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

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

The Monetary Policy Committee (MPC) is set to meet on Monday, 19th March, 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 January 2018, 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;

i. the inflation rate which had declined to 4.5% in December from 4.7% in November 2017, primarily due to reduced food prices, which offset the increases in fuel and electricity prices,
ii. a relatively stable foreign exchange market, supported by inflows from tea and horticultural exports, diaspora remittances, and strong recovery of tourism, and,
iii. a resilient banking sector, with the average commercial banks liquidity ratio and capital adequacy ratio at 43.7% and 18.5%, against statutory limits of 20.0% and 14.5%, respectively, as at December 2017, with the gross NPL ratio remaining unchanged at 10.6% from October.

The committee also noted that (i) inflation was expected to remain within the government target of 2.5% - 7.5%, despite pressure from rising global oil prices, (ii) the current account deficit was expected to decrease to 5.4% of GDP in 2018, with expected reduced Standard Gauge Railway (SGR) Phase II construction related imports, and food imports; and an increase in tea and horticultural exports, diaspora remittances and tourism-related forex inflows, and (iii) the economy is expected to remain resilient, with CBK's projected 2018 GDP growth of 6.2%, higher than the 2017 estimated growth rate of 4.8%, supported by the improvement in the business environment, improved growth in the agriculture sector, and continued government spending on infrastructural projects. However, the committee expressed concerns around the global economy, specifically post-Brexit resolutions in the Eurozone and U.S.A. economic policy.

Below, we analyse the macro-economic indicators trend since the January 2018 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 January 2018**	**Going forward**	**Probable CBR Direction (January)**	**Probable CBR Direction (March)**
Government Borrowing	The government expected to borrow Kshs 317.7 bn from the domestic market for the 2017/18 financial year and Kshs 206.0 bn from the foreign market, while KRA had a revenue collection target of Kshs 1.7 tn for the 2017/18 fiscal year	The domestic borrowing target was revised downwards to Kshs 297.6 bn from Kshs 410.2 bn (BROP) and Kshs 317.7 bn (BPS released in Feb 2017), as per the 2018 Budget Policy Statement (BPS), while the foreign borrowing target was revised upwards to Kshs 323.2 bn from Kshs 277.3 bn (BROP) and Kshs 206.0 bn (BPS released in Feb 2017) (i) The government is currently ahead of its domestic borrowing target for the 2017/18 fiscal year, having borrowed Kshs 219.7 bn against a target of Kshs 206.0 bn (ii) The government has borrowed 69.9% of its foreign borrowing target for the fiscal year 2017/18, with the estimate revised up to Kshs 323.0 bn as per the 2018 BPS, with the government having issued a Kshs 202.0 bn Eurobond and borrowed Kshs 24.1 bn by December 2017 (iii) KRA collected Kshs 709.4 bn in revenue by December 2017, against the government target of Kshs 777.7 bn, which was 91.2% of its half year target and 86.3% of its pro-rated target. They are not significantly behind target	We do not expect the government to come under pressure to borrow during the current fiscal year given their current position, hence we expect the interest rate environment to remain relatively stable throughout the fiscal year 2017/18	**Negative**	**Positive**

Key Macro-Economic Indicators – Kenya					
Indicators	**Expectations at start of 2017/2018 Fiscal Year**	**Experience since the last MPC meeting in January 2018**	**Going forward**	**Probable CBR Direction (January)**	**Probable CBR Direction (March)**
Inflation	To average above the government annual target of between 2.5% - 7.5% in 2017	Inflation in January and February 2018 came in at 4.8% and 4.5%, respectively, with y/y inflation remaining low mainly due to the base effect but m/m inflation rising by 1.4% in February due to increasing food, fuel, electricity and transport prices	Inflation in H1'2018 is expected to remain low mainly due to the base effect despite pressure on electricity, fuel and food prices. Inflation in H2'2018 however is expected to experience upward pressure, also partly due to the base effect but also due to an expected rise in electricity, fuel and transport prices as petroleum products get taxed 16.0% VAT as from September 2018. We expect Inflation to average 7.5% in 2018, which is at the upper limit of the 2.5% - 7.5% government target	**Positive**	**Positive**
Currency (USD/Kshs)	To remain stable supported by dollar reserves	The Shilling has appreciated by 1.9% against the USD YTD to 101.2 and by 1.5% since the last meeting, hitting a high of Kshs 100.8 due to increased flower exports to the Eurozone in mid-February Diaspora remittance increased by 16.3% to USD 203.8 mn in December from USD 175.2 mn in November, and the dollar index has lost 2.3% YTD	Kenya's forex reserves currently stand at USD 7.2 bn (equivalent to 4.8 months of import cover), with the country's current account deficit expanding to 7.0% of GDP in December from 6.5% in September 2017, on the back of higher global oil prices. The government projects it to narrow to 5.4% of GDP in 2018 due to lower food and SGR imports We expect the currency to remain relatively stable against the dollar, supported by the CBK activity, with ample reserves and the IMF extending the standby credit facility of USD 1.5 bn (approx. 1 month import cover) by 6 months, to allow for review, and weakening of the dollar, with	**Neutral**	**Neutral**

Key Macro-Economic Indicators – Kenya					
Indicators	**Expectations at start of 2017/2018 Fiscal Year**	**Experience since the last MPC meeting in January 2018**	**Going forward**	**Probable CBR Direction (January)**	**Probable CBR Direction (March)**
GDP Growth	GDP growth for 2017 to come in at between 4.7% - 5.2% , from 5.8% recorded in 2016	Average GDP growth for the first 3 quarters of 2017 came in at 4.7%, with estimates as per the 2018 BPS at 4.8% and our estimate at 4.7% for 2017. The consensus GDP growth projection for Kenya in 2018 is at 5.5% (an average taken from 14 research firms, global agencies and government organizations projections), which is better than GDP growth experienced in 2017	GDP growth is projected to come in at 5.4% in 2018 driven by recovery of growth in the agriculture sector, continued growth in the tourism, real estate and construction sectors, and growth in the manufacturing sector	**Neutral**	**Positive**
Private Sector Credit Growth	Private sector credit growth expected to remain low, below the government set annual target of 18.3%	The latest data from CBK indicates that private sector credit growth came in at 2.4% in December 2017, a slight improvement from 2.0% in October, but is below the government set annual target of 18.3%	Private sector credit growth has remained low throughout 2017, and is projected to remain low as the interest rate cap has made it difficult for banks to lend to riskier borrowers With calls by the IMF to re-look at the Act, a proposal by the Kenya Parliamentary Budget Office to review the cap, and the National Treasury planning to introduce a Consumer Protection Law to replace the law capping interest rates, we might see the law repealed or modified to accommodate faster private sector credit growth. However, nothing has been done yet and the cap is still in place	**Negative**	**Negative**

Key Macro-Economic Indicators – Kenya					
Indicators	**Expectations at start of 2017/2018 Fiscal Year**	**Experience since the last MPC meeting in January 2018**	**Going forward**	**Probable CBR Direction (January)**	**Probable CBR Direction (March)**
Liquidity	Liquidity expected to remain high given heavy maturities of government securities and following the capping of interest rates	Liquidity levels in the money markets have remained relatively stable as indicated by a decline in the weekly average interbank rate to 4.7% from 6.3% on the week ended 31st January, and also the decline in the weekly average interbank volumes by 0.7% to Kshs 13.5 bn from Kshs 13.6 bn on the week ended 31st January 2018, as larger banks dominated the market borrowing at low rates	(i) Money supply (M3) growth increased to 9.5% as at December from 8.4% in November 2017, but largely due to an increase in net credit to the government , (ii) In 2018, the CBK is exploring the use of pooled securities under the control of a central counterparty as collateral for interbank money market transactions, and we expect that this will serve to redistribute and improve liquidity in the money market. However, this has not been implemented yet	**Neutral**	**Neutral**

Conclusion

Of the six factors that we track, one is negative, two are neutral, and three are positive, with Government Borrowing & GDP Growth being the economic indicators that have changed since the last MPC meeting, both to positive from negative and neutral, respectively. With (i) inflation having eased to 4.5% from 4.8% since the last meeting and an average of 8.0% in 2017, (ii) the government being under no pressure to borrow from the local markets since they are ahead of their domestic borrowing target, and (iii) the currency having appreciated by 1.5% since the last meeting on January 22nd, 2018, we believe that the MPC should adopt a wait and see approach, given the stability in the macro-economic environment. We therefore expect the MPC to hold the CBR at 10.0%. The key concerns remain the low private sector credit growth, which improved slightly to 2.4% as at December from 2.0% in October 2017, but remained well below the government set annual target of 18.3%.