Ninetieth Sovereign Debt News Update: Transition at the Central Bank of Kenya: To Issue a US Dollar-Denominated Domestic Bond or Not?

By:

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The new Central Bank of Kenya's governor, Kamau Thugge, whose term began on 19 June 2023, intends to push for a US dollar-denominated domestic bond issuance. Kamau Thugge replaces Patrick Njoroge, whose eight-year tenure ended in June 2023. The targeted dollar-denominated bond sale expansion includes offers on diaspora remittances, foreign currency savings in local banks, and fuel subsidy arrears – all revenue-sourcing avenues to fund budget deficits – together with the hotly contested housing levy.

During his vetting before the Parliament's Finance and Planning Committee, Thugge cited high foreign currency deposits in local commercial banks. He stated that KES 1 trillion (approx. USD 7 billion) had been deposited in the local banks in the form of foreign currency at a time when the country is facing a dollar shortage, supporting the view that a local dollar bond is viable. According to him, he will work with the National Treasury to issue the dollar bond with attractive returns to get rich locals and businesses to release their fixed deposit accounts in local commercial banks. This is in a bid to release the greenback in fresh efforts to ease pressure on the Kenya Shilling.

The freefall of the Kenyan shilling is despite the existence of a government-backed deal to import fuel on credit from the Gulf nations, which was meant to reduce the demand and arrest the depreciation. Essentially, the credit period, in addition to the fuel marketers paying in Kenya shillings as opposed to the US dollars as has been the norm, was expected to reduce the demand for US dollars as well as reduce pressure on the foreign exchange reserves that have been low for a while. Investors, however, have continued to open foreign currency-dominated accounts in the hope of making gains from the sharp fall in the shillings against major currencies like the dollar and the pound. In fact, the dollar shortage had forced industrialists to start seeking the US currency daily and from several lenders for their monthly hard currency needs as the scarcity put a strain on supplier relations and the ability to negotiate favourable prices in spot markets. This is even as the IMF noted that the forex interbank market, which for long had been dysfunctional, has improved. Part of IMF's conditions for the Sh484.9 billion (approx. USD 3.52 billion) programme is for Kenya not to tinker with the exchange rate but instead let it act as a shock absorber.

In Thugge's words: "If we can get Kenyans holding dollars in deposit accounts to release them by buying into the bond, then we will have the possibility of increasing liquidity of dollars in the system and this will help us in building up foreign exchange reserves at the CBK… The CBK and the Treasury will seek to encourage Kenyans in the diaspora to invest in the dollar bond as a way of increasing inflows into the country."

However, the outgoing governor, Patrick Njoroge, urged caution with the local dollar bond issuance idea, saying the dollar deposits held by commercial banks were not idle. Njoroge noted that the proposal is based on the misplaced context that there exists a pool of idle foreign currency deposits in commercial banks. He, instead, tied the growing value of foreign currency deposits to increased regional operations by local banks with the commercial banks also mobilising new funding from external borrowing in recent years.

While noting the cons of issuing a Kenyan dollar bond would surpass the pros, Njoroge warned the issuance would disenfranchise retail investors while escalating the chances for the entrenchment of dollarisation in the economy. To Njoroge, it would not mop up excess dollars because there are no excess dollars in that sense, thus this would end up fanning the flames of dollarisation in the economy. In Njoroge's words: "It is very hard to think of how the government would mop up small deposits from retail investors, say with Sh1,000 (approx. USD10) each through a foreign currency issued bond. This would also end up fanning the flames of dollarisation in the economy and you can think of the effect this has had in other economies. I think it's a slippery slope and in terms of the benefits, I'm questioning the benefits of it…The bond would only be beneficial to the extent that it would attract new dollars from the rest of the world. We (however already) do this when we issue a Eurobond which is bought mainly by non-resident investors."

The issuance of a dollar-denominated local bond also raises other concerns in addition to the outgoing governor's concerns. For instance, currently, liquidity in the global market has tightened, with the US Federal Reserve acting aggressively on interest rates. The jittery now is about the refinancing of Kenya's 2024 Eurobond amid the rising interest rates that make refinancing an expensive adventure. So, the local bond market is one of the avenues President Ruto's government may be considering by issuing a dollar-denominated bond to repurchase its international debt like the 2024 Eurobond.

The question, however, is whether the local bond market is a safer option for the government to offer a dollar-denominated bond to repurchase the 2024 Eurobond. To start with, does Kenya have enough liquidity for the uptake of the bond by local investors? According to the latest figures from the Central Bank of Kenya, foreign currency deposits was worth Sh1 trillion (approx. USD 7.1 billion), with the greenback forming a large part of the deposits. So, for example, if the government targets issuing dollar-denominated bonds worth Sh800 billion (approx. USD 5.7 billion), it will exhaust all the dollars held in fixed deposits.

Additionally, the government will have to offer returns higher than 4-5 percent margin that banks are offering investors. The consequence, however, is that the government will be crowding out banks from accessing the dollar and raising the cost of borrowing. Besides, dollars are not domiciled in Kenya, therefore, the government will be in competition with banks (who offer returns to fixed depositors so they can have enough dollars to provide dollar loan facilities to their customers) for available dollars in the local market because both are dollar takers. Furthermore, given that the government is targeting foreign investors as well with the local dollar bond issuance, it has to offer returns much higher than what the US Treasury bonds will be offering so as to convince them to diversify their investments in a market like Kenya. In that case, the rates of the bond will come close to the rates of what investors will ask in the Eurobond market.

Lastly, the government will have to improve its fiscal status to make the local dollar bond attractive. However, this may not be feasible at this time because despite committing to reduce its budget by Sh300 billion (approx. USD2.1 billion), the Kenyan government instead intends to borrow Sh700 billion (approx. USD 4.9 billion) to finance its Sh3.6 trillion (approx. USD 25 billion) budget deficit for the fiscal year 2023/2024. This has not fostered confidence among the local bondholders as their uptake of the government's local bonds have been significantly low. For example, the government raised just a third of its targeted Sh50 billion (approx. USD356 million) in the February 2023 Treasury bond sale, with investors instead preferring to pump their funds into short-term Treasury bills on expectations that interest rates will soon go up in the country. The bond, a dual tranche offering comprising a reopened 10-year paper first sold in 2017 and a new 10-year paper, was undersubscribed despite offering interest rates of 13.87 percent and 14.15 percent respectively. The bond, instead, raised Sh16.74 billion (approx. USD114 million). This shows that investors are aware of the Kenyan government's strained fiscal position where revenue performance and borrowing are trailing target, while efforts to cut spending are hampered by factors such as debt obligations. This has seen bolder demands for higher rates in the securities auctions, going against the aversion by the Central Bank of Kenya against high priced bids that raise the cost of servicing domestic debt. The preference for Treasury bills also poses a problem for the Treasury's efforts to keep lengthening the debt maturity profile of the country in order to avoid short-term refinancing risk.

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