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

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The Monetary Policy Committee (MPC) is set to meet on Wednesday, 24th July 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 May 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, despite the possible spill overs of the food and fuel price increases, 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 within the target range of 2.5%-7.5%, despite rising to a high of 6.6% in April from 4.4% in March, mainly driven by a flare in food inflation following the late onset of long rains coupled with a rise in fuel prices, and
ii. Increased private sector optimism as per the MPC Private Sector Market Perception Survey conducted in May 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, growth in the tourism sector, a stable macroeconomic environment and investor confidence in the economy.

The Monetary Policy Committee also noted that the current account deficit had narrowed to 4.5% in the 12 months to April 2019 compared to 5.5% in April 2018, supported by strong growth of agricultural exports particularly coffee 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.

Below, we analyse the macro-economic indicators trend since the May 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 May 2019	Going forward	Probable CBR Direction (May)	Probable CBR Direction (July)
Government Borrowing	· The Government is currently behind its prorated domestic borrowing target for the current financial year, having borrowed Kshs 8.5 bn net of redemptions against a pro-rated target of Kshs 16.4 bn.	· We remain neutral on domestic borrowing, due to the high levels of domestic debt maturities coupled with the historical underperformance of ordinary revenues. Despite the continued underperformance, the Government raised its total revenue target by 14.2% to Kshs 2.1 tn for FY'2019/20 which we doubt it will meet, thus exert slight pressure on the domestic borrowing front to plug in the deficit	**Neutral**	**Neutral**

Indicators	Experience since the last MPC meeting in May 2019	Going forward	Probable CBR Direction (May)	Probable CBR Direction (July)
Inflation	· Inflation rate for the month of June 2019 rose to 5.7% from 5.5% in May. Y/Y inflation rose mainly due to the base effect. M/M inflation however declined due to a 1.6% decline in the food and non-alcoholic beverage index owing to favourable weather conditions that led to increased food production and subsequently reduced food prices for various commodities	· Inflationary pressure is expected to emanate from the effects of 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	**Positive**	**Positive**
Currency (USD/Kshs)	· The Shilling has depreciated by 1.8% since the last meeting attributed to the effects of demonetisation and increased demand by oil importers and other traders. Forex reserves have however increased to USD 9.8 bn (equivalent to 6.2 months of import cover) from USD 8.0 bn (equivalent to 5.2 months of import cover) since the last meeting. This 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, thus 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 9.8 bn (equivalent to 6.2-months of import cover) iii. Improving diaspora remittances, which have increased by 3.8% in May 2019 to USD 1.2 bn, from USD 1.1 bn recorded in a similar period of review in 2018 iv. The narrowing of the current account deficit with preliminary data indicating that the current account deficit narrowed to 4.2% of GDP in the 12 months to May 2019 from 5.8% recorded in May 2018	**Neutral**	**Neutral**
GDP Growth	· Kenya's economy expanded by 5.6% in Q1'2019, a decline from the 6.5% recorded in Q1'2018, which was due to: i. A slowdown in the Agricultural sector to 5.3% in Q1'2019 from 7.5% in Q1'2018 attributed to a delay in the long rains in most parts of the country which led to reduced agricultural production ii. A slowdown in the manufacturing sector to 3.2% in Q1'2019 compared to a growth of 3.8% in Q1'2018, largely attributed to the decline in agro-processing activities that were also subdued as a result of the delay in long rains	· 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 which is also expected to trickle down to the manufacturing sector due to a decline in agro-processing activities.	**Positive**	**Positive**
Private Sector Credit Growth	· The latest data from CBK indicates that private sector credit growth recorded a rise in April 2019 to 4.9% from 4.3% recorded in March 2019 but below the 5-year average of 11.6%	· 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**
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 3.5%, 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 949.2 bn, as well as continued government spending through the various infrastructure investments. We also expect the proposal to amend the Competition Authority Act to regulate payment matters and the measure to have all suppliers to Government paid within 60 days to have an immediate positive impact on the circulation of money in the economy	**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. Considering the heavy domestic debt maturities which currently stand at Kshs 949.2 bn for FY'2019/20, 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.
ii. Expectations of inflationary pressures remaining within the Government set range of 2.5%-7.5%. Risks are however abound in the short term, due to the expectations of food supply shocks specifically grain prices expected to lead to a surge in prices, with the Agriculture ministry's push for duty-free maize importation from the month of July to plug the grain deficit being blocked by the National Assembly's Agriculture committee.

We maintain our view that the key concern still lies in the weak private sector credit growth, despite improving to a 31-months high of 4.9% in the month of April 2019, from 4.2% recorded in March and higher than the 3.3% average in 2018. 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, with the loans having a repayment period of between 1 and 12 months and an interest of 9.0% per annum. Small business owners, youth and women are also expected to access loans from the state under the new Biashara Kenya Fund from rates of 6.0% on a monthly reducing balance as per the regulations tabled by the Treasury in parliament for approval.

The Cabinet Secretary, National Treasury and Planning, Mr. Henry Rotich during the Budget reading also proposed a repeal of the interest rate cap should be adopted in order to unlock credit, which would in effect boost the performance of the economy, and consequentially boost taxable income available. 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.