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

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The Monetary Policy Committee (MPC) is set to meet on Monday, 27th May 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 27th March 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 had remained stable as well as sustained optimism on the economic growth prospects, as evidenced by:

i. Inflation expectations, which had remained well anchored, within the target range, declining to 4.1% in February 2019 from 4.7% recorded in January 2019 mainly driven by a 0.5% m/m 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 March 2019, which indicated that the private sector was optimistic about local economic prospects. The private sector expects stronger economic growth in 2019, continued infrastructure development, expectations of adequate agricultural production despite the delayed onset of the long rains in most parts of the country and a stable macroeconomic environment.

The Monetary Policy Committee also noted that the current account deficit had narrowed to 4.7% in the 12 months to February 2019 compared to 5.5% in February 2018, supported by strong growth of agricultural exports particularly tea and horticulture, improved diaspora remittances, and tourism receipts. The decline was also partly supported by the slower growth in imports due to lower imports of food and machinery.

Below, we analyse the macro-economic indicators trend since the March 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 March 2019	Going forward	Probable CBR Direction (March)	Probable CBR Direction (May)
Government Borrowing	· The Government is currently 18.0% ahead of its domestic borrowing target for the current financial year, having borrowed Kshs 330.6 bn against a pro-rated target of Kshs 280.3 bn.	· We remain neutral on domestic borrowing, despite the government being ahead of its borrowing target due to the high levels of domestic debt maturities coupled with the underperformance of ordinary revenues which stood hit Kshs 1.1 tn as at the end of March against a target of Kshs 1.4 tn. We expect this to exert slight pressure on the domestic borrowing front forcing the government to continue issuing shorter tenor bonds at the expense of the debt maturity profile	**Neutral**	**Neutral**
Inflation	· Inflation rate for the month of April 2019 rose to a 19-month high of 6.6% from 4.4% recorded in March, driven by a flare in food inflation following the late onset of long rains coupled with the rise in fuel prices	· Inflationary pressure is expected to emanate from the effects of disrupted food supply due to the delayed long rains coupled with the rise in electricity tariffs and fuel prices. Despite this, inflation is still expected to remain within the 2.5%-7.5% government set target range with the food supply shocks being mitigated by the current measures being undertaken by the Government, key of which being the release of 3 million bags of maize from the strategic food reserves that has eased the grains shortage curbing rising flour prices	**Positive**	**Positive**

Indicators	Experience since the last MPC meeting in March 2019	Going forward	Probable CBR Direction (March)	Probable CBR Direction (May)
Currency (USD/Kshs)	· The Shilling has depreciated by 0.2% since the last meeting driven by increased dollar demand from merchandise importers. Forex reserves have also declined by 3.0% since the last meeting to USD 8.0 bn (equivalent to 5.2 months of import cover) from USD 8.3 bn (equivalent to 5.3 months of import cover). This still meets the CBK's statutory requirement to endeavour to maintain at least 4 months of import cover, and the EAC region's convergence criteria of 4.5 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 8.0 bn, equivalent to 5.2-months of import cover, iii. Improving diaspora remittances, which have increased cumulatively by 3.8% in Q1'2019 to USD 665.6 mn, from USD 641.5 mn recorded in a similar period of review in 2018.	**Neutral**	**Neutral**
GDP Growth	· Kenya's economy expanded by 6.3% in 2018, higher than 4.9% 2017 supported by: i. recovery in agriculture, which recorded a growth of 6.4% due to improved weather conditions, ii. improved business and consumer confidence iii. increased output in the manufacturing sectors which grew by 4.2% from 0.5% in 2017	· GDP growth is projected to come in between 5.7% - 5.9% in 2019 above the 5-year average of 5.6%, driven by the continued growth in the tourism, real estate, construction and manufacturing sectors. The slowdown in growth however is expected to emanate from lower productivity in the agricultural sector following the late onset of long rains	**Positive**	**Positive**
Private Sector Credit Growth	· The latest data from CBK indicates that private sector credit growth recorded a rise in February 2019 to 3.4% from 3.0% recorded in January 2019 but below the 5-year average of 11.9%	· Private sector credit growth is expected to remain anaemic this year with the interest rate cap still in place, which has made banks adopt a more stringent credit risk assessment framework thus limiting lending to riskier borrowers	**Negative**	**Negative**

Indicators	Experience since the last MPC meeting in March 2019	Going forward	Probable CBR Direction (March)	Probable CBR Direction (May)
Liquidity	· Liquidity levels in the money markets have remained favourable in 2019, with the average interbank rate since the start of the year coming in at 3.6%, lower than the 5.2% recorded in 2018 driven by government payments and domestic debt maturities	· Liquidity is expected to remain high with the heavy maturities of domestic debt in 2019 which currently stand at Kshs 1.0 tn, 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 still relatively stable. ***We therefore expect the MPC to hold the CBR at 9.0% with their decision being supported by:***

i. Expectations of easing of the recent inflationary pressures, which had mainly been driven by food supply shocks specifically grain prices with maize recording a 26.1% rise m/m leading to a 29.8% rise in the prices of maize flour. The surge in prices is however expected to be mitigated by the current measures being undertaken by the Government, key of which being the release of 3 million bags of maize from the strategic food reserves that has eased the grains shortage curbing rising flour prices
ii. The stability of the Kenyan Shilling having already gained by 0.6% YTD in 2019 and recording a 4-year high of Kshs 99.7 against the dollar during the year, reflecting a more stable economic environment,
iii. Considering the heavy domestic debt maturities which currently stand at Kshs 1.0 tn for 2019, we believe the MPC will maintain the CBR at the current rate, in order for the Government to continue accessing domestic debt at cheaper rates. This however might have adverse effects of further crowding out of the private sector.

The key concern continues to be the weak private sector credit growth, which was at 3.4% y/y in February 2019, lower than the 5-year average of 11.9%, with the highest growth in lending being recorded in consumer durables at 16.2%, finance and insurance at 13.1%, manufacturing at 7.7% and trade at 6.4%. This was a decline from 3.0% recorded in November and below the 3.3% average recorded in 2018. Despite the 100 bps cut of the policy rate in 2018, no significant change has been recorded in private sector credit growth which remains anaemic due to the effects of the interest rate cap. On this front we have seen various measures being put in place to address the low private sector credit growth with the recent initiative being the launch of Stawi, a mobile loan product led by five commercial Banks targeting micro, small and medium scale enterprises. As a result, the Central Bank of Kenya has 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.

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