Cytonn Note on the Monetary Policy Committee (MPC) Meeting for January 2018

The Monetary Policy Committee (MPC) is set to meet on Monday, 28th January 2019, to review the prevailing macro-economic conditions and make a decision on the direction of the Central Bank Rate (CBR). In their previous meeting held on 27th November 2018, the MPC maintained the CBR at 9.0%, citing that the economy was operating close to its potential and inflation expectations remained anchored within the target range and thus concluded that the prevailing monetary policy stance remained appropriate. This was in line with our expectations as per our MPC Note, informed by the country's stable macroeconomic fundamentals as well as sustained optimism on the economic growth prospects, as had been evidenced by:

i. Inflation expectations, which were well anchored, within the target range, averaged 4.5% in the first 10 months of 2018 compared to 8.7% experienced in a similar period in 2017, following declines in food prices, which continued to offset the increase in energy prices and transport costs following the implementation of VAT on petroleum products,

ii. Private sector credit growth, which had grown by 4.4% y/y in October, with the highest growth in lending being recorded in the manufacturing, business services, finance and insurance and building and construction, at 14.9%, 12.4%, 9.1% and 7.2% over the same period, respectively, and,

iii. Increased private sector optimism as per the MPC Private Sector Market Perception Survey conducted in November 2018, which indicated that the private sector was optimistic about local economic prospects. This mainly attributed to a rebound in agriculture, expected up-tick in trade and tourism due to the commencement of direct flights to the United States and the continued infrastructural development.

The Monetary Policy Committee also noted that the current account deficit had narrowed to 5.3% in the 12 months to September 2018 compared to 6.5% in September 2017, supported by strong growth of agricultural exports particularly tea and horticulture, improved diaspora remittances, and tourism receipts.

Below, we analyse the macro-economic indicators trend since the November 2018 MPC meeting, and how they are likely to affect the MPC decision on the direction of the CBR:

Indicators	Experience since the last MPC meeting in November 2018	Going forward	Probable CBR Direction (November)	Probable CBR Direction (January)
Government Borrowing	The government is currently 34.7% behind its pro-rated borrowing target for the FY'2018/2019, having borrowed Kshs 113.0 bn against a pro-rated target of Kshs 173.0 bn	We are neutral on domestic borrowing, as the government is behind its borrowing target, and as such we expect slight pressure on the domestic borrowing front, which might see it start issuing shorter tenor bonds at the expense of the debt maturity profile, as well as a slight uptick in yields on Government papers	**Positive**	**Neutral**
Inflation	Inflation rate for the month of December 2018 rose to 5.7% from 5.6% recorded in November bringing the 2018 average to 4.7% compared to the 2017 average of 8.0%	Inflation is expected to remain within the government's target range of 2.5%-7.5% anchored by lower food prices, reflecting favorable weather conditions, the decline in international oil prices, and the downward revision in electricity tariffs	**Positive**	**Positive**

Currency (USD/Kshs)	The Shilling has gained by 1.0% since the last meeting supported by improved diaspora remittances coupled with thin dollar demand from oil importers	We expect the Kenyan Shilling to remain relatively stable against the dollar, supported by i. CBK's activities in the money market, such as repurchase agreements and selling of dollars, ii. High levels of forex reserves, currently at USD 8.0 bn, equivalent to 5.3-months of import cover, iii. Improving diaspora remittances, which increased by 6.9% m/m in the month of October 2018 to USD 219.2 mn, from USD 205.1 mn recorded in September. Cumulatively, total diaspora remittances rose by 39.5% in the 12-months to October 2018, to USD 2.6 bn, from USD 1.9 bn recorded in a similar period in 2017.	**Neutral**	**Neutral**
GDP Growth	Kenya's economy expanded by 6.0% in Q3'2018, higher than 4.7% in Q3'2017 supported by: i. recovery in agriculture, which recorded a growth of 5.2% due to improved weather conditions, ii. improved business and consumer confidence iii. increased output in the manufacturing and wholesale & retail trade sectors which grew by 3.2% and 6.8%, respectively	GDP growth is projected to come in between 5.7% - 5.9% in 2019 driven by recovery of growth in the agriculture sector, continued growth in the tourism, real estate and construction sectors, and growth in the manufacturing sector	**Positive**	**Positive**
Private Sector Credit Growth	The latest data from CBK indicates that private sector credit growth recorded a recovery in 2018, rising to an average of 3.4% in the 10 months to October from an average of 2.3% recorded in a similar period in 2017 but still below the 5-year average of 12.4%.	Private sector credit growth is expected to remain low this year due to the interest rate cap, which has made banks adopt a more stringent credit risk assessment framework thus limiting lending to riskier borrowers.	**Negative**	**Negative**
Liquidity	Liquidity levels in the money markets have continued to improve coming into 2019, with the average interbank rate to 17th January 2019 coming in at 3.3% compared to the 8.0% recorded in December driven by government payments and domestic debt maturities	Liquidity is expected to remain high with the heavy maturities of domestic debt in 2019 currently comprising of Kshs 820.8 bn worth of T-bill and Kshs 127.0 bn worth of T-bond maturities as well as continued government spending through the various infrastructure investments. We expect the improved liquidity in the money markets to stabilize the interest rate environment due to an uptick in the demand side on government securities	**Neutral**	**Positive**

Conclusion

Of the six factors that we track, one is negative, two are neutral, and three are positive, with the changes since the last MPC meeting being on liquidity from neutral to positive as well as government borrowing from positive to neutral. We believe that the MPC should adopt a wait and see approach, given the macro-economic environment is relatively stable. ***We therefore expect the MPC to hold the CBR at 9.0% with their decision being supported by:***

i. Inflationary pressure expected to be muted in 2019, anchored by the declining food prices due to the improved weather conditions as well as a decline in fuel prices due to lower global prices with Petrol, Diesel and Kerosene prices having already declined by 8.2%, 8.9% and 3.3%, respectively for the period effective 15th January- 14th February, 2019,
ii. The stability of the Kenyan Shilling, being among the best performing currencies in 2018, having gained by 1.8% against the dollar which saw the IMF reclassifying it, from a floating arrangement to stabilized arrangement. The Kenyan Shilling is expected to remain stable having gained by 0.2% YTD in 2019 reflecting a more stable economic environment,
iii. The Government is currently behind its domestic borrowing schedule having borrowed Kshs 113.0 bn against its pro-rated target of Kshs 173.0 bn. As such, we believe the MPC will maintain the CBR at the current rate with a bias to further easing in order to access domestic debt at cheaper rates. This however might have adverse effects of further crowding out of the private sector,
iv. Private sector credit growth has recorded a recovery, rising to an average of 3.4% in the 10 months to October from an average of 2.3% recorded in a similar period in 2017, with growth coming in at 4.4% in October 2018 from 3.9% recorded in September, but still remains below the 5-year average of 12.4%,

The key concern however remains the effectiveness of monetary policy with the interest rate cap still in place. The Monetary Policy Committee through its assessment of the impacts of the interest rate cap noted that it has weakened the transmission of monetary policy. In particular, the transmission of changes in the CBR to growth and inflation takes longer compared to the period before implementation of the interest rate cap.