What Next for Monetary Policy in Kenya

Cytonn Weekly

Given the upcoming MPC meeting set for May 23, 2016, the purpose of this note is to first re-examine and review changes in the key macro-economic indicators since the last MPC meeting of March 21, 2016 ? see March MPC Note. The note gives an analysis of the background of the last MPC meeting as well as the current macro-environment, and finally a view of what we anticipate to transpire in the upcoming meeting.

The MPC is charged with the responsibility of reviewing the prevailing macro-economic environment and formulating the appropriate policies to maintain stability. Central Bank Rate (?CBR?) is the policy that is the base for all monetary policy operations in Kenya.

MPC in the first Quarter of 2016

During the March MPC meeting, the committee decided to maintain the rates at 11.5%. The decision was informed by the following factors;

i. Low inflation which declined to 6.8% in February from 7.8% in January, falling within the CBK target range of 2.5% - 7.5%,
ii. Stability in foreign exchange rates as the shilling has held stable on the account of a; (a) narrowing current account deficit to 11.4% of GDP, (b) improved exports, (c) increased diaspora remittances, and (d) a low oil import bill,
iii. Improved foreign exchange reserves by 5.1% to USD 7.4 bn from USD 7.0 bn in January 2016, and,
iv. Improved stability of the banking sector with increased supervision by the Central Bank of Kenya (CBK).

The Current Environment

The second quarter of 2016 started off with relative stability across all macro indicators, albeit in a rising political heat environment:

a. **Inflation: Has come down since the last meeting but upward pressures abound**

Inflation for the month of April came in at 5.3%, falling 118 bps from 6.5% in the month of March 2016 supported by a decline in food and transport indices. This is the lowest level since June 2013, and it is currently at the lower bound of the government target of 2.5% - 7.5%. However, going forward, pressures abound which could see inflation rising from the month of May driven by; (i) rising international oil prices that have since soared from a low of USD 26.1 per barrel in February 2016 to USD 44.7 per barrel resulting in an increase in local fuel prices, with super petrol rising by Kshs 3.5(4.4%), diesel by Kshs 4.1(6.2%) and kerosene by Kshs 3.0(6.8%) per liter in May, and (ii) increases in food, beverage/cigarette prices and transport indices owing to the introduction of excise duty and VAT on petroleum products, respectively. These two factors will lead to a possible rise in inflation, but we expect it to remain within CBK target range of 2.5% - 7.5%.

b. **Government Borrowing: Government ahead of its target on local borrowing, offsetting shortfalls in foreign borrowing and tax collections**

The government is already ahead of its local borrowing target, having borrowed Kshs 275.4 bn against a pro-rated target of Kshs 191.6 bn, hence an excess of Kshs 83.8 bn. On foreign borrowing, the government has raised Kshs 296.7 bn, against a pro-rated target of Kshs 351.5 bn, with a deficit of Kshs 54.8 bn. On tax collections, Kenya Revenue Authority (KRA) has recorded a deficit in the revenue collection budget, having missed the target by Kshs 255.5 bn, assuming a pro-rated basis, and using the 8 months published collection data.

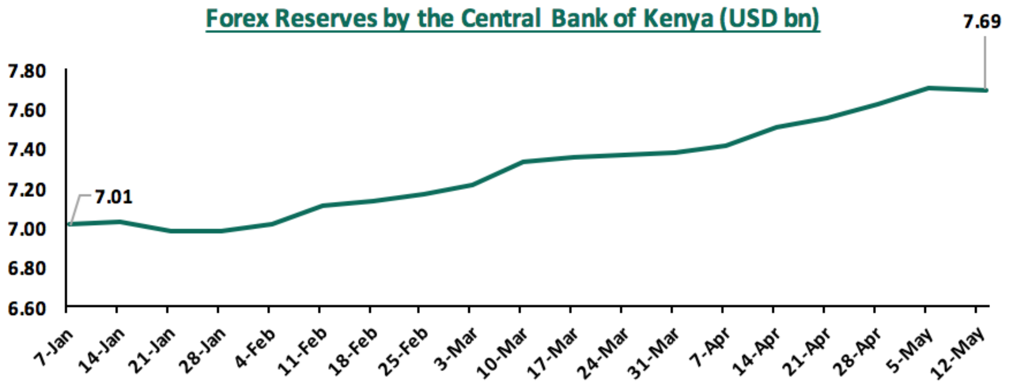
On the expenditure side, total usage is at Kshs 727.4 bn (as at December 2015), against a half year target of Kshs 997.0 bn resulting to a positive balance of Kshs 269.7 bn. The government funding gap of Kshs 226.6 bn is offset by a 269.7 bn shortfall in expenditure (actual spending vs target spending) and therefore we don?t expect upward pressure on interest rates. However, this is hinged not only on the success of foreign borrowing and practicality of the actual expenditure cut, but also the sizing of the budget in the next fiscal year, which is proposed at Kshs 2.3 tn, a 11.2% increase from 2015/2016 budget. Below is a summary of the 2015/2016 fiscal year budget financing and expenditure progress:

(all values in Kshs mn, unless stated otherwise)					
2015/2016 Budget Financing					
Source of Financing	**2015/2016 FY Target**	**Pro-rated Target**	**Actual Collection**	**Variance**	**Possible Effect on Interest Rates**
Foreign Borrowing	401,691	351,480	296,650	(54,830)	Negative
Domestic Borrowing	219,200	191,600	275,385	83,785	Positive
KRA Collections	1,254,867	1,098,008	842,500*	(255,508)	Negative
Total Funding	**1,875,758**	**1,641,088**	**1,414,535**	**(226,553)**	Negative
****Actual, based on 8 months published data***					

(all values in Kshs bn, unless stated otherwise)				
2015/2016 Expenditure Schedule as at - December 2015				
Expenditure	**Targets**	**Actuals**	**Variance**	**Possible Effect on Interest Rates**
Recurrent	501.7	416.5	85.2	Positive
Development	332.2	204.4	127.8	Positive
Others	163.1	106.5	56.7	Positive
Total	**997.0**	**727.4**	**269.7**	**Positive**

c. **Currency: Kenya shilling expected to remain stable supported by reserves & diaspora flows**

The Kenyan shilling has been stable since the beginning of the year appreciating 1.7% against the dollar to exchange at Kshs 100.8 from Kshs 102.3 at the beginning of the year. Since the last MPC meeting, the Kenyan shilling has appreciated 0.9% on account of (i) a narrowing current account deficit at 11.4% of GDP from 14.5% of GDP in 2014 supported by a reduced import bill, (ii) the high levels of forex reserves currently at USD 7.7 bn (equivalent to 5.0 months of import cover) compared to USD 7.4 bn (equivalent of 4.3 months of import cover) at the end of Q1 2016, and (iii) improved diaspora remittances, which grew by 8.4% in 2015.



We expect the shilling to hold stable against the dollar in the short term supported by (i) the approval of increased precautionary facility by the IMF amounting to USD 1.5 bn that will provide an adequate buffer against short-term shocks, (ii) the recovery of tourism industry, and (iii) The Fed Reserve?s dovish stance to hold off on raising interest rates leading to improved capital flows to emerging markets. However, in light of interest payments on dollar loans, we could expect a slight downward shift in dollar reserve levels.

d. **Banking Sector: Recovering from a volatile period and stability is expected**

The Kenyan banking sector has been hard hit with three banks being placed under receivership in less than a year, a situation that has led to a loss of confidence in the banking industry. Chase Bank was placed under receivership, which was followed by liquidity shifts within the sector, with capital flight from small banks to larger banks perceived as more stable. The bank has since been reopened and relatively stability has returned to the market. The banking sector contributes significantly to the overall growth of the Kenyan economy, having contributed 6.9% in 2015, compared to 5.7% in 2011. The banking sector is slowly returning to calm and stability and we expect the MPC to take into account the benefits of a much more stable financial system, since the closure and reopen of Chase Bank.

e. **Global Markets Exposure: Risks still abound on likelihood of Fed rate hikes**

The first quarter of the year was characterised by concerns over a global economic slowdown driven by concerns in China, the Eurozone that is yet to recover from the early Quantitative Easing offered last year as well as the impeding Brexit vote in July and concerns over Fed raising their Fed Funds Rate. Despite adopting a dovish stance and maintaining the Fed Funds rate at 0.25% - 0.50%, there is still a likelihood that the Fed with hikes reduced from an earlier 4 to 2 now. This will have possible effect across global markets, with much impact expected in emerging and frontier markets, Kenya included.

Macro-Economic Environment Currently: Are we in calm waters?

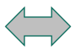
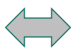
Given the favourable environment and positive factors outlined above, there is a possibility that MPC may consider lowering the CBR by up to 50 bps to 11.0%. This could serve as an indication that interest rates are attractive to the economy at the current levels anchored by a stable currency and inflation rates.

Nevertheless, we still maintain our view that the best move at this stage is to maintain the rate at the current levels of 11.5%. This decision would be propelled by the possibilities of:

a. Upward pressure on inflation in the coming months,
b. Spill over effects of an interest rate hike by the US Fed that will in effect strengthen the dollar thus exerting a downward pressure on the value of the Kenyan currency, and
c. Shifts in government borrowing, with focus on additional local borrowing, and/or Kenya issuing another Eurobond, will increase pressure on local rate environment and increase dollar obligations from the interest repayments which could possibly dig into the forex reserves
d. The need for time to strengthen the Kenyan financial system following the closure and reopening of Chase Bank.

In conclusion, the decision of the MPC now will be key in shaping the interest rate environment for the next fiscal year with only one month left in the current fiscal year. In our view, MPC will maintain CBR at the current rate for the best interest of the country?s economic stability.

Summary of the Key macro-economic Indicators

Indicators	Expectations at start of 2016	Experience since the last MPC meeting on March 21, 2016	Going forward	Probable CBR Direction
Government Borrowing	Government is expected to borrow Kshs 219 bn for the 2015/2016 financial year	Government ahead of its borrowing schedule in excess of 83.8 bn and behind its expenditure by 269.7 bn	We expect reduced pressure on government borrowing with the Government front loading for the next fiscal year	
Kenya Revenue Authority	KRA to continue missing their collection target	KRA to miss its collection target, despite a reduction in ordinary revenue target by Kshs 52.9 bn	Despite the missed target for revenue collection, we expect local and foreign borrowing to offset the difference.	
Inflation	Above the CBK target of 7.5%	Inflation declined from 6.5% in March 2016 to 5.3% in April	Expected to rise on account of fuel price hikes and new excise duty Act that adjusts goods prices by the inflation rate but is expected to remain within the CBK target	
Exchange rate (USD/Kshs)	To remain under pressure given a strong dollar and high capital goods importation	The shilling has been stable having appreciated against the dollar by 0.9% since the last MPC meeting	We expect the Shilling to remain stable given support from a strong dollar reserve and improved forex inflows from remittances	
Banking Sector	We expect improved governance, following the closure of Imperial and Dubai Banks	Chase bank was put under receivership by CBK, resulting in capital flight by investors, from smaller to large banks	We expect Increased CBK supervision and the low interest rate environment to persist	
Liquidity	Liquidity expected to improve given high maturities of government securities	The market has been relatively liquid evidenced by the low interbank rate from 4.2% in March to 3.8% in May 2016	With a further Kshs 130 bn in maturities to June, the market is expected to remain relatively liquid