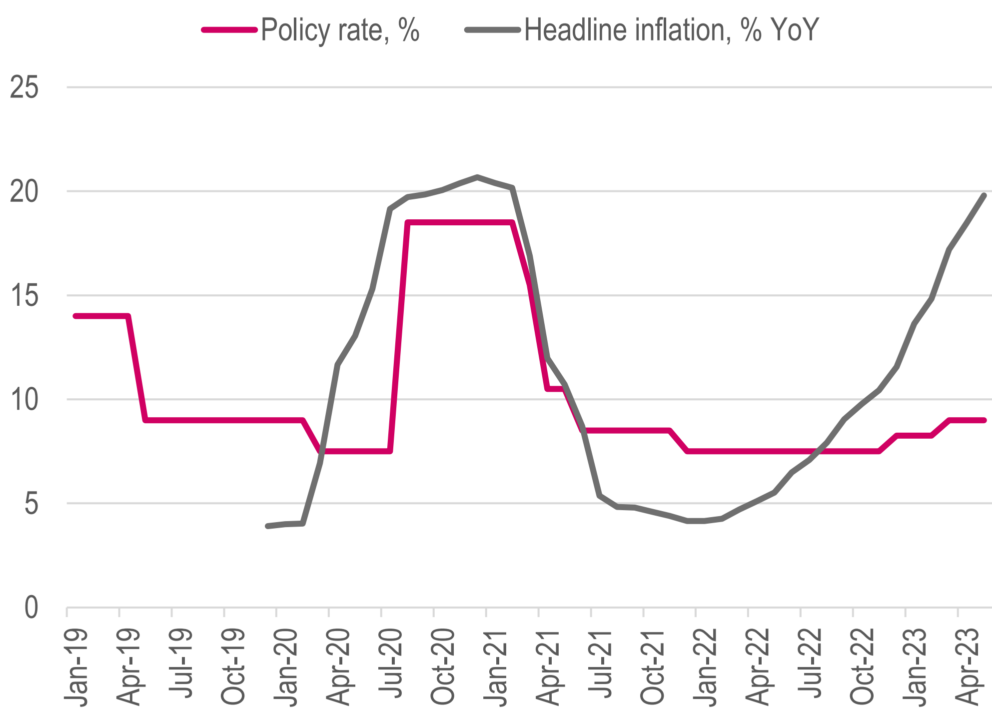


- The DRC economy grew by a brisk 8.9% in 2022, on the back of the acceleration of the extractive sector's growth to 22.6%.
- An expansion of mines and new smaller mines explains the increase in mining production, according to the IMF. However, the non-extractive economy grew by a relatively modest 3.1%.
- The DRC's growth is expected to moderate to 6.8% in 2023, by the IMF, owing to a slowdown in the extractive industry's growth to around 12%. The non-extractive economy's growth is expected to strengthen to around 4.5% in 2023.

DRC – runaway inflation

Single digit inflation likely to be restored in 2024

Figure 15: DRC – inflation and the benchmark interest rate

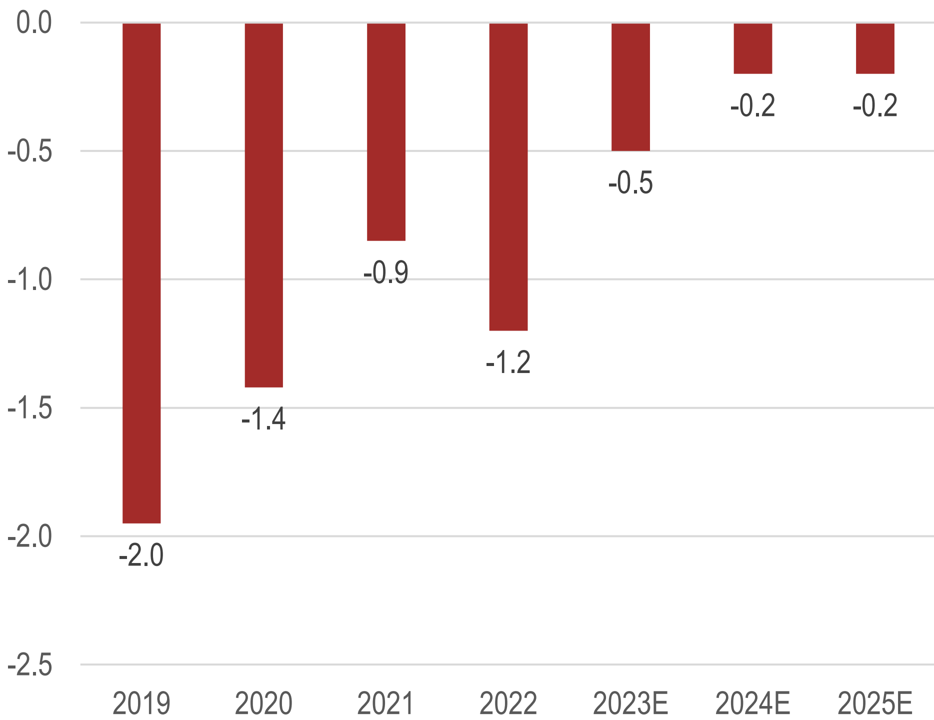


- The DRC's headline inflation accelerated to 19.8% YoY in May, from 5.5% YoY a year earlier, and is showing no signs of abating.
- Inflation is being driven by government spending pressures from the conflict in east DRC, and the depreciation of the Congolese franc.
- We forecast inflation of 12.5% at the end of 2023. Single-digit inflation will likely be restored in 2024, on the back of tighter policy.

DRC – Fiscal consolidation

More efficient spending

Figure 16: DRC – budget deficit, % of GDP

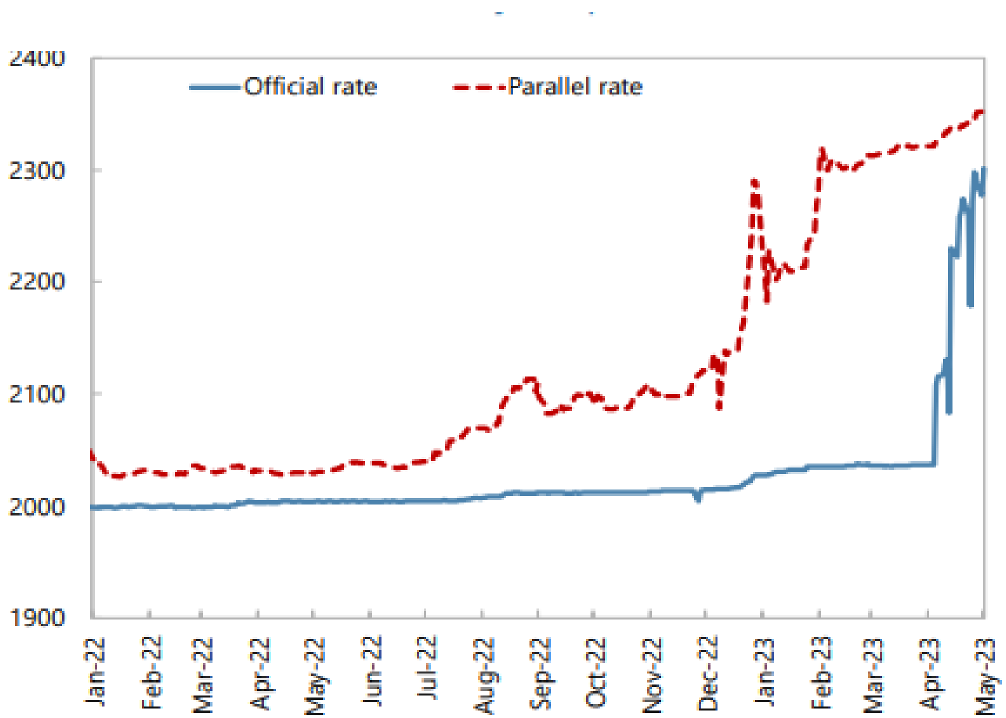


- The DRC government's budget deficit is projected to narrow to 0.5% of GDP in 2023, from 1.2% in 2022, by the IMF. A decrease in government spending that will counter a decrease in revenue and grants, explains the smaller deficit projections. There is a risk to this from higher security-related spending than planned.
- In the first five months of 2023, exceptional government spending continued to come in higher than expected, despite underperforming revenue. However, the government was able to contain its deficit because other spending came in below target.
- Among the fiscal structural reforms, the government is undertaking to make spending more efficient, are those related to the civil service and the fuel subsidy.

DRC – Foreign exchange rates

Convergence of the official and parallel FX rate

Figure 17: DRC – official and parallel exchange rate, CDF/$1



- The Congolese franc has depreciated by almost 20% against the US dollar in the year to date, to CDF2,394/$1 on 5 July, on the official market. Most of this depreciation occurred in May and June, when the central bank seemingly devalued the official exchange rate. Rapid public spending partly contributed to the pressure on the official exchange rate to weaken.

- The DRC's import cover is forecast to increase to 10 weeks at the end of 2023, from 7.9 weeks a year earlier, by the IMF, which implies an improvement in the county's external position. That said, this is still below the recommended three months of import cover, below which reserves are considered too low for a country to weather external shocks.

DRC – strong copper price

Smaller current account deficit over medium term is positive for DRC's external position

Figure 18: DRC – current account, % of GDP

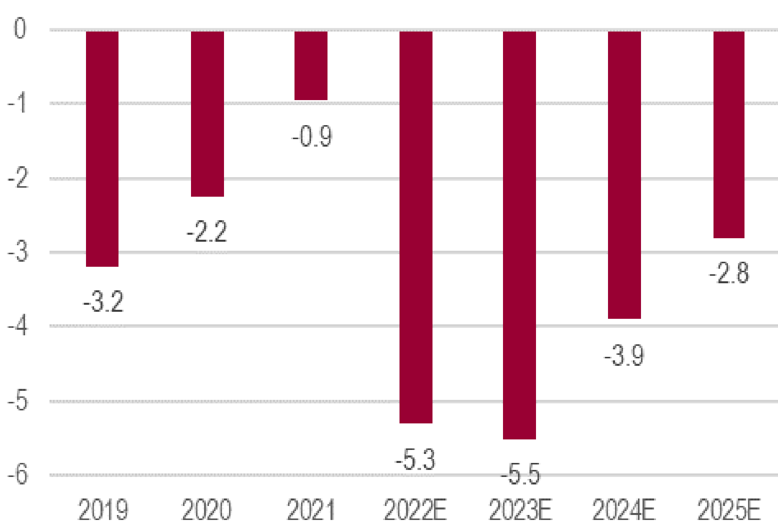
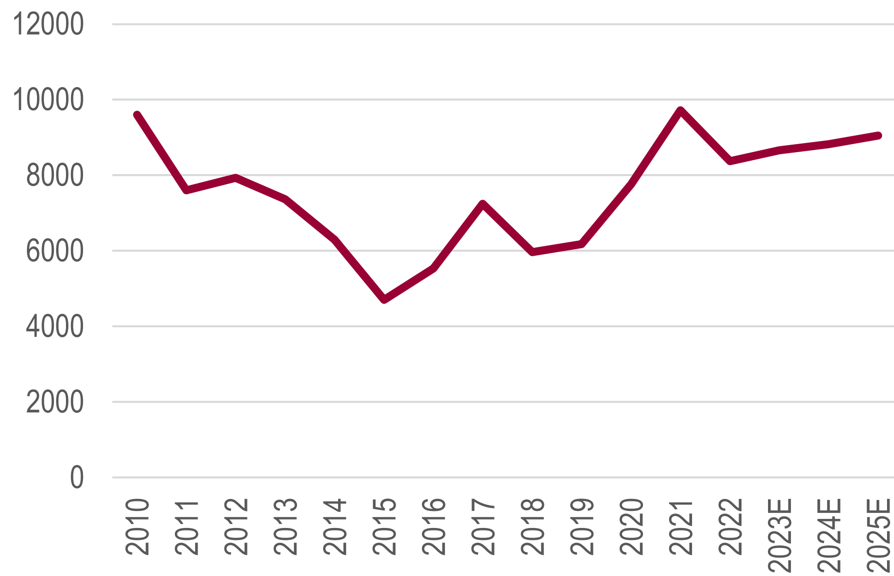


Figure 19: DRC – copper price, $/mt



- Exports – largely made up of copper and cobalt – are expected to decrease moderately in 2023, on the back of lower commodity prices. This explains the projection of a small increase in the current account deficit to 6.3% of GDP in 2023, from 6.2% of GDP in 2022.
- The copper price is expected to remain strong over the medium term, which is partly why the current account deficit is projected to narrow over that period, which is positive for the DRC's external position.
- The risk to the current account is higher-than-planned government spending which would exert further pressure on the Congolese franc to depreciate.

Conclusion

- We are living in challenging times, with stubborn inflation and high interest rates.
- Living in the fastest growing region of the world significantly mitigates those risks.
- Investors should be encouraged by the policy consistency in the countries Equity Bank operates in, and policy cohesion among the EAC member states.