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

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

The Monetary Policy Committee (MPC) is set to meet on Wednesday, 27th May 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 29th April 2020, the committee decided to reconvene within a month for an early assessment of the impact of these measures and the evolution of the COVID-19 pandemic. In the last sitting, the MPC lowered the CBR by 25 bps to 7.00% from 7.25% citing that the accommodative policy stance adopted in March 2020 was having the intended effects on the economy. They however noted that the Coronavirus pandemic had continued to affect economic growth and as such, there was need to further cushion the economy against the effects of the pandemic. This was in line with our expectations as per our MPC Note with our view having being informed by:

?. The threat of Cost-push inflation emanating from the expectations of a second wave of locust invasion as per experts recommendation which was expected to greatly affect the agricultural sector, causing a further increase in food prices as well as supply side constraints due to effects of the COVID-19 pandemic. We noted that inflation would be mitigated by the decline in oil prices across the globe due to a decline in demand and as such, the transport index, which has a new weighting of 9.7% in the total consumer price index (CPI), would decline due to the decrease in petrol and diesel prices, and,

i. The instability of the Kenyan Shilling which had already lost by 5.6% YTD in April 2020 reflecting a less stable economic environment due to high dollar demand from foreigners exiting the market as they directed their funds to safer havens as well as merchandise, and energy sector importers beefing up their hard currency positions amid a slowdown in foreign dollar currency inflows from diaspora remittances and fewer offshore investors to meet dollar demand,

Following the revision of the balance of payments data over the past five years, the current account deficits for 2018 and 2019 were revised to 5.8% of GDP, from the previously recorded deficits of 5.0% and 4.3% of GDP in 2018 and 2019 respectively. The Monetary Policy Committee also noted that the current account deficit was projected to remain at 5.8% of GDP in 2020 (a rate equal to the revised figure of 5.8% recorded in 2018 and 2019), supported by lower oil imports that would offset the projected reduction in remittances. However, receipts from the tourism and horticulture sectors are set to decline due to the lockdown measures put in place by Kenya’s trade partners in the wake of the Coronavirus pandemic.

Below, we analyze the trends of the macro-economic indicators since the April 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 April 2020	Going forward	Probable CBR Direction (April)	Probable CBR Direction (May)
Government Borrowing	• The Government, as at 15th May 2020, was 18.7% behind its current borrowing target having borrowed Kshs 290.9 bn against a prorated borrowing target of Kshs 357.7 bn and has to borrow on average, Kshs 176.8 bn monthly in the current financial year to meet its domestic borrowing target of Kshs 404.4 bn and has domestic maturities worth Kshs 148.8 bn .	• We remain negative on government borrowing given the recently approved Supplementary Budget estimates II, which saw the domestic borrowing target adjusted upwards to Kshs 404.4 bn for FY'2019/20 from Kshs 300.3 bn. With less than 2 months to the end of the fiscal year, we do not believe the government will be able to meet this target given the high domestic maturities that currently stand at Kshs 148.8 bn • Moody's Credit Rating Agency in their recently released rating outlook changed Kenya's sovereign credit outlook to "negative", from a previous outlook of "stable", and also affirmed the B2 credit rating. Additionally, the IMF raised Kenya's risk of debt distress to high from moderate, and as such, we believe the government may find it hard to access foreign debt with investors attaching a high-risk premium on the country.	**Negative**	**Negative**
Inflation	• Inflation for the month of April came in at 5.6%, bringing the m/m increase to 0.9%. Y/Y inflation increased mainly driven by an 1.8% increase in the food and non-alcoholic beverages index and a 1.3% increase in the transport index on account of increase in the prices of matatu and taxi fares	• The threat of Cost-push inflation emanating from the expectations of a second wave of locust invasion as per experts recommendation which was expected to greatly affect the agricultural sector, causing a further increase in food prices as well as supply side constraints due to effects of the COVID-19 pandemic. • We noted that inflation would be mitigated by the decline in oil prices across the globe due to a decline in demand and as such, the transport index, which has a new weighting of 9.7% in the total consumer price index (CPI), would decline due to the decrease in petrol and diesel prices.	**Neutral**	**Neutral**

Indicators	Experience since the last MPC meeting in April 2020	Going forward	Probable CBR Direction (April)	Probable CBR Direction (May)
Currency (USD/Kshs)	• The Kenya Shilling has appreciated by 0.4% against the US Dollar to Kshs 106.9, from Kshs 107.3 during the last meeting, attributable to reduced dollar demand from the merchandise traders. • The Kshs 78.7 bn from the IMF has led to the increase in the levels of Forex Reserves to USD 8.5 bn (equivalent to 5.1 months of import cover) from USD 8.0 bn (equivalent to 4.8 months of import cover) since the last meeting, thereby providing adequate buffer to the shilling against foreign exchange shocks	• In our view, the shilling will continue to depreciate against the dollar with the performance being on the back of: 1. Despite the Kshs 78.7 bn credit facility from the IMF that intends to boost our forex reserves, we expect continued pressure due to low exports of goods and lower diaspora remittances amidst increases in demand for dollars to service Kenya debt and as foreign investors flee to safer havens	**Negative**	**Negative**
GDP Growth	• Kenya’s economy grew by 5.4% in 2019, a decline from the 6.3% recorded in 2018, which was due to: 1. A slowdown in the Agricultural Sector to 3.6% in 2019 from 6.0% in 2018 attributable to the disruption in farming activities due to suppressed long rains experienced in the agricultural areas. 2. A slowdown in the manufacturing sector to 3.2% in 2019 compared to a growth of 4.3% in 2018, largely attributed to the short supply of raw materials and an decrease in the volume output to 2.0% in 2019 from 5.6% in 2018	• The key sectors of the economy affected by the Coronavirus pandemic include the Tourism, Agricultural, and Manufacturing sectors which were hit the hardest hit due to shutdowns in major markets and the disruption of the global supply chain. Combined, the 3 sectors account for 43.8% of Kenya’s GDP in 2018. • Based on the impacts witnessed so far we lowered the GDP growth estimates to 1.4%- 1.8% for the year 2020 depending on the severity of the outbreak and economic implications for Kenya.	**Negative**	**Negative**

Indicators	Experience since the last MPC meeting in April 2020	Going forward	Probable CBR Direction (April)	Probable CBR Direction (May)
Private Sector Credit Growth	• The latest data from CBK indicates that private sector credit growth recorded a growth in the 12 months to March 2020 to 8.9% from 7.1% recorded in December 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	**Neutral**	**Neutral**
Liquidity	• Liquidity levels in the money markets eased with the average interbank rate in 15th May 2020 coming in at 4.1% down from the 4.5% recorded on 30th April 2020, supported by government payments.	• Liquidity is expected to remain favorable with the heavy maturities of domestic debt in 2020 that currently stand at Kshs 117.9 bn worth of T-bill maturities and Kshs 31.0 bn worth of T-bond maturities. • We believe that the increased liquidity will be supported by government payments of pending bills as well as the reduction of the Cash Reserve Ratio (CRR) to 4.25%, from 5.25%, by the Monetary Policy Committee (MPC) during its March 2020 sitting.	**Neutral**	**Neutral**

Conclusion

Of the six factors that we track, three are neutral and three are negative, with no changes between April 2020 and May 2020. Central Banks around the world have been moving to cut the Central Bank Rate in a bid to boost the economy amid the economic uncertainty brought about by the Coronavirus. This has seen the Central Bank of Kenya cut its country’s growth prospects to 2.3% from their earlier projections of 3.4% and 6.2% projected in March 2020 and January 2020 respectively.

The main goal of the monetary policy is to maintain price stability and support economic growth by controlling 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:

?. Despite the increased liquidity in the money markets mainly attributable to the lowering of the Cash Reserve Ratio (CRR) to 4.25%, from 5.25% in the March 2020 meeting, inflation rates have remained stable and within the government’s target range of 2.5% - 7.5%, a trend witnessed by many economies globally as business and social activities come to a near standstill due to the Coronavirus pandemic. This has seen demand for goods decline as governments impose strict lockdown measures to control the spread of the virus. Given that one of the main goals of monetary policy is to ensure price stability, we believe that the stable inflation rate will not exert pressure on the MPC to implement inflationary control,

i. We foresee the MPC taking a wait and see approach as it observes the effects of the 25 bps rate cut seen in the April 2020 sitting. Despite the need for economic stimulus in the wake of the Coronavirus that has adversely effected the economic growth, we believe that additional policy rate cuts might be ineffective and may not translate to increased private sector credit growth or lower lending rates, on account of the bank's credit pricing models during this period of economic uncertainties, with the expectations of increased levels of Non-performing loans. As such, we believe the MPC will maintain the CBR rate at 7.00% as they continue monitoring the economy, and,

ii. By further implementing an accommodative policy stance, domestic investment activities will decline as Kenya's financial and capital assets become less appealing to investors on account of their lower real rate of return. Consequently, the shilling will continue to depreciate as the demand for the dollar increases. On this front however, Kenya recently received a Kshs 78.7 bn Rapid Credit Facility (RCF) from the IMF which is expected to boost Kenya's dwindling forex reserves. This will provide additional buffer to the Kenya shilling from foreign exchange shocks in the short term. As such, this has reduced pressure on the Central Bank to pursue additional policy measures.
