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

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The Monetary Policy Committee (MPC) is set to meet on Monday, 28th May, 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 on 19th March 2018, the MPC revised the CBR downwards to 9.5% from 10.0% previously, which was not in line with our expectations as per our MPC Note. The MPC noted that there was room for monetary policy easing to further support economic activity, as evidenced by:

i. inflation, which eased to 4.5% in February 2018 from 4.8% in January, and has remained well within the government target range of 2.5% - 7.5%, and,
ii. increased private sector optimism about local economic prospects in 2018 as per the MPC Private Sector Market Perception Survey conducted in March 2018 mainly attributed to a relatively stable operating environment, improving weather conditions, continued infrastructural investment by the government, direct flights to-and-from the USA, and perceived political stability that has resulted in improved investor confidence.

The decision to lower the CBR was not in line with our expectation which was to maintain the rate at 10.0%. We believed that the MPC would have adopted a wait and see approach given the stability in the macroeconomic environment, as evidenced by (i) inflation having eased to 4.5% from 4.8% since the last meeting, (ii) the government being under no pressure to borrow from the local markets since they were ahead of their domestic borrowing target, and, (iii) the currency having appreciated by 1.5% since the last meeting on January 22nd, 2018. We also reasoned that maintaining the CBR would be the better move given the low private sector credit growth; lowering the CBR would effectively lower lending rates, thus making credit pricing to private sector even harder hence negative effect on private sector credit growth.

The committee also noted that (i) inflation was expected to remain within the government target of 2.5% - 7.5% driven by lower food prices following improved weather conditions that outweigh the pressure of increased fuel prices resulting from rising global oil prices, (ii) the current account deficit was expected to decrease to 5.4% of GDP in 2018, with the expected reduction in 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 was expected to remain resilient, with CBK's projected 2018 GDP growth of 6.2%, higher than the 2017 growth rate of 4.9%, supported by the improvement in the business environment, improved growth in the agriculture sector, and continued government spending on infrastructural projects.

Below, we analyse the macro-economic indicators trend since the March 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 March 2018**	**Going forward**	**Probable CBR Direction (March)**	**Probable CBR Direction (May)**
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	(i) The government is currently ahead of its domestic borrowing target for the 2017/18 fiscal year, having borrowed Kshs 345.0 bn against a pro-rated target of Kshs 263.3 bn (ii) The government has borrowed 72.9% of its foreign borrowing target and 82.4% of their pro-rated target, for the fiscal year 2017/18, with the estimate having been revised up to Kshs 323.0 bn as per the 2018 BPS	Government to be under no pressure to borrow as it is ahead of both domestic and not far off from meeting its foreign borrowing target for FY 2017/18, and KRA is not significantly behind its target Past June, at the start of the next fiscal year however, the government will once again begin a new borrowing cycle, and will likely be behind target as per historical data. Despite this, with the interest rate cap still in place, we don't expect this to result in upward pressure on interest rates, like we saw at the start of the current fiscal year. Should the cap be repealed, we expect this to result in upward pressure on interest rates in the next borrowing cycle, as the government will be behind target and will no longer have an easy time collecting funds from the domestic market. However, with National Assembly against a complete repeal and the National Treasury working on a Bill to amend the law, we still remain positive on government borrowing until we have a feel of how the Bill will seek to amend the cap and how this in turn will affect borrowing by the government and the interest rate environment Also, with the Treasury's efforts to increase revenue collections and reduce expenditure as per directive by the IMF, the borrowing targets for the next fiscal year might be lower	**Positive**	**Positive**

Inflation	To average above the government annual target of between 2.5% - 7.5% in 2017	Inflation has averaged 4.3% in the first 4 months of 2018. The year on year inflation rate for the month of April declined to 3.7% , its lowest level since January 2013 driven by food inflation declining to 0.3% from 2.2% in March on account of improved weather conditions	Inflation in H1'2018 is expected to remain low mainly due to the base effect despite pressure on fuel and food prices. Electricity prices are expected to fall driven by the decline in forex levy and fuel levy components of electricity due to use of cheaper HEP as dams have filled up from the heavy rains experienced Inflation in H2'2018 however is expected to experience upward pressure, partly due to the base effect, and the expected rise in fuel and transport prices with the introduction of 16.0% VAT on petroleum products as from September 2018. However, we expect Inflation to average 7.0% in 2018 down from 8.0% in 2017 and within the government target range of 2.5% - 7.5%.	**Positive**	**Positive**
Currency (USD/Kshs)	To remain stable supported by dollar reserves	The Shilling has appreciated by 2.7% against the USD YTD to 100.4 and by 0.8% since the last meeting, hitting a high of Kshs 100.0 due to increased inflows from horticulture exports and diaspora remittances, and positive sentiments given the current high level of forex reserves, at USD 9.1 bn (equivalent to 6.2 months of import cover). Diaspora remittances increased by 5.6% to USD 222.2 mn in March from USD 210.4 mn in February 2018. The Shilling continued to appreciate despite the dollar index having gained 2.0% YTD	Kenya's forex reserves currently stand at USD 9.1 bn (equivalent to 6.2 months of import cover) and sufficient to cushion the economy from unforeseen short-term shocks. The country's current account deficit expanded to 6.7% of GDP in 2017 from 5.2% in 2016 as per the KNBS report on account of faster growth of imports at 20.5%, as compared to export growth at 2.8% but 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, (i) stronger horticulture export inflows driven by increasing production and improving global prices, (ii) improving diaspora remittances, and (iii) the ample reserves with the IMF having extended the standby credit facility of USD 1.5 bn (approx. 1 month import cover) by 6 months, to allow for review	**Neutral**	**Neutral**

GDP Growth	GDP growth for 2017 to come in at between 4.7% - 5.2% , from 5.9% recorded in 2016	Kenya's economy grew by 4.9% in 2017, compared to 5.9% in 2016 in line with our expectation of between 4.7% - 5.2%. 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 an improvement from the GDP growth experienced in 2017	GDP growth is projected to come in between 5.4% - 5.6% 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	**Positive**	**Positive**
Private Sector Credit Growth	Private sector credit growth expected to remain low, below the 5-year average of 14.0%	The latest data from CBK indicates that private sector credit growth came in at 2.1% in February 2018, slightly lower than 2.4% in December 2017, and still remains below the 5-year average of 14.0%	Private sector credit growth is projected to remain low this year as the interest rate cap has made banks adopt a more stringent credit risk assessment framework thus limiting lending to riskier borrowers. Despite calls by the IMF to re-look at the Act, and the President's and National Treasury's endorsement of these sentiments, the National Assembly, who are the legislators, remain against the repeal of the law, claiming that banks colluded to frustrate the cap's efforts. Despite this, the National Treasury is in the process of completing a draft proposal that will address credit management in the economy as well as introduce consumer protection policies that it will table in parliament soon. However, the Kenya Bankers Association estimates that even with a repeal, the market adjustment would not be instantaneous	**Negative**	**Negative**

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 slightly improved as indicated by a decline in the weekly average interbank rate to 4.4% from 4.6% on the week ended 23rd March, following end of the monthly Cash Reserve Requirement (CRR) cycle for the month of May, which ended on the 14th.	(i) Money supply (M3) growth remained unchanged at 9.5% as at January 2018 from December 2017, (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.	**Neutral**	**Neutral**

Conclusion

Of the six factors that we track, one is negative, two are neutral, and three are positive, with no change since the last MPC meeting. With (i) inflation having eased to 3.7% from 4.5% 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 0.8% since the last meeting on March 19th, 2018, the macroeconomic environment looks conducive for another rate cut. However, we see the MPC adopting a wait and see approach, as they monitor the effects of the previous rate cut. We therefore expect the MPC to hold the CBR at 9.5%. The key concern still remains the low private sector credit growth, which declined slightly to 2.1% in February 2018 from 2.4% in December 2017, which is well below the 5-Year average of 14.0% as well as the government set annual target of 12.0% – 15.0%.

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