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

The Monetary Policy Committee (MPC) is set to meet on Tuesday, 25th September, 2018 to review the prevailing macro-economic conditions and make a decision on the direction of the Central Bank Rate (CBR). While noting the risk of perverse outcomes, the MPC lowered the CBR by 50 bps to 9.0% from 9.5% in their previous meeting held on 30th July 2018, which was not in line with our expectations as per our MPC Note, citing that economic output was still below its potential despite improving economic growth prospects, as evidenced by:

i. Inflation expectations which were well anchored within the target range despite rising to 4.3% in June from 4.0% in May. The MPC noted that the overall inflation was expected to remain within the government target range of 2.5%-7.5% despite upward pressure from rising fuel prices due to a rise in global oil prices and the impact of excise duty on some of the CPI items. Expectations of declining food prices due to favorable weather conditions was expected to mitigate the upward inflationary pressure,

ii. Private sector credit growth, which grew by 4.3% y/y in June up from 2.8% in April, with the highest growth in lending being recorded in the building and construction, manufacturing, and trade sectors at 13.5%, 12.3% and 8.6% over the same period, respectively, and,

iii. Increased private sector optimism as per the MPC Private Sector Market Perception Survey conducted in May 2018, which indicated that the private sector was optimistic about local economic prospects in 2018. This was mainly attributed to a relatively stable macroeconomic environment, renewed business confidence, a rebound in agriculture due to improved weather conditions, continued infrastructure investment by the government, with the government's focus on the ***Big Four Agenda***.

The decision to lower the CBR was not in line with our expectation which was to maintain the rate at 9.5%. We believed that the MPC would adopt a wait and see approach as they monitor the effects of the previous rate cut given the stability in the macroeconomic environment, as had been evidenced by

i. Inflation which had averaged 4.2% in the first 6 months of 2018 compared to 9.8% experienced in a similar period in 2017. We expected inflation to rise in H2'2018, but the overall average inflation for the year to remain within the government target of 2.5%-7.5%, thus no need to tighten monetary policy which is used to restrict liquidity to slow down inflation, as there were no expectations of high inflationary pressure,
ii. The government was not expected to be under pressure to borrow given the decline in the borrowing requirement to plug in the FY'2018/2019 budget to Kshs 558.9 bn from Kshs 620.8 bn in the FY'2017/2018 budget, with domestic borrowing estimated at Kshs 271.9 bn, 8.6% lower than the 2017/2018 fiscal year's target of Kshs 297.6 bn, and,
iii. The currency had appreciated by 0.4% since their last meeting on 30th July, 2018. We also reasoned that maintaining the CBR would be a better move given the low private sector credit growth despite having improved to 2.8% in April from 2.0% in March; lowering the CBR would further limit credit access to the private sector, which was still a key concern as it was still below the 5-year average of 14.0% as well as the government set annual target of 12.0% – 15.0%.

The monetary policy committee also noted that

i. The overall inflation was expected to remain within the government target range mitigated by the decline in food prices following improved weather conditions despite expectations of upward pressure from rising fuel prices driven by the increase in international oil prices, and the impact of the excise duty indexation on prices of some of the CPI items,

ii. The current account deficit had narrowed to 5.8% in the 12 months to June 2018 from 6.3% in March 2018 and was expected to narrow further to 5.4% of GDP in 2018 supported by strong growth of agricultural exports particularly tea and horticulture, improved diaspora remittances, and tourism receipts. The petroleum products import bill was however expected to increase due to higher international oil prices but the effects on the current account were expected to be mitigated by lower imports of food and SGR-related equipment in 2018.

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

Key Macro-Economic Indicators – Kenya					
Indicators	**Expectations at start of 2018/2019 Fiscal Year**	**Experience since the last MPC meeting in July 2018**	**Going forward**	**Probable CBR Direction (July)**	**Probable CBR Direction (September)**
Government Borrowing	According to the FY 2018/19 Budget, the total borrowing target for the 2018/2019 financial year is Kshs 558.9 bn down from Kshs 620.8 bn in the FY'2017/2018 .The government is however likely to remain behind its borrowing target for the better part of the first half of the 2018/19 financial year as per historical data	The Government is currently 37.3% ahead of its pro-rated borrowing target for the FY'2018/2019, having borrowed Kshs 86.2 bn against a pro-rated target of Kshs 62.7 bn, and has been under no pressure to borrow as evidenced by the declining yield curve as the government continues to reject expensive bids	We expect the government to be under no pressure to borrow in the domestic market. With the rate cap still in place, the government is expected to continue accessing domestic debt at lower yields due to reduced competition from the private sector. The total borrowing requirement to plug in the fiscal deficit in FY'2018/2019 is also expected to decline to Kshs 558.9 bn from Kshs 620.8 bn with domestic borrowing estimated at Kshs 271.9 bn 8.6% lower than the Kshs 297.6 bn target in FY'2017/2018 thus reducing the pressure further	**Positive**	**Positive**
Inflation	To average within the government annual target of between 2.5% - 7.5% in 2017	Inflation has averaged 4.2% in the first 8 months of 2018 compared to 9.3% experienced in a similar period in 2017. Y/Y inflation rate for the month of August recorded a decline to 4.0% from 4.4% in July mainly due to a decline in food prices that constitute the food index, and the base effect. M/M inflation rate, however increased by 0.3% due to an increase in the housing, water, electricity, gas and other fuels' index, driven by a significant increase in prices of electricity, coupled with an increase in the transport index on account of increased pump price of petrol which outweighed the decrease in price of diesel	Inflation in H2'2018 is still expected to experience upward pressure, partly due to the base effect, and the rise in fuel and transport prices. This is due to the imposition of the 16.0% VAT on petroleum products having taken effect from 1st September 2018 despite National Assembly voting to postpone its imposition by 2 years through the Finance Bill 2018 which the President has since then referred back to the National Assembly for reconsideration due to reservations he had, after it was submitted to him for assent. Despite this, we still expect Inflation to average 7.0% in 2018 down from 8.0% in 2017 and within the government target	**Positive**	**Positive**
Currency (USD/Kshs)	To remain stable supported by dollar reserves	The Shilling has appreciated by 1.9% against the USD YTD to 100.8 but has lost by 0.4% since the last meeting which was mainly driven by increased dollar demand from banks and	Kenya's forex reserves currently stand at USD 8.5 bn (equivalent to 5.7 months of import cover), sufficient to cushion the economy from unforeseen short-term shocks.	**Neutral**	**Neutral**

		importers over uncertainty regarding the IMF stand-by arrangement that expired on 14th September 2018. The Shilling has however remained resilient, despite the dollar index having gained 2.6% YTD.	Kenya's current account deficit has also improved to 5.8% of GDP in Q1'2018, from 11.3% recorded in Q1'2017. Despite the expiry of the IMF standby credit facility, we expect the currency to remain relatively stable against the dollar, supported by, (i) stronger horticulture export inflows driven by increasing production and improving global prices, (ii) improving diaspora remittances, and (iii) the ample forex reserves		
GDP Growth	GDP growth projected to come in at between 5.4% - 5.6%	Kenya's economy expanded by 5.7% in Q1'2018, higher than 4.8% in Q1'2017. This was due to; 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 real estate, manufacturing, and wholesale & retail trade sectors, which grew by 6.8%, 2.3% and 6.3%, respectively	GDP growth is projected to come in between 5.4% - 5.6% in 2018 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	Private sector credit growth expected to remain low, below the 5-year average of 13.0%	The latest data from CBK indicates that private sector credit growth came in at 4.3% in June 2018, higher than 3.9% in May 2018. This was the highest growth rate since December 2016, pointing to a recovery albeit slow and still way below the 5-year average of 13.0%	Private sector credit growth is projected to remain low this year as the interest rate cap has made banks adopt a more stringent credit risk assessment framework thus limiting lending to riskier borrowers. Despite calls by the IMF to re-look at the Act, and the President's and National Treasury's endorsement of these sentiments, the National Assembly, remain against the repeal of the law having voted to retain the status quo on the ceiling rate on loans citing that there has been no concerted efforts by banks to address high credit risk pricing, and only proposed to remove the floor rate on deposit rates which was pegged at 70.0% of the CBR rate now leaving the decision of the rate at the discretion of the customer and the Bank ,	**Negative**	**Negative**
Liquidity	Liquidity expected to remain high given heavy maturities of government securities and following the capping of interest rates	Liquidity levels in the money markets have continued to improve as indicated by a decline in the average interbank rate to 5.8% at the end of August from 7.2% in July	Liquidity is still expected to remain high with the heavy maturities of short term domestic debt in the 2018/2019 financial year currently comprising of Kshs 709.0 bn T-bill and Kshs 864.3 bn worth of T-bond maturities as well as continued government spending through the various infrastructure investments, with	**Neutral**	**Neutral**

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			the main focus being on the Big Four Agenda.		

Conclusion

Of the six factors that we track, one is negative, two are neutral, and three are positive, with no change since the last MPC meeting. With inflation having eased to 4.0% from 4.4% since the last meeting despite the currency having depreciated by 0.5% mainly driven by increased dollar demand as the country edged closer to the expiry of the IMF standby precautionary facility, 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%. The key concerns still remain

i. **The low private sector credit growth, despite having improved to 4.3% in June, being the highest since December 2016, but still remains well below the 5-year average of 13.0% and the government set annual target of 8.8%, which is expected to slow economic growth.**
ii. **The country's fiscal deficit, which the government aims at reducing to 5.7% of GDP from 6.8% in FY'2017/2018 as per the fiscal consolidation agenda in the FY'2018/2019 budget with the 17.5% targeted increment in revenue collections to Kshs 1.9 tn through various tax policy measures, at the core of this agenda.**

Currently there are uncertainties due to the ongoing stalemate with the Finance Bill 2018, which has brought concerns in the effective transmission of monetary policy considering the current interest rate environment, with the proposal by the National Assembly, to retain the interest rate cap, only scrapping off the floor rate on deposits which had been pegged on the Central Bank Rate(CBR). The Finance Bill has also threatened to frustrate the government's efforts of raising additional tax revenues. With this, coupled with expectations of inflation remaining within the government set target of 2.5%-7.5% during the year despite inflationary pressures in H2'2018, we expect the MPC to retain the CBR at 9.0% which will also effectively maintain the current low lending rates to the government.