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

MPC

The Monetary Policy Committee (MPC) is set to meet on Monday, 22nd January 2018 to review the prevailing macro-economic conditions and make a decision on the direction of the Central Bank Rate (CBR). In their previous meeting held in November 2017, the MPC maintained the CBR at 10.0%, which was in line with our expectations as per our MPC Note. The decision was on the back of a relatively stable macroeconomic environment, driven by;

- the inflation rate which had declined to 5.7% in October from 7.1% in September, due to a decline in food prices brought about by the improved weather conditions,
- a relatively stable foreign exchange market, with the shilling remaining steady, supported by foreign reserves which stood at USD 7.1 bn (equivalent to 4.7 months of import cover), with a standby facility of USD 1.5 bn from the IMF, all providing adequate buffer in case of adverse movements in the forex market, and
- a resilient banking sector, with the average commercial banks liquidity ratio and capital adequacy ratio at 44.7% and 18.8%, against statutory limits of 20.0% and 14.5%, respectively, with the gross NPL ratio improving slightly to 10.6% in October, from 10.7% in August.

The committee also noted that (i) inflation was expected to continue declining in the short term due to the extension of the subsidy on maize and improved weather conditions, that was expected to offset rising fuel prices, (ii) the current account deficit was expected to narrow to 6.2% of GDP by December 2017, as the quantity of Standard Gauge Railway (SGR) construction related imports declines; and the favourable weather conditions support food production and boost agricultural exports, and (iii) the economy is expected to remain resilient, with expected 2017 GDP growth at 5.1% (MPC expectation), supported by a resilient services sector, Micro, Small and Medium Enterprises (MSME's) in particular, improved growth in the agriculture sector supported by favourable weather conditions and continued government spending on infrastructure. However, the committee expressed concerns around the global economy, specifically post-Brexit resolutions in the Eurozone and monetary policies biased towards economic tightening in the U.S.A.

Below, we analyse the macro-economic indicators trend since the November 2017 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 2017/2018 Fiscal Year	Experience since the last MPC meeting in November 2017	Going forward	Probable CBR Direction (November)	Probable CBR Direction (January)

Key Macro-Economic Indicators – Kenya

Indicators	Expectations at start of 2017/2018 Fiscal Year	Experience since the last MPC meeting in November 2017	Going forward	Probable CBR Direction (November)	Probable CBR Direction (January)
Budget Deficit	The government expected to borrow Kshs 317.7 bn from the domestic market for the 2017/2018 financial year and Kshs 206.0 bn from the foreign market, while KRA has a revenue collection target of Kshs 1.7 tn for the 2017/18 fiscal year	The government has remained behind its domestic borrowing target for the current fiscal year, having currently borrowed Kshs 110.6 bn against a target of Kshs 228.8 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 410.2 bn budgeted for the full financial year as per the Cabinet-approved 2017 Budget Review and Outlook Paper (BROP))	(i) The government is currently behind its domestic borrowing target for the 2017/18, having borrowed Kshs 110.6 bn against a target of Kshs 228.8 bn (ii) The government has borrowed only 43.8% of its foreign borrowing target for the 1st quarter of the 2017/18 fiscal year as per the Q1'2017/18 Budget Review by the CBK - which translates to 2.7% of the full year target - despite budget estimates having been revised downwards to Kshs 277.3 bn (BROP) from Kshs 462.3 bn in FY'2016/17 (iii) KRA is expected to face challenges in meeting its overall revenue collection target of Kshs 1.7 tn for the 2017/18 fiscal year due to the economic slowdown brought about by expected subdued corporate earnings growth During the 1st quarter of the fiscal year 2017/18, recurrent and development expenditure were at 102.4% and 102.9% absorption respectively, but this was just 20.8% and 14.4% of the full fiscal year targets (less than 25.0%), respectively; attributable to the reduced business activity and political uncertainty experienced during the quarter. However, given KRA is expected to miss its revenue collection target, and the government is significantly behind its borrowing target in the fiscal year 2017/18, the government may come under	**Negative**	Negative

Key Macro-Economic Indicators – Kenya

Indicators	Expectations at start of 2017/2018 Fiscal Year	Experience since the last MPC meeting in November 2017	Going forward	Probable CBR Direction (November)	Probable CBR Direction (January)
Inflation	To average above the government annual target of between 2.5% - 7.5% in 2017	Inflation declined to 4.5% in the month of December from 5.7% in October, due to improved weather conditions. The 2017 average inflation rate was 8.0%, compared to average 8.7% at the time of the last MPC meeting and 6.3% in 2016	We expect the inflation rate to increase marginally in January from December due to rising food and fuel prices but remain within the government target range, and average at 6.6% in 2018	**Positive**	**Positive**
Currency (USD/Kshs)	To remain stable supported by dollar reserves	The shilling has appreciated by 0.5% against the dollar since the last meeting, depreciating by 0.7% in 2017, primarily driven by increased diaspora remittances and Central Bank support. Diaspora remittances however decreased by 5.6% to USD 175.2 mn in November from USD 185.5 mn in October	Kenya's forex reserves have declined from a high of USD 8.3 bn in May 2017 and USD 7.5 bn as at the last meeting; and currently stand at USD 7.0 bn (equivalent to 4.7 months of import cover). The balance of payment position continues to worsen with the country's current account deficit expanding to 6.5% of GDP in September from 6.4% in July 2017, on the back of higher global oil prices. Despite the weak fundamentals, the Central Bank has managed to support the shilling. We expect the currency to remain relatively stable against the dollar, supported by the CBK activity	**Neutral**	**Neutral**

Key Macro-Economic Indicators – Kenya

Indicators	Expectations at start of 2017/2018 Fiscal Year	Experience since the last MPC meeting in November 2017	Going forward	Probable CBR Direction (November)	Probable CBR Direction (January)
GDP Growth	GDP growth to come in at between 4.7% - 5.2% in 2017, from 5.8% recorded in 2016	GDP growth for Q3'2017 came in at 4.4%, primarily on account of subdued performance of the financial & insurance sector and the manufacturing sector, bringing the average growth for the first 3 quarters of 2017 to 4.7%. The IMF cut their 2017 GDP growth projection to 5.0% from 5.7% due to slower agriculture growth in the 1st half of the year, slowing private sector credit growth and political uncertainty experienced during the year	GDP growth in 2017 is expected to come in at 4.5% - 4.8%, having averaged 4.7% for the first three quarters. 2018 GDP growth is expected to come in between 5.3% and 5.5% driven by (i) recovery of the agriculture sector, (ii) continued strong growth in the real estate and tourism sectors, (iii) public infrastructural investments boosting growth in the construction sector, and (iv) growth in the manufacturing sector driven by the government's initiatives towards supporting the various industries	**Neutral**	**Neutral**
Private Sector Credit Growth	Private sector credit growth expected to remain at low levels, below the government set annual target of 18.3%	The latest data from CBK indicates that private sector credit growth came in at 2.0% in October 2017, a slight improvement from 1.6% in August, which is below the government set annual target of 18.3%	Private sector credit growth has remained low, improving slightly to 2.0% in October from 1.7% in September, and is projected to remain low as the interest rate cap has made it difficult for banks to lend to riskier borrowers	**Negative**	**Negative**
Liquidity	Liquidity expected to remain high given heavy maturities of government securities	The money market has been relatively liquid, with bank's excess reserves improving to Kshs 7.0 bn as at 5th January 2018, compared to Kshs 0.9 bn at the start of November, as evidenced from the interbank rate's decline to 7.1% from 8.8% at the time of the last meeting. However, the CBK has been active in the Repo market in a bid to inject liquidity, having injected Kshs 52.8 bn during the month of December and Kshs 22.8 bn in the first week of January	(i) Money supply (M3) growth is stable, at 8.7% as at October from 8.3% in July 2017 (ii) The CBK will remain active in the Repo market in a bid to inject liquidity in the market	**Negative**	**Neutral**

Conclusion

Of the six factors that we track, two are negative, three are neutral, and one positive, with Liquidity being the economic indicator that has changed since the last MPC meeting in November, moving to a Neutral from Negative. With inflation having eased to 4.5% from 5.7% since the last meeting and the currency having appreciated by 0.5% over the same period of time, 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 10.0%. The key concerns still remain (i) declining economic growth that came in at 4.4% in Q3'2017 and averaged 4.7% for the first 3 quarters of 2017, though expected to improve to 5.4% in 2018, but remain lower than the 5.8% recorded in 2016, and (ii) the slowed private sector credit growth, which improved slightly to 2.0% as at October from 1.7% in September, but remained well below the government set annual target of 18.3%, which is expected to hit economic growth.