

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

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The Monetary Policy Committee (MPC) is set to meet on Tuesday, 27th November 2018, the last MPC meeting in 2018, to review the prevailing macro-economic conditions and make a decision on the direction of the Central Bank Rate (CBR). While noting the need to monitor the second-round inflationary effects arising from the VAT on petroleum products, and any perverse response to its previous decisions, the MPC maintained the CBR at 9.0% in their previous meeting held on 25th September 2018. This was in line with our expectations as per our **MPC Note**, citing that the country's macroeconomic fundamentals were stable as well as sustained optimism on the economic growth prospects, as evidenced by:

- i. Inflation expectations, which were well anchored within the target range, having fell to 4.0% in August from 4.4% in July, following decreases in food prices that offset the increase in energy prices, including the increase in the price of charcoal. The MPC noted that the overall inflation was expected to remain within the government target range of 2.5%-7.5% despite upward pressure from rising fuel prices due to a rise in global oil prices and the impact of excise duty on some of the CPI items. Expectations of declining food prices due to favorable weather conditions was expected to mitigate the upward inflationary pressure,
- ii. Private sector credit growth, which grew by 4.3% y/y in August, with the highest growth in lending being recorded in the building and construction, manufacturing, consumer durables and trade sectors at 14.9%, 13.3%, 11.5% and 7.0% over the same period, respectively, and,
- iii. Increased private sector optimism as per the MPC Private Sector Market Perception Survey conducted in May 2018, which indicated that the private sector was optimistic about local economic prospects in 2018. This was mainly attributed to a rebound in agriculture, pick-up in private sector economic activity, strong forward hotel bookings, renewed business confidence due to the ongoing war against corruption, and a stable macroeconomic environment.

The monetary policy committee also noted that;

- i. The overall inflation was expected to remain within the government target range mitigated by the

decline in food prices following improved weather conditions despite expectations of upward pressure from rising fuel prices driven by the increase in international oil prices, and the impact of the excise duty indexation on prices of some of the CPI items, and,

- ii. The current account deficit had narrowed to 5.3% in the 12 months to July 2018 from 5.6% in June 2018 and was expected to narrow further to 5.4% of GDP in 2018 supported by strong growth of agricultural exports particularly tea and horticulture, improved diaspora remittances, and tourism receipts. The petroleum products import bill was however, expected to increase due to higher international oil prices and expected front-loading of imports with respect to the ongoing SGR project but the effects on the current account were expected to be mitigated by lower imports of food in 2018.

Below, we analyse the macro-economic indicators trend since the September 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 2018/2019 Fiscal Year	Experience since the last MPC meeting in September 2018	Going forward	Probable CBR Direction (September)	Probable CBR Direction (November)
Government Borrowing	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 the FY'2017/2018. The government is however likely to remain behind its borrowing target for the better part of the first half of the 2018/19 financial year as per historical data	The Government is currently 33.2% ahead of its pro-rated borrowing target for the FY'2018/2019, having borrowed Kshs 146.2 bn against a pro-rated target of Kshs 109.8 bn, and has been under no pressure to borrow as evidenced by the declining yield curve as the government continues to reject expensive bids	We expect the government to be under no pressure to borrow in the domestic market. With the rate cap still in place, the government is expected to continue accessing domestic debt at lower yields due to reduced competition from the private sector coupled with improved liquidity. The total borrowing requirement to plug in the fiscal deficit in FY'2018/2019 is also 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 Kshs 297.6 bn target in FY'2017/2018 thus reducing the pressure further	Positive	Positive

Key Macro-Economic Indicators - Kenya

Indicators	Expectations at start of 2018/2019 Fiscal Year	Experience since the last MPC meeting in September 2018	Going forward	Probable CBR Direction (September)	Probable CBR Direction (November)
Inflation	To average within the government annual target of between 2.5% - 7.5% in 2017	Inflation has averaged 4.5% in the first 10 months of 2018 compared to 8.7% experienced in a similar period in 2017. The Y/Y inflation rate for the month of October recorded a decline to 5.5% from 5.7% in September. The decline in the inflation rate was attributed to a 1.8% and 0.9% decline in the food and non-alcoholic beverages index and the transport index, respectively.	Inflation in the remaining part of the year is expected to experience upward pressure due to the various tax amendments as per the Finance Bill 2018, but at a lower rate than earlier anticipated following the reduction of the VAT charge on fuel to 8.0% from 16.0% effective 21st September 2018, affirming our expectations on inflation for the year averaging within the government's set target of 2.5%-7.5%	Positive	Positive
Currency (USD/Kshs)	To remain stable supported by dollar reserves	The Shilling has lost by 2.2% since the last meeting, mainly driven by levels of dollar inflows failing to meet the demand mainly from oil importers, which has also seen the oil import bill rise, on the back of a rally in fuel prices. The IMF's remarks on the over-valuation of the Kenyan shilling by 17.5% has also triggered some panic dollar buying, which has further led to the erosion of the year to date gains by the Kenyan shilling.	We expect the Kenyan Shilling to remain relatively stable against the dollar, supported by i. CBK's activities in the money market, such as repurchase agreements and selling of dollars, ii. High levels of forex reserves, currently at USD 8.1 bn, equivalent to 5.3-months of import cover, which is above the Kenya's optimum levels as per the IMF which is 3.5 months iii. Improving diaspora remittances, which increased by 71.9% y/y to USD 266.2 mn in June 2018 from USD 154.9 mn in June 2017 and by 4.9% m/m, from USD 253.7 mn in May 2018	Neutral	Neutral

Key Macro-Economic Indicators - Kenya

Indicators	Expectations at start of 2018/2019 Fiscal Year	Experience since the last MPC meeting in September 2018	Going forward	Probable CBR Direction (September)	Probable CBR Direction (November)
GDP Growth	GDP growth projected to come in at between 5.4% - 5.6%	Kenya's economy expanded by 6.3% in Q2'2018, higher than 4.7% in Q2'2017 supported by i. recovery in agriculture, which recorded a growth of 5.6% due to improved weather conditions, ii. improved business and consumer confidence iii. increased output in the manufacturing and electricity & water supply sectors which grew by 3.1% and 8.6% 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 13.0%	The latest data from CBK indicates that private sector credit growth has remained unchanged at 4.3% since July to September 2018. This has been the highest growth rate since December 2016, pointing to a recovery albeit slow and still way below the 5-year average of 13.0%	Private sector credit growth is projected to remain low this year due to i. The interest rate cap, which has made banks adopt a more stringent credit risk assessment framework thus limiting lending to riskier borrowers. ii. The Governments fiscal consolidation strategy aimed at reducing the fiscal deficit which would effectively result in reduction in government borrowing, and hence lower yields on government securities, thus promoting lending to the private sector has also not fully taken root	Negative	Negative

Key Macro-Economic Indicators - Kenya

Indicators	Expectations at start of 2018/2019 Fiscal Year	Experience since the last MPC meeting in September 2018	Going forward	Probable CBR Direction (September)	Probable CBR Direction (November)
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 continued to improve as indicated by the declined average interbank rate to 3.6% in October from 4.5% in September. There has however been a concern that the increased liquidity in the inter-bank market could further weigh down the shilling.	Liquidity is expected to remain high with the heavy maturities of short-term domestic debt in the 2018/2019 financial year currently comprising of Kshs 629.3 bn T-bill and Kshs 155.4 bn worth of T-bond maturities as well as continued government spending through the various infrastructure investments.	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. 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 9.0% with their decision being on the back of:***

- Despite expectations of inflationary pressure in the remainder of the year as the effects of the various tax policy measures introduced through the Finance Bill 2018 continue to be felt, we do not believe that the pressure is high enough to warrant a policy shift. Inflationary pressure has further been mitigated by the declining food prices due to the improved weather conditions and as such, inflation is expected to be within the government set target of 2.5%-7.5%.
- Despite the recent depreciation of the Kenyan Shilling against the US dollar, it has remained relatively stable, reflecting a more stable economic environment, which saw the IMF reclassifying Kenya, from a floating arrangement to stabilized arrangement, in their Annual Report on Exchange Arrangements and Exchange Restrictions released on 30th April 2018. The classification of the arrangement, is primarily based on the degree to which the exchange rate is determined by the market- rather than by official action. For a country to be classified as a stabilized arrangement, the market exchange rate should remain within a margin of 2.0% for 6 months or more with respect to a single currency or a basket of currencies, thus showing the stability of the Kenyan shilling. Volatility of the Kenyan shilling has however mainly been cushioned by central Bank's activities, which has seen the forex reserves decline by 4.4% to USD 8.1 bn from USD 8.4 bn, since the last MPC meeting but still remain high and above the optimal level of reserves for Kenya as per the IMF set at 3.5 months of imports . The ongoing prospects of the Treasury issuing another Eurobond could also eliminate the need for tightening the monetary policy, as it will enhance the forex reserves thus cushioning the shilling.
- Private sector credit growth has remained unchanged at 4.3% for the 3 months to September, since the lowering of the CBR to 9.0% in July, higher than the 3.3% average for the 9 months to September 2018 as well as the 2017 average of 2.5% but is still below the 5-year average of 12.6%

Liason House, StateHouse Avenue
The Chancery, Valley Road
www.cytonn.com
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