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

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The Monetary Policy Committee (MPC) is set to meet on Thursday, 25th June 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 May 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 maintained the CBR at 7.00% citing that the accommodative policy stance adopted in March and April 2020 sittings, which saw a cumulative 125bps 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:

?. Inflation stability, with the inflation rate having remained within the government's target range of 2.5% - 7.5%, 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 stability has been 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.

i. We foresaw the MPC taking a wait and see approach as it observed 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 believed 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, and,

ii. By further implementing an accommodative policy stance, domestic investment activities would decline as Kenya's financial and capital assets become less appealing to investors on account of their lower real rate of return.

The Monetary Policy also noted that the current account deficit was projected to remain stable at 5.8% of GDP in 2020, from the previously recorded deficits of 5.0% and 4.3% of GDP in 2018 and 2019 respectively, supported by lower oil imports that would offset the projected reduction in remittances and exports.

Below, we analyze the trends of the macro-economic indicators since the May 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 May 2020	Going forward	Probable CBR Direction (May)	Probable CBR Direction (June)
Government Borrowing	· The Government, as at 12th June 2020, was 15.3% behind its current borrowing target having borrowed Kshs 309.7 bn against a prorated borrowing target of Kshs 365.5 bn and has to borrow on average, Kshs 163.7 bn in the month of June in order to meet its domestic borrowing target of Kshs 404.4 bn and has domestic maturities worth Kshs 81.7 bn	· We remain negative on government borrowing following the recently read FY'2020/21 budget which has seen an increase in the domestic borrowing targets to Kshs 493.4 bn from Kshs 404.4 bn in FY'2019/20. The budget deficit is projected at Kshs 840.6 bn, equivalent to 7.5% of GDP from Kshs 842.7 bn, 8.3% of GDP in the previous year.	**Negative**	**Negative**
Inflation	· Y/Y inflation for the month of May came in at 5.5%, while the m/m came in at 0.6%. Y/Y inflation increased mainly driven by an 10.6% increase in the food and non-alcoholic beverages index and a 0.02% increase in the transport index on account of increase in the prices of matatu and taxi fares despite the decline in petrol and diesel prices by 9.8% and 19.1%, respectively	· We expect inflation to remain stable despite supply side disruption due to COVID-19 as low demand for commodities compensates for the cost-push inflation, coupled with the low oil prices in the international markets. The recent reopening of majority of the global markets will also address supply chain issues causing import prices to stabilize	**Neutral**	**Positive**
Currency (USD/Kshs)	· The Kenya Shilling has appreciated by 0.7% against the US Dollar to Kshs 106.3, from Kshs 107.1 during the last meeting, attributable to increased inflows from diaspora remittances · The Kshs 78.7 bn from the IMF has led to the increase in the levels of Forex Reserves to USD 9.2 bn (equivalent to 5.6 months of import cover) from USD 8.5 bn (equivalent to 5.1 months of import cover) since the last meeting, thereby providing adequate buffer to the shilling against foreign exchange shocks	· We maintain our view on the continued pressure on the Kenyan shilling, with the performance being on the back of increase in dollar demand from merchandise importers as the easing of coronavirus restrictions jumpstart economic activities, thus boosting demand for hard currency	**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: i. 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. ii. 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 May 2020	Going forward	Probable CBR Direction (May)	Probable CBR Direction (June)
Private Sector Credit Growth	· The latest data from CBK indicates that private sector credit growth recorded a growth in the 12 months to April 2020 to 8.9% from 7.1% recorded in December 2019 but below the 5-year average of 11.2%	· The tough economic conditions have brought about by the pandemic has increased the cash constraint on businesses as well as households with most businesses struggling to keep afloat due to subdued revenues. Consequently, this led to high Gross Non-Performing Loans in Q1'2020 of 11.3%, from 10.4% recorded in Q1'2019 · 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 on 12th June 2020 coming in at a 10-month low of 2.6% down from the 4.1% recorded on 29th May 2020, supported by government payments.	· Liquidity is expected to remain favorable with the maturities of domestic debt in 2020 that currently stand at Kshs 50.7 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 negative, two are neutral, and one is positive, with one change in our inflation projections from neutral to positive, between May 2020 and June 2020. Central Banks around the world have adopted a wait and see approach by maintaining the Central Bank Rate at the previous levels citing that the accommodative policy stance was helping their economies. The table below shows how Central Banks of major global economies that have moved to maintain their interest rates so far:

No.	Country	Central Bank	Rate in May 2020	Current Rate	Variance
1	USA	Federal Reserve	0%-0.25%	0%-0.25%	0.00%
2	Australia	Reserve Bank of Australia	0.25%	0.25%	0.00%
3	Malaysia	Central Bank of Malaysia	2.00%	2.00%	0.00%
4	China*	People's Bank of China	3.85%	3.85%	0.00%
5	**England**	**Bank of England**	**0.10%**	**0.10%**	**0.00%**

The MPC is scheduled to meet on 22nd June 2020

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:

?. Inflation is expected to remain stable and within the government’s target range of 2.5% -7.5% on account of the reopening of the Global markets which will address supply chain issues causing import prices to stabilize coupled with depressed global oil prices. 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. The recent economic stimulus package unveiled by the President is expected to stimulate economic activities amid the COVID-19 pandemic. The post COVID-19 economic stimulus package will provide credit guarantee loans to Micro, Small and Medium Enterprises (MSMEs) as well as promote tourism, which has been hit hard by the pandemic. The government has set aside Kshs 56.6 bn to cater for the program. The stimulus package is set to take effect on 1st July 2020 and as such, we believe that these will help in the mitigation against the adverse impacts of the pandemic and will further reposition the economy towards a recovery in a sustainable and steady trajectory. The credit facilities by the World Bank of USD 1.0 bn (Kshs 106.5 bn) and the USD 739.0 mn (Kshs 78.7 bn) from the International Monetary Fund (IMF) will go a long way in supporting the government’s efforts of economic recovery. We believe that this will reduce pressure on the MPC to pursue additional policy measures, and,
ii. The MPC will not come under pressure to cut the policy rates given that additional rate cuts will not translate to increased private sector growth. Should the MPC pursue additional rate cuts, Kenya’s financial and capital assets will become less appealing to investors on account of the lower rate of return. Consequently, the shilling will continue to depreciate on the back of increased dollar demand. As such, we believe the MPC will maintain the CBR at 7.00%

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