DEPRECIATION OF THE KENYA SHILLING, CAUSES AND IMPLICATIONS.

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Introduction: Background of the Issue and Current Status

The exchange rate in Kenya has gone through various regimes to the current liberalized exchange rate system. From independence to 1974, exchange rate was pegged to the dollar. Between 1974 and 1982, the exchange rate experienced a series of devaluations that led to moving to a crawling peg in real terms by end of 1982. The crawling peg regime lasted up to 1990, when Kenya adopted a dual exchange rate up to 1993, when the exchange rate was fully liberalized. Kenya's exchange rate regime is free float determined in the market through demand and supply forces. The Central Bank of Kenya my participate in the forex market when it needs to stem volatility emanating from external shocks, when it is building the stock of foreign reserves, when effecting government payments and when injecting or withdrawing liquidity in the market.

The debate between a stronger and a weaker shilling versus a hard currency like the USD is not always clear. A depreciating shilling implies a higher cost in shillings to finance imports. However, a weak shilling may also lower foreign prices for Kenya's exports which will increase the country's competitiveness in the world market. This will improve the balance of trade position of the country. Besides, a weak shilling may promote domestic investments that create employment and also discourages final consumption of luxury imports. All these are may improve the current account balance and support economic growth. Central Bank of Kenya (2011) report shows that there was a large current account deficit of about 11 percent of GDP, the exchange rate had to depreciate significantly to correct this imbalance in the economy. However, a small, open and developing economy like Kenya that has a huge oil import bill, a progressively weakening of the shilling may eventually cause inflationary pressures by knock-on effects through energy prices via consumption and production processes.

On the other hand, a strong Kenya shilling reduces the competitiveness of the country's exports which may stifle economic growth. Kenyan exports become expensive in foreign markets and imports become cheaper hence reducing domestic competitive industries as the share of foreign goods in our domestic market increases. This is coupled with the fact that a high interest rate which discourages domestic investment, which in turn impacts negatively on economic growth and employment, is generally associated with short-term inflows of foreign exchange which strengthens the Kenya shilling. Strengthening the shilling by short-term foreign exchange inflows increases the risk of exchange rate instability since these can be easily reversed. An appreciating currency increases the burden on manufacturers of domestic goods while making imports cheaper domestically. This can lead to a recession as excess capacity can trigger layoffs. As the economy goes into a recession there would be a weak effective demand and the government would collect less tax revenue which would undermine the activities of the government.

According to the Central Bank of Kenya (2021), Kenya currently transacts between USD 350 to 500 million a day, that translates to between USD 12 and 15 billion a month. The Central Bank endeavors to keep foreign exchange reserves equivalent to 4 months of import cover that is currently slightly over USD 4 billion. Central Bank of Kenya currently holds forex reserves of USD 7.7 billion (equivalent to 4.4-months of import cover), which is therefore above the statutory requirement of at least 4 months of import cover, and the East African Community region's convergence criteria of 4.5-months of import cover. This therefore means that were the Central Bank of Kenya to intervene in an attempt to hold the exchange rate at a particular level or move it towards a certain direction, its holdings of reserves will probably last around one week. In the year 2022, on a year-to-date basis, the shilling has depreciated by 5.5 percent against the dollar, higher than the 3.6% depreciation recorded in 2021. In the mid October 2022, the shilling already reached at 120.9 shillings and continues to increase constantly.

Causes and Implications of the Depreciation

The depreciation may be attributed to increase in global oil prices, higher demand versus low supply of dollars following the reopening of economies, balance of payment deficit, public debt and declining forex reserves as the major causes. The depreciation of the local currency is partly attributable to increased dollar demand from the oil and energy sectors. The cost of crude oil jumped to $123 per barrel after the Russia-Ukraine conflict started, holding above the $100 mark for the better part of this year. Oil imports account for close to 20% of all imports in the Kenya. The high 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. High global crude oil prices are due to persistent supply chain bottlenecks coupled with high demand as most economies gradually recover from the Covid-19 pandemic and the Russia-Ukraine conflict.

The depreciation is also partly attributable to increased dollar demand against a slower supply of hard currency following reopening of economies as from 2021 going to 2022. At the peak of COVID-19 pandemic in 2020, many countries placed restrictions and lockdowns that slowed down economic growth. With subsequent vaccine discovery, accessibility and mass vaccination most economies reopened and have continued to rebuild hence increasing the global demand for the USD for global trade. USD demand around the globe has created a dollar supply shortage in developing markets leading to depreciation of most currencies against the dollar. Increased demand from merchandise traders as they beef up their hard currency positions in anticipation of increased demand as economies pick up will keep the shilling under pressure, unless counterbalanced by increased dollar inflows through exports.

The balance of payments deficit in the first five months of 2022 was KES 666.2 billion, piling further pressure on the shilling. Data from the Central Bank of Kenya (CBK) showed that the growth in imports had significantly outstripped that of export earnings, which in the period grew by KES 41 billion to KES 354 billion. The cost of petroleum imports jumped by 90 percent to Sh258.7 billion, surpassing expenditure on machinery, transport equipment and manufactured goods. Expenditure on chemicals/fertilizers increased by KES 22.5 billion or 16 percent to KES 162 billion, while that of edible oils rose by KES 20 billion to KES 62 billion. A current account deficit due to an imbalance between imports and exports, with Kenya's current account deficit estimated at 5.3 percent of GDP in the 12 months to May 2022 compared to the 5.0 percent within a similar period in 2021. The high import bill will continue making it challenging improving current account balance and therefore, the shilling may continue depreciating against the dollar.

The impact of foreign debt on the shilling is perhaps one of the most important points to underscore. Kenya's fiscal policy space has changed significantly in the last 10 years on account of an expansionary fiscal policy driven by large infrastructure spending. This has pushed gross public debt as a percentage of GDP from 44.4% at the end of 2010 to an estimated 69% at the end of 2021. External debt exposes the country in case of the risk of depreciation of the local currency against the dollar. The rising external debt, whose composition is currently 66.6% USD denominated, has continued to weigh down on the shilling as the government through the Central Bank of Kenya has service the debt from the foreign reserves. In 2017/18, Kenya's debt service was predominantly composed of domestic debt repayments amounting to 69 percent of the total as compared to 31 percent for external debt. However, this picture changed significantly in 2018 with the share of external debt rising from 31 percent to 48 percent. This was mainly driven by some of the commercial debt obligations that came due in 2019, including some to the Chinese Exim Bank for the standard gauge railway loan.

This is a shift from previous years where approximately 70 percent of the debt service bill was to repay domestic debt. While domestic debt service still accounts for the larger share of all payments, its share has been gradually reduced as that of external debt increases. There are advantages to having a large share of debt service being domestic. A key one is that it is in local currency which reduces the risks associated with foreign exchange volatility; and, secondly, it is easier to restructure domestic debt in case of shocks that could lead to defaults. The increase in the proportion of external debt service erodes these two advantages and is of concern. Kenya is now among 23 African countries that are at risk of debt distress due to weak fiscal management and macroeconomic frameworks to support growth, changing composition of debt towards more expensive sources of financing, and high levels of public spending. The aggressively growing government debt, with Kenya's public debt, has increased to 8.6 trillion shillings in May 2022, from 1.6 trillion shillings in May 2012 thus putting pressure on forex reserves to service some of the public debt.

Going forward, the elevated debt levels are likely to put forex reserves under pressure as a significant amount will be used to repay the debts. As a result, the Kenyan shilling will continue being exposed to foreign exchange volatility causing it to weaken. If however, the reserves improve due to the increasing diaspora remittance inflows, continued investor capital inflows and increasing exports as key economies continue to regain after the containment of the Covid-19 pandemic, then that may work to the advantage of the shilling. Improving diaspora remittances are evidenced by a 6.6 percent year to year increase to USD 326.1 million as of June 2022, from USD 305.9 million recorded over the same period in 2021, which has continued to cushion the shilling against a faster depreciation. In the recently released June 2022 diaspora remittances figures, North America remained the largest source of remittances to Kenya accounting for 59.1 percent in the period, followed by Europe at 18.2% while the rest of the world accounted for 22.7 percent of the total.

Conclusion

On a macro level, the depreciating shilling has added over KES 500 billion to Kenya's foreign debt. This is no small amount, at a time when the country has little fiscal space on account of large public debt. Besides, a depreciating shilling means imports, such as petrol, food, and raw materials, will become more expensive which will further push up the household cost of living as importers pass the hiked bill to consumers. The government must think of long-term measures to stop further slide of the shilling. This may include policies to boost exports and reduce the deficit in the balance of trade, reduction of foreign debt, and more specifically commercial debt and replacing it with more concessional loans among other options. Prolonged depreciation of the shilling will hurt the ability of the country to not only meet budgetary obligations but to also meet foreign debt payment obligations.

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