Cytonn Note on the Monetary Policy Committee (MPC) Meeting for March 2019

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The Monetary Policy Committee (MPC) is set to meet on Wednesday, 27th March 2019, 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 January 2019, the MPC maintained the CBR at 9.0%, citing that the economy was operating close to its potential and inflation expectations remained anchored within the target range thus the prevailing monetary policy stance remained appropriate. This was in line with our expectations as per our MPC Note, informed by the country's macroeconomic fundamentals, which remained stable as well as sustained optimism on the economic growth prospects, as evidenced by:

i. Inflation expectations, which have remained well anchored, within the target range, declining to 4.7% in January 2019 from 5.7% recorded in December 2018 mainly driven by a 1.4% decline in the transport index attributable to a decline in pump prices of petrol and diesel, and
ii. Increased private sector optimism as per the MPC Private Sector Market Perception Survey conducted in January 2019, which indicated that the private sector was optimistic about local economic prospects. The private sector expects stronger economic growth in 2019, driven by a better investment climate, continued infrastructure development, expectations of increased agricultural production, the continued decline in international oil prices, and strong tourism performance.

The Monetary Policy Committee also noted that the current account deficit had narrowed to 5.1% in the 12 months to November 2018 compared to 6.5% in November 2017, supported by strong growth of agricultural exports particularly tea and horticulture, improved diaspora remittances, and tourism receipts. The decline was also partly supported by higher tea and horticultural exports coupled with the slower growth in imports due to lower food and SGR–related equipment imports and declining international oil prices.

Below, we analyse the macro-economic indicators trend since the January 2019 MPC meeting, and how they are likely to affect the MPC decision on the direction of the CBR:

Indicators	Experience since the last MPC meeting in January 2019	Going forward	Probable CBR Direction (January)	Probable CBR Direction (March)
Government Borrowing	· The government is currently 2.7% behind its domestic borrowing target for the current financial year, having borrowed Kshs 220.4 bn against a pro-rated target of Kshs 226.6 bn.	· We are neutral on domestic borrowing, as the government is behind its borrowing target, and as such we expect slight pressure on the domestic borrowing front, which might see it start issuing shorter tenor bonds at the expense of the debt maturity profile	**Neutral**	**Neutral**
Inflation	· Inflation rate for the month of February 2019 declined to a 6-month low of 4.1% from 4.7% recorded in January, mainly due to the base effect and a 0.5% decline in the transport index	· Inflation is expected to remain muted and within the government's target range of 2.5%-7.5% anchored by lower food prices, reflecting favorable weather conditions, the decline in international oil prices, and the downward revision in electricity tariffs	**Positive**	**Positive**
Currency (USD/Kshs)	· The Shilling has gained by 0.1% since the last meeting supported by improved diaspora remittances coupled with thin dollar demand from oil importers. Forex reserves have also increased by 3.1% since the last meeting to USD 8.4 bn (equivalent to 5.5 months of import cover) from USD 8.1 bn (equivalent to 5.3 months of import cover), providing an adequate buffer for the Kenyan shilling from external shocks.	· 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 8.4 bn, equivalent to 5.5-months of import cover, iii. Improving diaspora remittances, which increased by 38.6% in 2018 to USD 2.7 bn, from USD 1.9 bn recorded in 2017.	**Neutral**	**Neutral**
GDP Growth	· Kenya's economy expanded by 6.0% in Q3'2018, higher than 4.7% in Q3'2017 supported by: 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 manufacturing and wholesale & retail trade sectors which grew by 3.2% and 6.8%, respectively	· GDP growth is projected to come in between 5.7% - 5.9% in 2019 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	· The latest data from CBK indicates that private sector credit growth recorded a decline in December 2018 to 2.4% from 3.0% recorded in November 2018 and below the 2018 average of 3.3%	· Private sector credit growth is expected to remain low this year due to the interest rate cap, which has made banks adopt a more stringent credit risk assessment framework thus limiting lending to riskier borrowers. · The High Court of Kenya recently ruled that the interest rate cap under the Banking Act Section 32B is 'unconstitutional' with the effective date of the ruling being delayed for 12 months to allow the regulator to put in place the 'appropriate mechanisms'. The implications and next steps following the ruling are still unclear as the full judgement is yet to be availed.	**Negative**	**Negative**
Liquidity	· Liquidity levels in the money markets have continued to improve coming into 2019, with the average interbank rate since the last MPC meeting coming in at 3.2% compared to the 3.3% recorded in the period to January 28th 2019 driven by government payments and domestic debt maturities	· Liquidity is expected to remain high with the heavy maturities of domestic debt in 2019 as well as continued government spending through the various infrastructure investments. We expect the improved liquidity in the money markets to stabilize the interest rate environment due to an uptick in the demand side on government securities	**Positive**	**Positive**

Conclusion

Of the six factors that we track, one is negative, two are neutral, and three are positive, with no changes since the last MPC meeting. We believe that the MPC will maintain the current policy stance, given the macro-economic environment is relatively stable. ***We therefore expect the MPC to hold the CBR at 9.0% with their decision being supported by:***

i. Expectations of muted Inflationary pressure in 2019, anchored by the declining food prices going forward with the expectations of long rains starting in late March as well lower global fuel prices,
ii. The stability of the Kenyan Shilling having already gained by 1.2% YTD in 2019 and recording a 4-year high of Kshs 99.7 against the dollar during the period under review, reflecting a more stable economic environment,
iii. Considering the Government is currently behind its domestic borrowing schedule having borrowed Kshs 220.4 bn against a pro-rated target of Kshs 226.6 bn, we believe the MPC will maintain the CBR at the current rate with a bias to further easing in order to continue accessing domestic debt at cheaper rates. This however might have adverse effects of further crowding out of the private sector.

Going forward, the key concern lies in the weak private sector credit growth, which was at 2.4% y/y in December 2018, with the highest growth in lending recorded in the finance and insurance at 17.5%, Consumer durables at 11.0%, business services 8.0%, and private households 6.8%, over the same period, respectively. This was a decline from 3.0% recorded in November and below the 3.3% average recorded in 2018.

The Central Bank of Kenya has also continued to express concern over the effectiveness of monetary policy with the interest rate cap still in place. The Monetary Policy Committee through its assessment of the impacts of the interest rate cap noted that it has weakened the transmission of monetary policy. In particular, the transmission of changes in the CBR to growth and inflation takes longer compared to the period before implementation of the interest rate cap. The High Court of Kenya recently held that the provisions relating to the Banking (Amendment) Act 2016 (section 33B), which set the interest rate caps are unclear and unconstitutional with the effective date of the ruling being delayed for 12 months to allow the regulator to put in place the appropriate mechanisms. We are of the view that no convincing argument in favor of a repeal of the rate cap has been made to the Members of Parliament to warrant a shift in their policy stance and as such, they are likely to maintain the rate cap while amending the section to make it clear and unambiguous.