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

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The Monetary Policy Committee (MPC) is set to meet on Monday, 23rd September 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 24th July 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:

?. Inflation expectations, which had remained within the target range of 2.5% - 7.5%, coming in at 5.7% in June from 5.5% in May, mainly due to the base effect and a rise in the transport index, and

i. Increased private sector optimism as per the MPC Private Sector Market Perception Survey conducted in July 2019, which indicated that the private sector was optimistic about local economic prospects. The private sector expects stronger economic growth in 2019, supported by the continuing payment of pending bills, implementation of the Big 4 agenda projects, improved weather conditions and ongoing investments in public infrastructure,

The Monetary Policy Committee also noted that the current account deficit had narrowed to 4.2% of GDP in the 12 months to June 2019 compared to 5.4% in June 2018, supported by strong growth in diaspora remittances and resilient performance of horticultural exports. The decline was also partly supported by the slower growth in imports of food and equipment for the SGR project.

Below, we analyse the macro-economic indicators trend since the July 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 July 2019	Going forward	Probable CBR Direction (July)	Probable CBR Direction (September)
Government Borrowing	· The Government is currently 20.4%, behind its prorated domestic borrowing target and has to borrow on average Kshs 113.6 bn on a monthly basis in the current financial year in order to meet its domestic borrowing target of Kshs 300.3 bn	· We remain neutral on domestic borrowing, due to the levels of domestic debt maturities in FY'2019/20 currently at Kshs 817.7 bn, coupled with the historical underperformance of ordinary revenues, with the Government having met 93.1% of its target as per the FY'2018/2019 budget outturn. Despite the 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**
Inflation	· Inflation for the month of August declined to 5.0%, from 6.3% recorded in July. Y/Y inflation declined mainly due to a decline in the food & non-alcoholic beverages index. M/M inflation also declined due to a 1.9% decline in the food and non-alcoholic beverage index	· 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 remained stable against the US dollar at Kshs 103.8 since the last meeting supported by improved inflows from diaspora remittances and portfolio investors buying government securities. Forex reserves have however declined to USD 9.3 bn (equivalent to 5.8 months of import cover) from USD 9.8 bn (equivalent to 6.2 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 9.2 bn (equivalent to 5.8-months of import cover) iii. Improving diaspora remittances, which have increased by 11.1% in July 2019 to USD 2.8 bn, from USD 2.5 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 July 2019 from 5.4% recorded in July 2018	**Neutral**	**Neutral**

Indicators	Experience since the last MPC meeting in July 2019	Going forward	Probable CBR Direction (July)	Probable CBR Direction (September)
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 that 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 June 2019 to 5.2% from 4.4% recorded in May 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 3.6%, 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 that currently stand at Kshs 817.7 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:***

?. Considering the heavy domestic debt maturities, which currently stand at Kshs 817.7 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,
i. Expectations of inflationary pressures remaining within the Government set range of 2.5%-7.5%. This is mainly due to expectations of lower food prices following improved weather conditions and lower electricity prices with the reduced reliance on expensive power sources.

We also expect the MPC to maintain the current policy stance due to the current uncertainty in the market around the Finance Bill 2019 that is proposing removal of interest rate cap law. If it is repealed, the expectations are that the banks will have a bias in lending to the private sector, as banks would be able to price for risk even for more risky borrowers. This would have an impact on the yields on Government securities as they would have to be adjusted upwards in order to incentivise investors so that the Government can meet its domestic borrowing target. With the uncertainty still in place, we expect the MPC to take a wait and see approach and thus maintain the CBR at 9.0%.

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