Cytonn Note on the Monetary Policy Committee (MPC) Meeting for March 2020

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The Monetary Policy Committee (MPC) is set to meet on Monday, 23rd March 2020, to review the outcome of its previous policy decisions and recent economic developments, and to make a decision on the direction of the Central Bank Rate (CBR). In their previous meeting held on 27th January 2020, they lowered the CBR by 25 bps to 8.25% from 8.5%, citing that the economy was operating below its potential level concluding that there was room for accommodative monetary policy to support economic activity. This was lower than our expectations as per our MPC Note with our view being informed by:

i. The need to stimulate growth, with GDP growth in 2019 having slowed down averaging 5.1% in Q3’2019 lower than 6.4% in Q3’2018 and below the CBK’s estimated growth 6.3%. With the plans of the continued fiscal consolidation by the Government, we believe that a further cut will be necessary to provide the required economic growth stimulus, further boosted by the repeal of the interest rate cap, which going forward is expected to provide more efficient transmission of monetary policy as opposed to the interest rate cap era,

ii. Inflation has remained contained and within the Government set target of 2.5% - 7.5%, amid slowed economic growth, thus providing room for moderate stimulus through expansionary monetary policy,

The Monetary Policy Committee also noted that the current account deficit had narrowed to 4.6% of GDP in 2019 compared to 5.0% in 2018, supported by lower imports of SGR-related equipment, resilient diaspora remittances and strong receipts from transport and tourism services.

Below, we analyze the trends of the macro-economic indicators since the January 2020 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 January 2020	Going forward	Probable CBR Direction (January)	Probable CBR Direction (March)
Government Borrowing	• The Government is currently 42.3% ahead its prorated domestic borrowing target and has to borrow on average Kshs 100.5 bn monthly in the current financial year to meet its domestic borrowing target of Kshs 300.3 bn and has domestic maturities worth 355.9 bn	• We are negative on domestic borrowing, due to the levels of domestic debt maturities in FY'2019/20 currently at Kshs 355.9 bn, coupled with the historical underperformance of ordinary revenues, with the Government having met 93.1% of its target as per the FY'2018/2019 budget outturn. Despite the underperformance, the Government raised its total revenue target by 14.2% to Kshs 2.1 tn for FY'2019/20 which we doubt it will meet, thus exert slight pressure on the domestic borrowing front to plug in the deficit. • The government may also find it hard to access foreign debt due to uncertainity affecting the global markets which might see investors attaching a high risk premium on the country as evidenced by all Eurobond yields having increasing significantly as at last week	**Neutral**	**Negative**
Inflation	• Inflation for the month of February increased to 6.4%, from 5.8% recorded in January 2020, Y/Y inflation increased mainly driven by a 10.6% increase in the food and non-alcoholic beverages index. M/M inflation also increased by 0.6% due to a 2.6% increase in the food and non-alcoholic beverages index	• Inflationary pressure is expected to emanate from the effects of the world Pandemic-Coronavirus and the locust invasion which may greatly affect the agricultural sector. The shortage of imports due to lockdowns across the globe has also caused prices to rise in the local market, leading to cost-push inflation	**Positive**	**Neutral**

Indicators	Experience since the last MPC meeting in January 2020	Going forward	Probable CBR Direction (January)	Probable CBR Direction (March)
Currency (USD/Kshs)	• The Kenya Shilling has depreciated by 2.5% against the US Dollar to Kshs 103.4, from Kshs 100.9 during the last meeting, attributable to reduced dollar demand from the merchandise traders. Forex reserves have however declined to USD 8.4 bn (equivalent to 5.2 months of import cover) from USD 8.5 bn (equivalent to 5.2 months of import cover) since the last meeting. This however still meets the CBK's statutory requirement to endeavor to maintain at least 4 months of import cover and the EAC region's convergence criteria of 4.5 months of import cover, thus providing an adequate buffer for the Kenyan Shilling from external shocks	• In our view, the shilling should remain relatively stable against the dollar with a bias to a 2.4% depreciation by the end of 2020, with the sentiments being on the back of; 1. Rising uncertainties in the global market due to the Coronavirus outbreak, which has seen the disruption of global supply chains. The shortage of imports from China for instance, which accounts for an estimated 21.0% of the country's imports, is likely to cause local importers to look for alternative import markets, which may be more expensive and as such higher demand for the dollar from merchandise importers, 2. Subdued diaspora remittances growth following the close of the 10.0% tax amnesty window in July 2019. We also foresee reduced diaspora remittances, owing to the decline in economic activities globally hence a reduction in disposable incomes. This coupled with increased prices of household items abroad might see a reduction in money expatriated into the country	**Neutral**	**Negative**
GDP Growth	• Kenya's economy expanded by 5.1% in Q3'2019, a decline from the 6.4% recorded in Q3'2018, which was due to: 1. A slowdown in the Agricultural sector to 3.2% in Q3'2019 from 6.9% in Q3'2018 attributed to a drop in production of key crops in the country such as tea, vegetable, and fruit exports 2. A slowdown in the manufacturing sector to 3.1% in Q3'2019 compared to a growth of 4.6% in Q3'2018, largely attributed to the decline in agro-processing activities that were also subdued as a result of the reduced production of tea and sugar	• Based on the impact on other economies, we believe that coronavirus may have a 10.0% to 25.0% impact on GDP growth for the year 2020. The 10.0% impact is an optimistic case in the event the outbreak is contained, and a 25.0% impact in the event it is not contained • As such, the coronavirus could reduce Kenya's GDP growth to a range of 4.3% to 5.2% for the year 2020 depending on the severity of the outbreak and economic implications for Kenya	**Positive**	**Negative**
Private Sector Credit Growth	• The latest data from CBK indicates that private sector credit growth recorded a growth in the 12 months to December 2019 to 7.1% from 7.0% recorded in September 2019 but below the 5-year average of 11.2%	• The effects of the coronavirus pandemic are expected to negatively affect the financial sector. We expect to see increased caution on lending especially to businesses that rely on imports hence inhibiting private credit sector growth due to the high risk of credit default, with the possibility of heightened Non Performing Loans if the pandemic is to continue	**Positive**	**Neutral**

Indicators	Experience since the last MPC meeting in January 2020	Going forward	Probable CBR Direction (January)	Probable CBR Direction (March)
Liquidity	• Liquidity levels in the money markets remained favorable with the average interbank rate to 16th March 2020 coming in at 4.3% similar to what was recorded in 27th January 2020 , supported by government open market activities with the CBK engaging in mopping up activities through repurchase agreements to ease up liquidity, which offset tax payments.	• Liquidity is expected to remain high with the heavy maturities of domestic debt in 2020 that currently stand at Kshs 305.59 bn worth of T-bill maturities and Kshs 50.35 bn worth of T-bond maturities. We also expect the amendment to regulate payment matters and the measure to have all suppliers to Government paid within 60 days to have a positive impact on the circulation of money in the economy	**Positive**	**Neutral**

Conclusion

Of the six factors that we track, three are neutral and three is negative, with changes in government borrowing and currency which were neutral in January 2020 and now negative in March 2020 and inflation, GDP,liquidity, and private sector credit growth which were positive in January 2020 and now neutral in March 2020. Similar to other Central Banks around the world, the MPC is likely to adopt the status quo and cut the Central Bank Rate in a bid to boost the economy amid the uncertainty and supply chain shortages caused by the Coronavirus. The shortage of imports may cause prices to rise in the local market, which may lead to cost-push inflation. Most Central Banks around the world have taken a dovish monetary policy stance in a bid to boost the economy amid the negative macroeconomic effects emanating from the coronavirus outbreak. The table below shows how Central Banks of major global economies that have moved to cut interest rate so far;

No.	Country	Central Bank	Reduction Margin	Current. Rate
1	USA	Federal Reserve	1.00% Points	0%-0.25%
2	Australia	Reserve Bank of Australia	0.25% Points	0.5%
3	China	People’s Bank of China	0.10% Points	4.1%
4	Malaysia	Central Bank of Malaysia	0.25% Points	2.75%
5	England	Bank of England	0.50% Points	0.25%

We expect the MPC to reduce the Central Bank Rate (CBR) by 100 bps to 7.25% from 8.25%, with their decision mainly being supported by:

i. Cost-Push Inflation may be a threat to the economy due to supply-side shortages caused by lockdowns across the globe. The prices of consumer and capital goods in the market may rise to exorbitant levels as the supply will be unable to meet the demand in the market. The locust invasion which has plagued the country since the end of 2019 which may greatly affect the agricultural sector, causing a further increase in food prices which has a weight of 36.0% in the Consumer Price Index.
ii. The instability of the Kenyan Shilling having already lost by 2.0% YTD in 2020 and recording the lowest performance since October- 2019 reflecting a less stable economic environment. The country is experiencing high dollar demand from foreigners exiting the market as they direct their funds to safer havens, and
iii. The need to avail more money to importers who can import goods from alternative markets, other than China, as they may be more expensive, in a bid to reduce the supply side shortages. The MPC

may also cut the rate to encourage financial institutions to lend money to the private sector as most businesses may need to take up loans for business continuity purposes due to subdued revenues.

Despite this, we do not believe monetary stimulus measures will be highly effective in combating the effects emanating from the Covid-19 pandemic especially in some sectors such as the tourism sector which have been hit by demand-side issues. We believe what businesses and the economy as a whole needs is financial relief in order to ensure survival during this period of uncertainties. Some of the measures that would be effective include:

i. Encourage banks to give concessionary loans at lower rates to facilitate businesses, and as well provide moratoriums on loans that are due,
ii. Grant tax breaks to companies seeking to increase their capacity to produce import substitute goods, which could even mean zero-rating VAT for the next 3-months,
iii. Release VAT refunds to assist businesses with managing their cash flow,
iv. Announce and provide for a Business Stabilization Fund to cushion the impact of the coronavirus, especially for Small & Medium Enterprises (SME's),
v. Consider reducing corporate tax for industries that have been highly affected by the virus such as the aviation industry, or waiving corporate tax for a 3-month period as well as a reduction in payroll tax for the next 3 months for the low-income bracket workers, and,
vi. Strengthen the local supply chain for traders to be able to access import substitute goods.
