Causes and Implications of the Appreciation of the Kenyan Shilling

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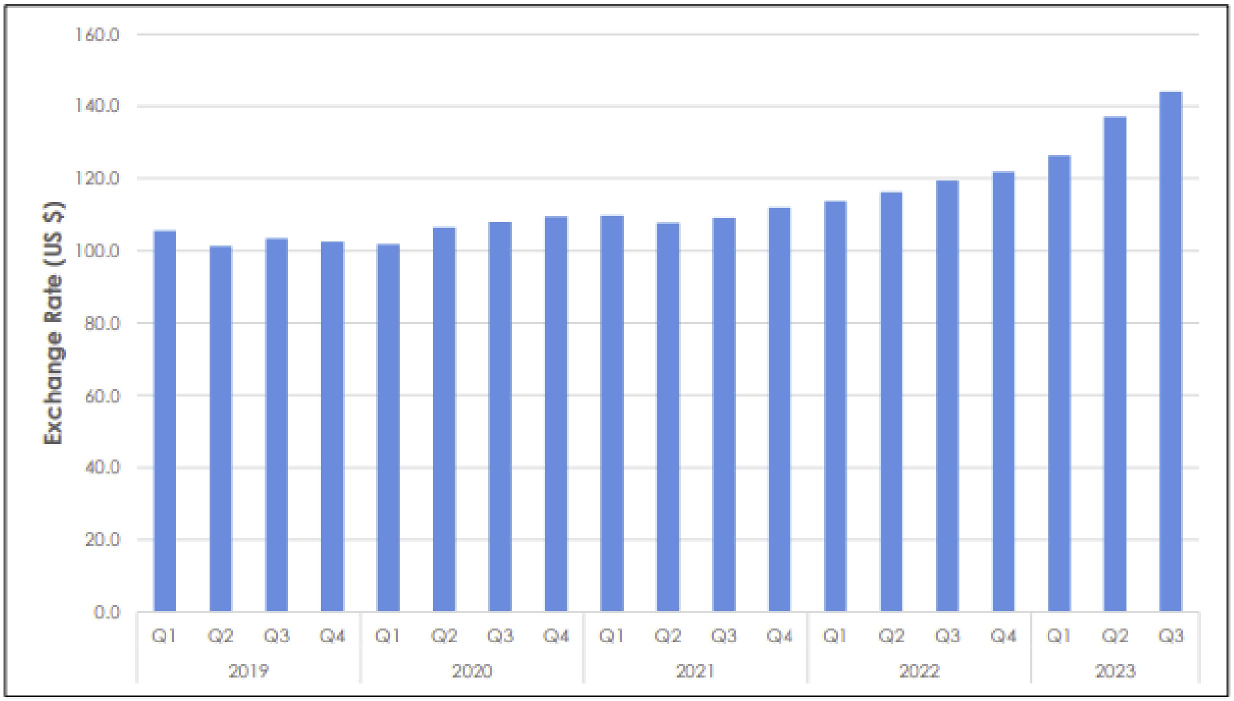
Introduction

The year 2023 and beginning of 2024 were not particularly good for the Kenyan shilling. The shilling can be said to have experienced a freefall, depreciating from KES 113 to KES 160 to the US Dollar. The year 2023 alone saw the value of the shilling depreciate by more than 20%. By the end of December 2023, the Central Bank of Kenya (CBK) quoted the exchange rate at Ksh156, up from the Ksh135 range that prevailed in the past weeks. This crossed the Ksh160 mark by the end of January 2024. The International Monetary Fund estimated that the shilling was overvalued by 15.5% and many bank CEOs and analysts expected the shilling to continue depreciating up to more than KES 180 to the US Dollar. In January 2022 one USD exchanged for an average of KES 112.8349; while in January 2023, one USD exchanged at an average of KES. 123.3806 KES. On 22nd January 2024, the shilling hit the lowest value with one USD exchanged at KES.162.50.

In the period 2019-2023, the Kenya National Bureau of Statistics (2023) statistical bulletin shows that the Kenyan Shilling depreciated against all major international trading currencies. The depreciation in the third quarter of 2023 was greater than the second third quarter of 2022. The average depreciation against the Euro, Pound Sterling, US Dollar, and Japanese Yen by 30.3 per cent, 29.7 per cent, 20.6 per cent, and 15.3 per cent, respectively. The local currency also depreciated against key African currencies, such as the South African Rand, Tanzania Shilling, and Uganda Shilling. The rapid depreciation of the shilling caused panic in the forex market and claims were made that some market participants were hoarding dollars due to the uncertainty of the extent to which it will depreciate. The Governor of the Central Bank of Kenya alluded to an overvalue shilling but expected the shilling to appreciate in the coming months.

While the shilling has been exposed due to the reality that Kenya is a net importer and the increasing debt service costs, further impetus was given by the consistent hike in interest rates in USA which made dollar returns more attractive. The Federal Reserve raised interest rates 11 times from March 2022 to March 2023 after inflation crossed the 9% mark. The dollar markets therefore offered better returns in investors shifted their money from emerging markets. Shifting of capital from emerging markets like Kenya means an outflow of US Dollars. This could explain why over 16% of the depreciation happened between 2023 and 2024 while the shilling lost close to 40% of its value against the dollar in the period 2020 to the start of 2024.

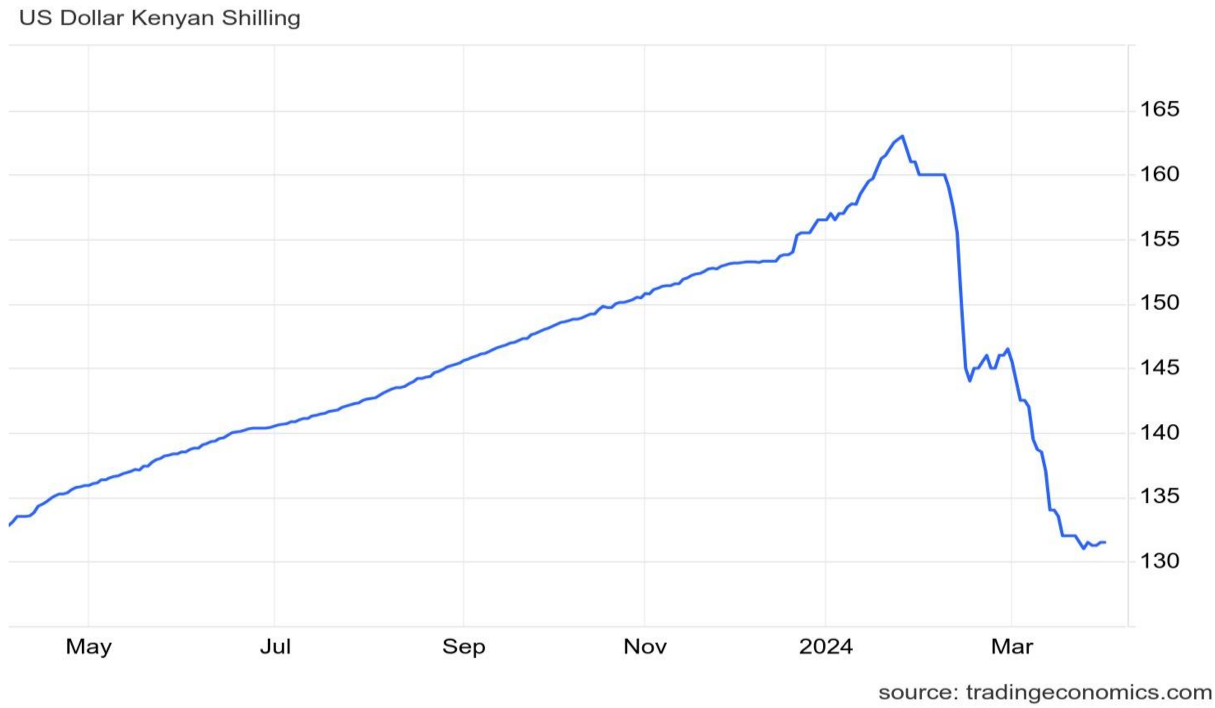
Foreign Exchange Rate of Kenyan Shilling against US Dollar, 2019-2023



Source: Kenya National Bureau of Statistics. (2023)

Strengthening of the KES to US Dollar 1

However, as from mid-February 2024, the shilling freefall seems to have come to an end. After shedding 21% of its value in 2023, the Kenyan shilling has appreciated 12% against the US dollar to close the month of February at Ksh143.6/$ from Ksh160.8/$ in January. The winning streak seems to have continued in the month of March with the local currency approaching KES 130/$



The strengthening of the KES to US Dollar coincided with the issuing of a Eurobond by the government to raise money for settling the old Eurobond that is maturing in June 2024 and a local infrastructure bond that was oversubscribed. As a result, strong positive sentiment swept through the forex markets and the shilling began strengthening. According to the Central Bank of Kenya results for Amortized Bond Issue No. IFB1/2024/8.5, the infrastructure which was oversubscribed by 412.37 percent, and the government raising over KES 240 billion was a sign of strong investor confidence in Kenya's economic prospects. Equally, the National Treasury Press statement showed that the government received a lot of interest in the Eurobond that was issued. When the government successfully raised USD 1.5 billion through the Eurobond, although at the highest interest rate ever of 10.5%, the risk of default in the USD 2 billion Eurobond maturing in June was substantially reduced.

Causes and Consequences of the Strengthening of the Kenyan Shilling

Key recent trends can be observed which explain the appreciation of the shilling. First are the increasing diaspora remittances which have grown to USD 4,330.0 million in the 12 months to February 2024, 7.5 percent higher than the USD 4,026.0 million recorded over the same period in 2023, a 7.5% growth. In the year 2023, tourism generated forex of USD 333.9 million compared to USD 268.1 million in 2022. In appreciation that import of oil constitutes over 25% of the imports, the government in 2023 entered a deal with oil companies in Saudi Arabia to import oil on credit hence reducing immediate demand for US Dollars. President Dr. William Ruto even promised that the exchange rate will fll to around KES 120/1 US Dollar but the shilling continued depreciating. No other policy interventions were/have been taken by the government to directly protect the shilling from further freefall. However, the magic bullet seems to be the two bonds that were issued by the government. After the issues, a positive sentiment swept through the economy due to the reduced risk of default in the 2014 Eurobond. Before the issue of the Eurobond, the investor sentiment was that the government could go to the market to buy dollars to settle the 2014 Eurobond. Investors were therefore buying and hoarding as many dollars as possible to speculate on when the government would go to the market and buy dollars. With the issue of the USD 1.5 billion Eurobond, the ones who were hoarding the dollars to benefit when the government goes into the market had no choice but to offload the dollars. As a result, the market began self-correcting as the hoarders had to sell their dollars, leading to the continued appreciation of the shilling.

A strong shilling is good news for Kenyans who rely on imported goods, Kenya being a net importer, it means cheaper imports which is likely to benefit consumers and businesses that rely on imports. The cost of living that has been consistently high, is likely to come down because of the stronger shilling. The cheaper imports are likely to reduce the inflationary pressures in the economy due to the low cost of imported raw materials and finished goods. The resulting price stability will ultimately be beneficial to the consumers and businesses. Besides, the strong Kenya shilling is likely to signal stability and confidence to both domestic and foreign investors leading to increased local investment, economic growth, and development. The initial shortage of US Dollars was already curtailing manufacturing sectors that rely on imported raw materials. The cost of fuel, whose large component is forex, was making the cost of doing business locally skyrocket.

Perhaps the government is one of the biggest beneficiaries of the strengthening of the shilling. Depreciation of the shilling by one unit was adding KES 37 billion to the government debt daily. With a large component of dollar-denominated debt, the government was facing a lot of pressure in debt servicing costs, which were estimated to be growing at a rate of USD 19 million daily. The stronger shilling means that the country requires fewer shillings to service this debt. This will lessen the financial burden on the government and free up resources for other priorities such as infrastructure or social programs.

However, the export competitiveness of the country is likely to be affected by the strengthening of the shilling. Kenya operates a market-driven exchange rate regime where the value of the shilling is largely determined by demand and supply. The Central Bank of Kenya only intervenes in the market to reduce volatility if the shilling experiences rapid fluctuations. The intervention by Central Bank of Kenya is only through buying and selling of foreign currency. However, Central Bank of Kenya Act requires the bank to maintain adequate foreign exchange reserves, equivalent to four months import cover. Kenya's agricultural sector is the biggest employer in the country and generates billions of US Dollars in foreign exchange. While the strong shilling will ultimately benefit importers, it will hurt exporters by making Kenya's key exports like tea, coffee, and tourism expensive for foreign buyers. This decline in competitiveness will most likely impact on the local economy through reduced forex earnings or even shrinking employment opportunities due to suppressed foreign demand. A strong shilling is likely to encourage more imports than exports. It is worth noting that the value of imports in the third quarter of 2023 went down to Sh648.6 billion from Sh659 billion for the similar period in 2022. With a strong local currency, the trade imbalance is likely to be exacerbated, leading to a widened current account deficit. Tourism is one of the key contributors to the Kenyan economy and a strong shilling is likely to make Kenya more expensive to foreign tourists. This may in the long run reduce tourism arrivals and the revenue generated by the tourism sector.

Conclusion

Analysts will be concerned whether this is temporary optimism driven by market sentiment or if it is likely to be sustained in the future. The risk of further depreciation of the shilling remains high because the country is highly in debt and further borrowing is inevitable, given the current government policies of running a large deficit budget. The government has not implemented any clear framework to reduce its expenditure and live within its means in the future. Because oil constitutes over 25% of Kenya's imports, the government early in 2023 entered a deal with oil-producing companies in Saudi Arabia which allowed for purchase of oil on credit so as to reduce pressure on the demand for the dollar. It is not clear how this will solve the problem because the demand for dollars is only postponed and at the time of payment, the oil importers will still go to the market to buy the dollars.

With debt repayment costs now equivalent to over 70% of tax revenues the country can be said to be in financial distress. This is more than double the IMF's recommended limit of 30.0%, hence showing how the debt service costs are a burden to the economy. With a growing foreign debt, the demand for US Dollars for debt repayment costs in the future will most likely exert pressure on the shilling unless there are policy interventions to ramp up dollar inflows. Such policies should ideally include export promotion, especially for the agricultural output of the country, diversification into new exports, especially export of labor through the emerging online environment that young people are currently taking advantage of and tourism development. The tourism potential of the country remains unexploited and can be a rich avenue for ramping up dollar inflows. Perhaps one low hanging fruit it the diaspora remittances which, if the investment climate is appropriate and the remittance channels are friendly, the Kenyan diaspora will find a lot of incentive to invest their hard currency back at home.

With the above reality, the government is better off targeting stability in the exchange rate. A strong Kenyan shilling may not necessarily be a good thing. Kenya being a net importer suffers extreme consequences of any volatility in the exchange rate because it affects not only business contracts but also the pricing of imported products. Intervention by the Central Bank of Kenya should only be limited to smoothing the market and reduce extreme volatility. In the process, the value of the shilling should ultimately settle at its fundamental level, which reflects both the import and export realities of the economy.

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