Cytonn Note on the 26th May 2021 Monetary Policy Committee (MPC) Meeting

The Monetary Policy Committee (MPC) is set to meet on Wednesday, 26th May 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 29th March 2021, the committee maintained the CBR at 7.0%, 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. Stable Inflation which had remained within the 2.5%-7.5% target range despite the recent increases in fuel prices. February's inflation of 5.8% was an 11 month high and was above the midpoint of the government's target and as such, we felt that if inflation continued to rise, there might have been some pressure on the MPC in the long term to maintain price stability, and,
ii. The need to support the economy by adopting an accommodative stance and pumping money into the economy. We believed that any additional rate cuts would not lead to a rise in Private sector credit growth given the elevated credit risks.

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, partly reflecting the expected pickup in imports. Receipts from tea, Horticulture and flower exports rose by 8.1% and 3.4%, respectively, in the 12 months to February 2021, largely reflecting increased demand from the key international markets. Imports of goods declined by 11.8% in the 12 months to February 2021, mainly reflecting lower imports of oil products due to relatively low international oil prices.

Below, we analyze the trends of the macro-economic indicators since the March 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 March 2021	Going forward	Probable CBR Direction (March)	Probable CBR Direction (May)
Government Revenue Collection	• Following the release of the Q2' 2020/2021 fiscal year budget outturn figures, the fiscal measures implemented by the Government in order to cushion Kenyans against the adverse impact of the pandemic and to further increase liquidity in the economy, is estimated to cost the exchequer Kshs 172.0 bn in revenue foregone by the Government • For FY'2020/21 the total revenue collected in the 10 months to April 2021 amounted to Kshs 1,337.4 bn against a revised target of Kshs 1,383.9 bn, a 3.4% shortfall. However, the decision by the government to reverse some of the tax incentives implemented in April 2020 as part of the COVID-19 economic stimulus relief coupled with changes in the Finance Bill 2020 has led to a revenue over performance in the first 4 months of 2021.	• We expect a gradual economic recovery going into 2021 as evidenced by KRA collecting Kshs 176.7 bn in April, a 22.2% improvement from March's collection of Kshs 144.6 bn, and, • We believe that the reversal of the COVID related tax incentives as well as amendments in the Finance Bill 2020 such as the introduction of digital taxes will boost revenue collection. However, given that we are in the last quarter of the current fiscal year and the government is still behind target in revenue collection having recorded a 3.4% shortfall in the first 10 months, we do not expect the government to meet the revenue collection target by 30th June 2021.	Neutral	Neutral
Government Borrowing	• The Government, as of 13th May 2021, was 1.6% ahead of its current borrowing target having borrowed Kshs 492.1 bn against a prorated borrowing target of Kshs 484.6 bn against a domestic borrowing target of Kshs 572.7 bn and has domestic maturities worth Kshs 165.0 bn. With a high possibility of the	• The downgrading of Kenya's credit rating by Standard & Poor's credit rating agency to 'B' from 'B+' means Kenya will find it harder to borrow from the international market and may have to pay more on interest to borrow money from the	Neutral	Negative

	government not hitting its borrowing target, there has been aggressive domestic borrowing to bridge the fiscal deficit gap.	foreign lenders due to the perceived higher risk. As such, we expect the aggressive domestic borrowing to persist, thus creating uncertainty in the interest rate environment		
Inflation	• Y/Y inflation for April came in at 5.8%, while the m/m inflation came in at 0.8%. This was mainly attributable to a 1.7% increase in the Food and Non-Alcoholic Drinks' Index coupled with a 0.3% increase in the Transport Index	• Y/Y inflation declined to 5.8% in April from 5.9% in March despite the recent hikes 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**	**Positive**
Currency (USD/Kshs)	• Since the last meeting, the Kenyan Shilling has appreciated by 2.3% against the US Dollar to Kshs 107.3 as of 18th May 2021, from Kshs 109.8 on 29th March 2021, mainly attributable to market participants anticipating a positive economic recovery following the arrival of the Covid-19 vaccines in the country in March • Forex Reserves have increased to USD 7.6 bn (equivalent to 4.6 months of import cover) from USD 7.3 bn (equivalent to 4.5 months of import cover) since the last meeting. The Forex reserves remain above the statutory requirement of at least 4.0-months of import cover, and the EAC region's convergence criteria of 4.5-months of import cover	• We expect the Kenya Shilling to remain stable and trade within the range of between Kshs 107.0 and Kshs 110.0 against the USD in 2021. This will be supported by: (i) The improving diaspora remittances which totaled to Kshs 122.7 bn for the first 4 months of 2021 as compared to Kshs 93.4 bn remitted over a similar period in 2020, and, (ii) Improving forex reserves which are currently at USD 7.6 bn which is equivalent to 4.6 months of import cover, further disbursements of the IMF credit facility, including the Kshs 44.0 bn in May 2021, are expected to boost the reserves. • However, the shilling may come under pressure from dollar demand as foreign investors receive the annual dividend payments and increase in imports by energy and general merchants as economies of key trading partners open up	**Negative**	**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 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	• We expect a gradual recovery in 2021 with an improved business activity following the reopening and easing of some of the government restrictions. The average PMI coming in at 49.1 for the first 4 months of 2021. • The IMF and World Bank project the Kenyan economy to register a 4.7% GDP growth in 2021 supported by favourable weather conditions and the reopening of schools during the year. The third wave of COVID-19 globally however constrains the growth of the tourism, accommodation and food services sector which is yet to recover since the onset of the pandemic in March 2020	**Neutral**	**Neutral**
Private Sector Credit Growth	• The latest data from CBK indicates that private sector credit growth recorded a	• The tough economic conditions brought about by the pandemic have increased	**Neutral**	**Neutral**

	9.7% growth in the 12 months to February 2021 as demand recovered as a result of improved economic activity. The operationalisation of the Credit Guarantee Scheme for the vulnerable Micro Small and Medium-sized Enterprises (MSMEs), will de-risk lending by commercial banks to the sector and is critical to increasing credit to the MSME sector	cash constraints by businesses as well as households with most businesses struggling to keep afloat due to subdued revenues. Consequently, this led to an increase in the banking sector's Gross Non-Performing Loans to 14.5% as of February 2021 compared to 14.1% in December 2020, and, • Total loans amounting to Kshs 1.7 tn were restructured (57.0% of the total banking sector loan book of Kshs 3.0 trillion) by the end of February 2021, in line with the emergency measures announced by CBK on March 18 2020 to provide relief to borrowers. However, the one-year restructuring period expired on 2nd March 2021, with the Central Bank revealing that the outstanding amount of restructured loan amounts to Kshs 569.3 bn (19.0% of the banking sector's loan book) by end of February 2021		
Liquidity	• Liquidity levels in the money markets improved, with the average interbank rate on 13th May 2021 coming in at 5.0%, a decline from the 5.4% recorded during the last meeting on 29th March 2021, supported by government payments	• Liquidity is expected to remain favorable due to: i. Domestic debt maturities that currently stand at Kshs 165.0 bn worth of T-bill maturities, 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, four are neutral, two are positive and one is negative, with changes in government borrowing which was neutral in March 2021 and now negative in May 2021 and currency which was negative in March 2021 and now neutral in May 2021. The downgrading of Kenya's credit rating by S&P Global to 'B' from 'B+' will make it hard to access external borrowing at favorable rates. Consequently, the government will be forced to borrow domestically so as to bridge the fiscal deficit which stood at 8.7% as per the supplementary budget I of the current fiscal year. Local investors are now demanding higher yields from government papers, which can also be reflected in the yield curve readjusting upwards mostly in the shorter end, as investors feel that pandemic related risks still persist in the economy. On the other hand, we are neutral on currency given the continued appreciation of 2.0% in 2021 as compared to 7.7% depreciation in 2020. Diaspora remittances continue to boost the forex reserves and support the shilling coupled with the improving current account condition.

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. The inflation for the month of April was at 5.8% and given the possibility of further fuel price hikes we might see an even higher inflation figure and as such, if inflation continues to rise, there might be some pressure on the MPC in the long term to maintain price stability,
ii. The need to support the economy by adopting an accommodative stance and pumping money into the economy. The current macro and business environment fundamentals might constrain the

transmission of further accommodative cuts, 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. The reopening and easing of some of the containment measures put in place in March 2021 will boost economic recovery for the rest of the year. However, the speed of vaccine inoculation will determine how fast normalcy will return in key sectors such as agriculture and wholesale/retail trade, and,

iii. The FY'2021/22 budget estimates indicate that the government will set aside Kshs 26.6 bn of funds through the Post - COVID recovery strategy, of which, Kshs 8.6 bn will go towards enhancing liquidity to businesses. Additionally, we expect that these funds will be directed towards reviving sectors such as Tourism and Education that were adversely impacted by the pandemic, and will further reposition the economy towards recovery in a sustainable and steady trajectory. As such, we believe that this will reduce pressure on the MPC to pursue additional policy measures.