Cytonn Note on the 29th March 2021 Monetary Policy Committee (MPC) Meeting

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The Monetary Policy Committee (MPC) is set to meet on Monday, 29th March 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 27th January 2021, the committee decided to reconvene on March 2021, while highlighting that they would remain ready to reconvene earlier if necessary, as they continue to closely monitor the impact of the policy measures. Additionally, the MPC 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 was projected to be within the government's target range of 2.5%-7.5% on account of stable food prices attributable to favourable weather and stable fuel prices,
ii. Support for the local currency as the fundamentals support a more stable shilling i.e. the current account position which had been improving narrowed to 4.9% of GDP in the 12 months to October 2020, compared to 5.3% of GDP during a similar period in 2019. The recent reprieve from debt servicing in the form of the Debt Service Suspension Initiative (DSSI) from 1st January 2021 to 30th June 2021 is meant to support the shilling, and,
iii. The need to support the economy by continuously pumping money into the economy. The macro and business environment fundamentals would constrain the transmission of further accommodative cuts, despite the need to stimulate economic growth. Therefore, we believed that any additional rate cuts would not lead to a rise in private sector credit growth as elevated credit risks persist in the current environment.

The Monetary Policy Committee also noted that the current account deficit was projected at about 4.8% of GDP in 2020, from 5.8% in 2019, attributable to the recovery of exports of goods which had rebounded by 3.3% in 2020. The current account deficit is projected at 5.1% in 2021, partly reflecting the expected pickup in imports. Receipts from tea exports rose by 10.1% in 2020, largely reflecting increased output. Horticulture and flower exports also rebounded, growing by 27.7% in 2020, reflecting the normalization of demand in the international market, and the availability of adequate cargo space. Imports of goods declined by 12.5% in 2020 compared to 2019, mainly reflecting lower imports of oil products due to relatively low international oil prices in 2020.

Below, we analyze the trends of the macro-economic indicators since the January 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 January 2021	Going forward	Probable CBR Direction (January)	Probable CBR Direction (March)
Government Revenue Collection	· Following the release of the Q1' 2020/2021 fiscal year budget outturn figures, the fiscal measures implemented by the Government to cushion Kenyans against the adverse impact of the pandemic are estimated to cost the exchequer Kshs 41.7 bn in revenue. Total revenue collected in Q1 of FY' 2020/2021 amounted to Kshs 378.7 bn against a revised target of Kshs 428.9 bn, a 10.1% shortfall. This led the government to reverse some of the tax incentives implemented in April 2020 as part of the COVID-19 economic stimulus relief	· We expect a gradual economic recovery going into 2021 as evidenced by KRA collecting Kshs 121.3 bn in February, a 9.0% improvement from January's collection of Kshs 111.3 bn, and, · The reversal of the COVID related tax incentives and the introduction of digital taxes will boost revenue collection	**Neutral**	**Neutral**
Government Borrowing	· The Government, as of 19th March 2021, was 9.6% behind its current borrowing target having borrowed Kshs 358.5 bn against a prorated borrowing target of Kshs 396.5 bn against a domestic borrowing target of Kshs 572.7 bn and has domestic maturities worth Kshs 283.6 bn	· There is increased demand for shorter-dated government debt due to increased uncertainty in the current environment, · The downgrading of Kenya's credit rating by Standard & Poor's credit rating agency to 'B' with a stable outlook from 'B+' with a negative outlook 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 foreign lenders due to the perceived higher risk, and, · The proposed increase of the fiscal deficit to 8.7% from the Budget and Appropriation Committee's (BAC) recommended fiscal deficit target of 7.5% means the government's fiscal consolidation targets may not be achieved. The government's increased appetite for borrowing could also lead to upward pressure on government borrowing rates	**Neutral**	**Neutral**
Inflation	· Y/Y inflation for February came in at 5.8%, while the m/m inflation came in at 0.7%. This was mainly attributable to a 1.0% increase in the Food and Non-Alcoholic Drinks' Index coupled with a 2.3% increase in the Transport Index	· Y/Y inflation increased to 5.8% in February from 5.7% in January and we expect it to continue on its upward trajectory, mainly due to increasing fuel prices. We expect an increase in the transport and fuel index which carries a weighting of 8.7% in the total consumer price index (CPI) as a result of the increase 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**

Indicators	Experience since the last MPC meeting in January 2021	Going forward	Probable CBR Direction (January)	Probable CBR Direction (March)
Currency (USD/Kshs)	· Since the last meeting, the Kenyan Shilling has appreciated by 0.2% against the US Dollar to Kshs 109.9 as of 23rd March 2021, from Kshs 110.1 on 27th January 2021, mainly attributable to market participants anticipating a positive economic recovery following the arrival of the Covid-19 vaccines in the country during the month · Forex Reserves have declined to USD 7.4 bn (equivalent to 4.6 months of import cover) from USD 7.7 bn (equivalent to 4.7 months of import cover) since the last meeting. The Forex reserves have declined but are still above the statutory requirement of maintaining at least 4.0-months of import cover, and the EAC region's convergence criteria of 4.5-months of import cover. Key to note, the week ending 12th March 2021 saw the forex reserves decline to USD 7.4 bn (equivalent to 4.5 months of import cover), the same level as the EAC criteria of 4.5 months of import cover	· We project 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, supported by the improving current account position which narrowed to 4.9% of GDP in the 12 months to October 2020 compared to 5.3% of GDP during a similar period in 2019. However, the dwindling forex reserves may mean the government of Kenya will struggle to support the local currency when it depreciates	**Negative**	**Negative**
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 following improved business activity in the fourth quarter with the average PMI coming in at 53.9 in Q4'2020 · 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 an 8.4% growth in the 12 months to December 2020 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	· The tough economic conditions brought about by the pandemic have increased 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 14.1% as of December 2020 compared to 12.5% in December 2019, and, · Total loans amounting to Kshs 1.63 trillion were restructured (54.2% of the total banking sector loan book of Kshs 3.0 trillion) by the end of December, in line with the emergency measures announced by CBK on March 18 2020 to provide relief to borrowers. The one-year restructuring period however expired on 2nd March 2021, with the Central Bank revealing that since March 2020, loans amounting to Kshs 1.7 tn were restructured (57.0% of the banking sector's loan book) by end of February 2021	**Neutral**	**Neutral**

Indicators	Experience since the last MPC meeting in January 2021	Going forward	Probable CBR Direction (January)	Probable CBR Direction (March)
Liquidity	· Liquidity levels in the money markets improved, with the average interbank rate on 22nd March 2021 coming in at 5.7%, an increase from the 5.6% recorded during the last meeting on 27th January 2021, supported by government payments	· Liquidity is expected to remain favorable due to: i. High domestic debt maturities that currently stand at Kshs 283.6 bn worth of T-bill maturities and Kshs 19.5 bn worth of T-bond 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, unchanged from January 2021, where four were neutral, two were positive and one was negative.

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. Key to note, February's inflation of 5.8% was an 11 month high. At 5.8%, the y/y inflation is above the midpoint of the government's target and as such, if inflation continues to rise, there might be 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. 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 lowering of the government's credit rating by Standard and Poor's however poses the risk of upward pressure on interest rates as the Central Bank aims to prop up the economy on the back of a subdued economic performance in 2020, in addition to providing support to the economy in the midst of a third wave of COVID-19.