Cytonn INVESTMENTS

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

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The Monetary Policy Committee (MPC) is set to meet on Monday, 30th July 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 28th May 2018, the MPC maintained the CBR at 9.5%, in line with our expectations as per our MPC Note. The MPC noted that the impact of the 50 bps reduction in March was yet to be fully transmitted to the economy, despite there being room for monetary policy easing to further support economic activity, as evidenced by:

i. Inflation, which had eased to 3.7% in April 2018 from 4.2% in March, which was well within the government target range of 2.5% - 7.5%,
ii. An uptick in private sector credit growth, which grew by 2.8% in April up from 2.1% in February, with growth in lending being recorded in the manufacturing, building and construction, finance and insurance and trade sectors, and,
iii. Increased private sector optimism as per the MPC Private Sector Market Perception Survey conducted in May 2018, which showed that the private sector was optimistic about local economic prospects in 2018. The April Stanbic Bank Kenya PMI corroborated this, having hit a 27-month high of 56.4, remaining well above 50.0, which is the mark that signals an improvement in the business environment. This was mainly attributed to a relatively stable operating environment, improving weather conditions, continued infrastructure investment by the government, the government's focus on the ***Big Four Agenda***, the expected direct flights to-and-from the USA, and perceived political stability that has resulted in improving investor confidence.

The decision to maintain the CBR at 9.5% was in line with our expectation. We believed that the MPC would adopt a wait and see approach as they monitor the effects of the previous rate cut given the stability in the macroeconomic environment, as evidenced by:

i. Inflation having averaged 4.3% in the first 4 months of 2018 and having eased to 3.7% in April from 4.2% since the last meeting its lowest level since January 2013,
ii. The government was under no pressure to borrow from the local markets since they were ahead of their domestic borrowing target, and,
iii. The currency had appreciated by 0.8% against the USD to 100.4 from 101.3 since their last meeting on March 19th, 2018.
iv. We also reasoned that maintaining the CBR would be the better move given the low private sector credit growth which had declined slightly to 2.0% in March from 2.1% February; 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) that the overall inflation was expected to remain within the government target range despite upward pressure from rising fuel prices as it would be mitigated by

the expected decline in food prices following improved weather conditions, (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; coupled with an increase in tea and horticultural exports, diaspora remittances and tourism-related forex inflows, and, (iii) the economy was expected to remain resilient, supported by a recovery in the agriculture sector, continued resilience in the services sector as well as the stable macroeconomic environment.

Below, we analyse the macro-economic indicators trend since the May 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 May 2018**	**Going forward**	**Probable CBR Direction (May)**	**Probable CBR Direction (July)**
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 surpassed its domestic borrowing target for the 2017/18 fiscal year, having borrowed Kshs 390.2 bn against a target of Kshs 297.6 bn (ii) According to the FY 2018/19 Budget, the total borrowing target for the 2018/2019 financial year is Kshs 558.9 bn down from Kshs 620.8 bn, in a bid to reduce Kenya's public debt burden which stood at 55.6% of GDP as at 2017, 5.6% above the East African Community (EAC) Monetary Union Protocol, the World Bank Country Policy and Institutional Assessment Index, and the IMF threshold of 50.0%, but well below the 74.0% mark considered a signal for debt unsustainability	The total borrowing requirement to plug in the budget deficit is expected to decline to Kshs 558.9 bn from Kshs 620.8 bn, with domestic borrowing estimated at Kshs 271.9 bn 8.6% lower than the 2017/2018 fiscal year's target of Kshs 297.6 bn, in a bid to reduce Kenya's public debt burden. With the rate cap still in place, we expect the government to be under no pressure to borrow due to the reduced competition from the private sector. However should the cap be repealed as per the national treasury's recommendation, coupled with high maturities expected in the 2018/2019 Financial Year currently at Kshs 1.1 tn, the government may be under pressure to borrow, as we expect upward pressure on interest rates thus it may no longer have an easy time collecting funds from the domestic market. However, with the Treasury's efforts to increase revenue collections and reduce expenditure as per the IMF directive , this might be mitigated.	**Positive**	**Positive**

Key Macro-Economic Indicators – Kenya

Indicators	Expectations at start of 2017/2018 Fiscal Year	Experience since the last MPC meeting in May 2018	Going forward	Probable CBR Direction (May)	Probable CBR Direction (July)
Inflation	Inflation expected to average 7.5% compared to 8.0% last year	Inflation has averaged 4.2% in the first 6 months of 2018 compared to 9.8% experienced in a similar period in 2017. Y/Y inflation in June 2018 increased to 4.3% in June from 4.0% in May mainly due to the base effect, however, m/m inflation declined by 0.9% due to a 2.2% decline in the Food and Non-Alcoholic Drinks' Index driven by a decrease in prices of some food basket items outweighing increases in others	Inflation in H2'2018 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 and other tax reforms proposed under the Finance Bill 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 2.3% against the USD YTD to 100.8 and by 0.4% since the last meeting, due to increased inflows from principal exports and diaspora remittances, and positive sentiments given the current high level of forex reserves, at USD 8.9 bn (equivalent to 5.9 months of import cover). The Shilling has remained resilient and continued to appreciate despite the dollar index having gained 2.6% YTD	Kenya's forex reserves currently stand at USD 8.9 bn (equivalent to 5.9 months of import cover) and sufficient to cushion the economy from unforeseen short-term exogenous shocks. Kenya's current account deficit improved to 8.9% of GDP in Q1'2018, from 11.3% recorded in Q1'2017 due to export growth outpacing the growth in imports, growing at 7.1% compared to the 6.5% increase in 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. Key to note, the IMF recently completed the performance review and handed over the report findings to the government but they are yet to be published	**Neutral**	**Neutral**

Key Macro-Economic Indicators – Kenya

Indicators	Expectations at start of 2017/2018 Fiscal Year	Experience since the last MPC meeting in May 2018	Going forward	Probable CBR Direction (May)	Probable CBR Direction (July)
GDP Growth	GDP growth projected to come in at between 5.3% - 5.5%	Kenya's economy expanded by 5.7% in Q1'2018, higher than 4.8% in Q1'2017. This was due to; i. recovery in agriculture, which recorded a growth of 5.2% due to improved weather conditions, ii. improved business and consumer confidence, iii. increased output in the real estate, manufacturing, and wholesale & retail trade sectors, which grew by 6.8%, 2.3% and 6.3%, respectively	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 2.8% in April 2018, higher than 2.0% in March 2017, and still remains below the 5-year average of 14.0%	Private sector credit growth is projected to remain low this year if the interest rate cap is maintained as banks will continue with the stringent credit risk assessment framework thus limiting lending to riskier borrowers. The Draft Financial Markets Conduct Bill, 2018 tabled in parliament only addressed consumer protection, but did not address the interest rate cap. The IMF recommendation of re-looking at the Act, was however endorsed by the National Treasury in the financial year 2018/2019 budget and is still waiting for approval by the National Assembly. Even with the repeal of the rate cap, the Kenya Bankers Association estimates, the market adjustment would not be instantaneous	**Negative**	**Negative**

Key Macro-Economic Indicators – Kenya

Indicators	Expectations at start of 2017/2018 Fiscal Year	Experience since the last MPC meeting in May 2018	Going forward	Probable CBR Direction (May)	Probable CBR Direction (July)
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 4.8% in June from 5.1% in May	(i) Broad Money supply (M3) growth has improved to 7.6% in May from 5.5% in April, (ii) Liquidity is still expected to remain high, given the heavy maturities of domestic debt in the 2018/2019 financial year as well as continued government spending through the various infrastructure investments, with the main focus being on the Big Four Agenda.	**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. Inflation is expected to rise in H2'2018, but the overall inflation in 2018 is projected to remain within the government target of 2.5%-7.5%, thus no need to implement restrictive monetary policy as there are no expectations of high inflationary pressure. Increasing the CBR, which has a net effect of slowing down economic growth, would also be against the fiscal consolidation policy the government is undertaking aimed at narrowing the fiscal deficit to 5.7% of GDP from 7.2% in the 2017/2018 financial year, by reducing expenditure and increasing revenue as an economic slowdown would hinder the government from achieving the revenue targets for the 2018/2019 financial year of Kshs 1.9 tn, a 17.5% rise from the Kshs 1.7 tn target in the 2017/2018 financial year. Reducing the CBR on the other hand would further limit credit access to the private sector, which remains a key concern despite improving to 2.8% in April from 2.0% in March as its still below the 5-year average of 14.0% as well as the government set annual target of 12.0% – 15.0%, since it would effectively lower lending rates, thus making credit pricing to private sector harder. With the macroeconomic environment improving from 2017, as evidenced by the 5.7% Q1'2018 GDP growth, we see the MPC maintaining the wait and see approach, as they continue to monitor the effects of the rate cut to 9.5% in March as well as await the National Assembly's decision on the interest rate cap from the proposed amendment of the Banking (Amendment) Act, 2016 by repealing section 33B. We therefore expect the MPC to hold the CBR at 9.5%.