Cytonn Note on the 28th July 2021 Monetary Policy Committee (MPC) Meeting

The Monetary Policy Committee (MPC) is set to meet on Wednesday, 28th July 2021, to review the outcome of its previous policy decisions and recent economic developments, and to decide on the direction of the Central Bank Rate (CBR). In their previous meeting held on 26th May 2021, the committee decided to reconvene on July 2021, while highlighting that they would remain ready to reconvene earlier if necessary, as they continue to closely monitor the impact of the policy measures. Additionally, the MPC maintained the CBR at 7.00%, citing that the accommodative policy stance adopted in March 2020, and all the other sittings since, which saw a cumulative 125 bps cut, was having the intended effects on the economy. This was in line with our expectations as per our MPC Note with our view having being informed by:

i. The need to support the economy by adopting an accommodative stance and pumping money into the economy. The macro and business environment fundamentals might have constrained the transmission of further accommodative cuts, despite the need to stimulate economic growth. Therefore, we believed that any additional rate cuts would not lead to a rise in private sector credit growth as elevated credit risks persisted in the business environment,
ii. Inflation stability, with the inflation rate having remained within the 2.5%-7.5% target range despite the increase in fuel prices. April's inflation was at 5.8%, which was the first decline since September 2020 attributable to the higher base effect, and,
iii. The FY'2021/22 budget estimates indicated that the government would set aside Kshs 26.6 bn through the Post - COVID recovery strategy, of which Kshs 8.6 bn would go towards enhancing liquidity to businesses. We expected these funds to be directed towards reviving sectors such as Tourism and Education that were adversely impacted by the pandemic, and would further reposition the economy towards recovery in a sustainable and steady trajectory. As such, we believed that this would reduce pressure on the MPC to pursue additional policy measures.

In the May meeting, the Monetary Policy Committee also noted that the current account deficit was projected at about 5.2% of GDP in 2021, from 4.8% in 2020, attributable to lower service trade receipts, which offset the increased receipts from exports and remittance.

Below, we analyze the trends of the macro-economic indicators since the May 2021 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 May 2021	Going forward	Probable CBR Direction (May)	Probable CBR Direction (July)
Government Revenue Collection	• Total revenue collected in FY'2020/2021 amounted to Kshs 1.67 tn, against a revised target of Kshs 1.65 tn, representing an out-performance of 101.0%. The out-performance, despite the challenges posed by the COVID-19 pandemic on business conditions and people's income, is mainly attributable to; (i) enhanced compliance enforcement efforts and the implementation of new tax measures focused on ensuring that that non-compliant taxpayers pay their due taxes, (ii) introduction of new taxes such as digital services tax, minimum tax and voluntary tax disclosure as KRA bid to expand sources of revenue, and, (iii) the reopening of the economy which led to a 12.0% growth in Domestic Excise tax in FY'2020/21, compared to a decline of 6.4% recorded in the last financial year	• We expect a gradual economic recovery going into FY'2021/2022 as evidenced by KRA collecting Kshs 1.7 tn in FY'2020/2021, a 3.9% increase from Kshs 1.6 tn collected in FY'2020/2021 and a 101.0% out-performance despite implementing fiscal measures to cushion Kenyans against the adverse impact of the pandemic in Q1'2020/2021 and Q2'2020/2021	**Neutral**	**Positive**

Government Borrowing	• The Government, as of 16th July 2021, was 36.8% ahead of its current borrowing target, having borrowed Kshs 52.0 bn against a prorated borrowing target of Kshs 38.0 bn and has domestic maturities worth Kshs 770.0 bn. The government will have to borrow Kshs 52.9 bn monthly to meet its domestic borrowing target of Kshs 658.5 bn in the 2021/2022 fiscal year • Key to note, the government has raised USD 714.5 mn (Kshs 77.0 bn) from the IMF, USD 130.0 mn (Kshs 14.1 bn) from the World Bank and USD 1.0 bn (Kshs 107.8 bn) from the Eurobond issue, totalling USD 1.8 bn (Kshs 198.9 bn) in external borrowing since April 2021	• The budgetary support received from the IMF under the Extended Fund Facility (EFF)/ Extended Credit Facility (ECF), which is pegged on fiscal and structural reforms aimed at reducing debt-related vulnerabilities, is expected to lead Kenya on a path to debt sustainability • The IMF Economic Recovery Program has boosted investor confidence in Kenya, as evidenced by the 12-year Eurobond issued in June 2021, which recorded an oversubscription of 5.4x and was priced at 6.3%, 1.7% points lower than the 12-year 2019 issue which was priced at 8.0%. As such, the domestic interest rate environment may stabilize since the government will not be desperate for cash	**Negative**	**Neutral**
Inflation	• Y/Y inflation for June came in at 6.3%, while the m/m inflation came in at 0.1%. This was mainly attributable to an 8.5% increase in the Food and Non-Alcoholic Drinks' Index, a 4.3% increase in the Housing, Water, Electricity, Gas and Other Fuels and a 14.7% increase in the Transport Index	• Y/Y inflation increased to 6.3% in June from 5.9% in May and we expect it to continue on its upward trajectory, mainly due to increasing fuel prices • We expect an increase in the transport and fuel index, which carries a weighting of 9.7% in the total consumer price index (CPI) as a result of the increase in fuel prices. Inflation is however still projected to remain within the government's target range of 2.5%-7.5% due to the expected rains which are expected to stabilise the Food and Non-Alcoholic Drinks' Index	**Positive**	**Neutral**
Currency (USD/Kshs)	• Since the last meeting, the Kenyan Shilling has depreciated by 0.4% against the US Dollar to Kshs 108.2 as of 19th July 2021, from Kshs 107.7 on 26th May 2021, mainly attributable to dollar demand from commodity importers outweighing the supply of dollars from exporters, and, • Forex Reserves have increased to USD 9.6 bn (equivalent to 5.9 months of import cover) from USD 7.6 bn (equivalent to 4.6 months of import cover) since the last meeting. The Forex reserves remain above the statutory requirement of maintaining at least 4.0-months of import cover, and the EAC region's convergence criteria of 4.5-months of import cover	• We project the Kenya Shilling to remain stable supported by the sufficient forex reserves, currently at USD 9.6 bn (equivalent to 5.9 months of import cover), and the improving diaspora remittances evidenced by a 6.0% y/y increase to USD 305.9 mn in June 2021, from USD 288.5 mn recorded over the same period in 2020 • The shilling is however expected to remain under pressure in the medium term following the demand from merchandise traders as they beef up their hard currency positions in anticipation for more trading partners reopening their economies globally	**Neutral**	**Neutral**
GDP Growth	• Kenya's economy contracted by 1.1% in Q3'2020, a decline compared to the 5.8% growth recorded in Q3'2019, which was mainly due to: i. A 57.9% contraction in the accommodation and food services sector, compared to an expansion of 9.8% in Q3'2019. This sector was the worst hit by the COVID-19	• We expect a gradual recovery in 2021 with improved business activity following the reopening and easing of some of the government restrictions. The average PMI came in at 50.0 for the first 6 months of 2021 • The World Bank projects the Kenyan economy to register a 4.5% GDP growth in	**Neutral**	**Neutral**

	pandemic as businesses in the sector either operated under minimum capacity or completely closed down, and, ii. This contraction was mitigated by the 6.3% growth in the agriculture and forestry sector, compared to 4.3% growth recorded in Q3'2019, supported by favourable weather conditions	2021 supported the gradual recovery of the business environment more so in sectors such as trade, tourism and education which were the worst hit by the pandemic in 2020 • Although improving external demand and the gradual recovery of the economy are expected to propel growth in 2021, risks abound such as the new COVID-19 variant and slow vaccine inoculation still persist and could weaken the economic rebound		
Private Sector Credit Growth	• The latest data from CBK indicates that private sector credit growth recorded a 6.8% growth in the 12 months to April 2021, the lowest it has been since October 2019 when the private sector credit growth stood at 6.6%, reflecting the persistent uncertainty in the economy on account of the toll of the COVID-19 pandemic on the business environment	• The tough economic conditions brought about by the pandemic have increased cash constraints for businesses as well as households with most businesses struggling to keep afloat due to subdued revenues. Slight improvements have however been witnessed in the banking sector's Gross Non-Performing Loans, which declined to 14.2% in April 2021 compared to 14.5% in February 2020 • The emergence of the new COVID-19 variant coupled with the slow vaccine distribution are expected to negatively affect the financial sector. We expect to see continued caution on lending especially to the tourism and hospitality sectors which are yet to recover from the adverse effects of the pandemic such as global travel restrictions	**Neutral**	**Neutral**
Liquidity	• Liquidity levels in the money markets improved, with the average interbank rate on 19th July 2021 coming in at 3.5%, a decline from the 5.1% recorded during the last meeting on 26th May 2021, supported by government payments	• Liquidity is expected to remain favorable due to: i. High domestic debt maturities that currently stand at Kshs 706.2 bn worth of T-bill maturities and Kshs 63.8 bn worth of T-bond maturities as at 16th July 2021, and ii. Low Cash Reserve Ratio (CRR) currently at 4.25% from 5.25% previously. Despite the reduction of the CRR, lending to the private sector has remained muted	**Positive**	**Positive**

Conclusion

Of the factors that we track, five are neutral and two are positive, with changes in government revenue collection which was neutral in May 2021 and is now positive in July 2021, government borrowing which was negative in May 2021 and is now neutral in July 2021 and inflation which was positive in May 2021 and is now neutral in July 2021. Despite the downgrading of Kenya's credit rating by Standard & Poor's credit rating agency to 'B' with a stable outlook from 'B+' with a negative outlook, the budgetary support received from the IMF Economic Recovery Program under the Extended Fund Facility (EFF)/Extended Credit Facility (ECF), which is pegged on fiscal and structural reforms aimed at reducing debt-related vulnerabilities is expected to lead Kenya on a path to debt sustainability. The USD 2.3 bn (Kshs 248.9 bn) three-year financing package under the ECF and EFF arrangement coupled with the USD 1.0 bn (Kshs 107.8 bn) Eurobond issue and the USD 130.0 mn (Kshs 14.1 bn) World Bank financing will reduce the government's reliance on domestic borrowing to bridge the fiscal deficit and as such, the domestic interest rate environment may stabilize since the government will not be desperate for cash.

The main goal of the monetary policy is to maintain price stability and support economic growth by controlling the money supply in the economy. We expect the MPC to maintain the Central Bank Rate (CBR) at 7.00%, with their decision mainly being supported by:

i. Stable Inflation which is projected to remain within the 2.5%-7.5% target range despite the recent increases in fuel prices. Key to note, June's inflation rate of 6.3% was a 16 month high and is above the midpoint of the government's target. We note that the IMF recently raised a concern on the country's rising inflation rates noting that should the country's three-month average inflation rate breach the CBK's target range, IMF would pause the USD 2.3 bn (Kshs 248.9 bn) three-year financing package under the EFF/ECF programme. Therefore, we believe that the MPC might come under pressure in the short term to maintain price stability should the inflation rates continue rising,
ii. High domestic maturities, which currently stand at Kshs 770.0 bn as at 16th July 2021. The government will have to borrow Kshs 52.9 bn monthly to meet its domestic borrowing target of Kshs 658.5 bn in the 2021/2022 fiscal year and as such, we expect the government to maintain the current rates so as to continue accessing domestic debt at cheaper rates. Increasing domestic debt composition could however lead to crowding out of the private sector,
iii. The need to support the economy by maintaining an accommodative monetary policy stance to strengthen the ongoing recovery. The current macro and business environment fundamentals might constrain the transmission of further easing, despite the need to stimulate economic growth. Therefore, we believe that any additional rate cuts will not lead to a rise in private sector credit growth as elevated credit risks persist in the current environment. However, the speed of vaccine inoculation will determine how fast normalcy will return in key sectors such as tourism and wholesale/retail trade, and,
iv. The FY'2021/22 National Budget Statement indicates that the government will set aside Kshs 23.1 bn under the Economic Stimulus Programme, with Kshs 2.6 bn going towards improving liquidity to businesses and Kshs 6.4 bn allocated to education. Furthermore, we expect that funds will also be directed towards reviving sectors such as Tourism and Hospitality that were negatively impacted by the pandemic, repositioning the economy to recover in a sustainable and steady trajectory. As such, we believe that the MPC will be under less pressure to pursue additional policy measures.