Cytonn INVESTMENTS

Cytonn Note on the Monetary Policy Committee (MPC) Meeting for January 2020

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The Monetary Policy Committee (MPC) is set to meet on Monday, 27th January 2020, to review the outcome of its previous policy decisions and recent economic developments, and to make a decision on the direction of the Central Bank Rate (CBR). In their previous meeting held on 25th November 2019, the MPC lowered the CBR by 50 bps to 8.5% from 9.0%, citing that the economy was operating below its potential level concluding that there was room for accommodative monetary policy to support economic activity. This was in line with our expectations as per our MPC Note, with our view being informed by:

i. The need to stimulate growth, with GDP growth in 2019 having slowed down averaging 5.6% in H1'2019 lower than 6.4% in H1'2018 and below the CBK's estimated growth at 6.3%. With the plans of the continued fiscal consolidation by the Government, we believe that a further cut will be necessary to provide the required economic growth stimulus, further boosted by the repeal of the interest rate cap, which going forward is expected to provide more efficient transmission of monetary policy as opposed to the interest rate cap era,
ii. Inflation had remained contained and within the Government set target of 2.5%-7.5%, amid slowed economic growth, thus providing room for moderate stimulus through expansionary monetary policy, and,
iii. A further reduction of the Central Bank Rate (CBR), coupled up with the interest rate cap repeal would provide the requisite stimulus to private sector credit growth which had remained below the 5 year average, having grown by 6.3% in the 12 months to August 2019, below the 5-year average of 11.0%.

The Monetary Policy Committee also noted that the current account deficit had narrowed to 4.1% of GDP in the 12 months to September 2019 compared to 5.1% in September 2018, supported by strong growth in diaspora remittances. The decline was also partly attributable to higher receipts from the tourism and transport services as well as lower food imports and import of SGR-related equipment.

Below, we analyze the trends of the macro-economic indicators since the November 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 November 2019	Going forward	Probable CBR Direction (November	Probable CBR Direction (January)
Government Borrowing	· The Government is currently 11.2%, behind its prorated domestic borrowing target and has to borrow on average Kshs 120.2 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 493.0 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 December increased to 5.8%, from 5.6% recorded in November. Y/Y inflation increased mainly driven by a 10.0% increase in the food and non-alcoholic drinks' index. M/M inflation also increased by 0.9% due to a 2.1% increase in the transport index	· Inflationary pressure is expected to emanate from the effects of the increase in international oil 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 appreciated against the US dollar by 0.6% to Kshs 101.0 from Kshs 101.6 during the last meeting, supported by inflows of hard currency from remittances by Kenyan workers abroad and offshore investors. Forex reserves have however declined to USD 8.5 bn (equivalent to 5.2 months of import cover) from USD 8.9 bn (equivalent to 5.6 months of import cover) since the last meeting. This however 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, thus providing an adequate buffer for the Kenyan Shilling from external shocks	· In our view, the shilling should remain relatively stable against the dollar in the short term 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 8.5 bn (equivalent to 5.2-months of import cover) iii. The narrowing of the current account deficit, with preliminary data indicating that Kenya's current account deficit improved by 7.6% during Q3'2019, coming in at a deficit of Kshs 101.0 bn, from Kshs 109.3 bn in Q3'2018, equivalent to 8.2% of GDP, from 9.3% recorded in Q3'2018	**Neutral**	**Neutral**
GDP Growth	· Kenya's economy expanded by 5.1% in Q3'2019, a decline from the 6.4% recorded in Q3'2018, which was due to: i. A slowdown in the Agricultural sector to 3.2% in Q3'2019 from 6.9% in Q3'2018 attributed to a drop in production of key crops in the country such as tea, vegetable, and fruit exports ii. A slowdown in the manufacturing sector to 3.1% in Q3'2019 compared to a growth of 4.6% in Q3'2018, largely attributed to the decline in agro-processing activities that were also subdued as a result of the reduced production of tea and sugar	· We project 2020's GDP growth to come in between 5.6% - 5.8% in 2020 above the 5-year average of 5.6%, driven by the improvement in private sector credit growth following the repeal of the interest rate cap, stable growth in the agricultural sector due to spill over effects from the heavy rains experienced in Q4'2019, and public infrastructural investments. · Risk on growth, however, is expected to emanate from reduced government spending in a bid to reduce the country's fiscal deficit as well as debt sustainability strains which continue to be a key concern as the current Debt to GDP ratio stands at 62.0%	**Positive**	**Positive**
Private Sector Credit Growth	· The latest data from CBK indicates that private sector credit growth recorded a drop in October 2019 to 6.6% from 7.0% recorded in September 2019 but below the 5-year average of 11.2%	· Private sector credit growth is expected to increase going forward with the interest rate cap repeal, which will make banks revise their credit risk assessment framework thus increasing lending to riskier borrowers	**Positive**	**Positive**

Indicators	Experience since the last MPC meeting in November 2019	Going forward	Probable CBR Direction (November	Probable CBR Direction (January)
Liquidity	· Liquidity levels in the money markets have continued to improve coming into 2020, with the average interbank rate to 17th January 2020 coming in at 4.5%, lower than the 5.9% recorded in December 2019 driven by government payments and domestic debt maturities	· Liquidity is expected to remain high with the heavy maturities of domestic debt in 2020 that currently stand at Kshs 442.7bn worth of T-bill maturities and 50.4 bn worth of T-bond maturities. We also expect the amendment to regulate payment matters and the measure to have all suppliers to Government paid within 60 days to have a positive impact on the circulation of money in the economy	**Positive**	**Positive**

Conclusion

Of the six factors that we track, two are neutral and four are positive, unchanged since the last MPC meeting. With the repeal of interest rate cap law, expectations are that the banks will have a bias in lending to the private sector, as they will be able to price for risk appropriately even for more risky borrowers thus stimulating private sector credit growth. As per comments from Central Bank Governor Patrick Njoroge, there are expectations that the repeal of the interest rate cap will eventually unlock the stand-by credit facility with the International Monetary Fund (IMF), after the expiry of a previous program last year, since it was one of the conditions set, thus providing a buffer for the Kenyan Shilling. The Monetary Policy Committee, through its assessment of the impact of the interest rate cap in the rate cap era, had also noted that it had weakened the transmission of monetary policy. With the repeal however, there is renewed clarity and certainty in the market's response to policy signals.

We expect the MPC to maintain the Central Bank Rate (CBR) at 8.5%, with their decision mainly being supported by:

i. Considering the heavy domestic debt maturities, which currently stand at Kshs 493.0 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. Inflation has remained contained and within the Government set target of 2.5%-7.5%, with inflationary pressure gradually easing off, due to improved agricultural production thus causing a decline in food prices which has a weight of 36.0% in the Consumer Price Index following favourable weather conditions, and,
iii. We foresee the Central Bank taking a wait and see approach as it observes the effects of the 50 bps rate cut witnessed in the November 2019 meeting as there remains some opacity in terms of response from the banks and consumers. From the last MPC briefing, the Central Bank of Kenya (CBK) Governor indicated that following the interest rate cap repeal, re-learning by Banks and consumers was essential so that the market can react appropriately to any monetary policy. The Central Bank of Kenya (CBK) Governor also indicated that they were re-calibrating their models so as to determine the effect of changes in the CBR on the other macro-economic indicators such as GDP and inflation over a certain period. Based on this, we believe the MPC will hold the rates steady as they continue monitoring the market reactions of the previous cut.

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