Cytonn Note on the Monetary Policy Committee (MPC) Meeting for September 2017

The Monetary Policy Committee (MPC) is set to meet on Monday, 18th September 2017 to review the prevailing macro-economic conditions and give direction on the Central Bank Rate (CBR). In their previous meeting, held in July 2017, the MPC maintained the CBR at 10.0%, which was in line with our expectations as per our MPC Note. The decision was on the back of a relatively stable macroeconomic environment, given (i) the inflation rate had declined to 9.2% in June from a high of 11.7% in May, due to a decline in food prices brought about by the rains, albeit depressed, (ii) a relatively stable foreign exchange market, with foreign reserves at USD 7.8 bn (equivalent to 5.2 months of import cover), despite the current account deficit widening to 6.2% of GDP in May from 6.0% in March, and (iii) a resilient banking sector, with the average commercial banks liquidity ratio and capital adequacy ratio at 44.7% and 19.6%, above the statutory minimum of 20.0% and 14.5%, respectively, as at June 2017. The committee also noted that (i) inflation was expected to continue declining, supported by lower food and fuel prices, (ii) the current account deficit was expected to narrow in the second half of 2017, due to improvement in tea and horticulture exports, and (iii) the economy remained resilient, with economic growth in Q1'2017 coming in at 4.7%, despite the poor performance in agriculture. However, there still remains risks to economic growth, brought about by (i) the slow-down in private sector credit growth that came in at 2.1% in May compared to 11.1% recorded the same time last year, and (ii) uncertainty in the political environment, with the Supreme Court having nullified President Uhuru Kenyatta's re-election.

Below, we analyse the macro-economic indicators trend since the July 2017 MPC meeting and how they are likely to affect the MPC decision on the direction of the CBR:

Key Macro-Economic Indicators – Kenya					
Indicators	**Expectations at start of 2017/2018 Fiscal Year**	**Experience since the last MPC meeting in July 2017**	**Going forward**	**Probable CBR Direction (July)**	**Probable CBR Direction (September)**
Budget Deficit	The government is expected to borrow Kshs 317.7 bn from the domestic market for the 2017/2018 financial year and Kshs 206.0 bn from the foreign market, while KRA has a revenue collection target of Kshs 1.7 tn for the 2017/18 fiscal year	The government is behind its domestic borrowing target for the current fiscal year, having borrowed Kshs 18.4 bn against a target of Kshs 61.1 bn (assuming a pro-rated borrowing throughout the financial year of Kshs 317.7 bn budgeted for the full financial year)	(i) The government is expected to meet its domestic borrowing target for the 2017/18 fiscal year, as reduced credit to private sector, following the capping of interest rates, will make it easier for government to raise funds, as banks channel funds more actively towards government securities (ii) The government is expected to meet its foreign borrowing target in the 2017/18 fiscal year, as budget estimates have been revised downwards to Kshs 206.0 bn from Kshs 462.3 bn previously (iii) KRA is expected to face challenges in meeting its overall revenue collection target of Kshs 1.7 tn for the 2017/18 fiscal year due to expected subdued corporate earnings growth Domestic borrowing is expected to pick up in the coming weeks, with improved liquidity levels in the market, brought about by heavy maturities of government securities, and hence we don't expect the government to be under pressure to meet its borrowing targets for the fiscal year 2017/18	**Neutral**	**Neutral**

Inflation	To average above the government annual target of between 2.5% - 7.5% in 2017	Inflation rose to 8.0% in the month of August from 7.5% in July, due to limited food supply to Nairobi and other urban centers in the month	We expect the inflation rate to stabilize going forward but to average above the 7.5% upper bound government target in 2017	**Neutral**	**Neutral**
Currency (USD/Kshs)	To remain stable supported by dollar reserves	The shilling has appreciated by 1.0% against the dollar since the last meeting and depreciated by 0.4% on a YTD basis, with the 1.0% appreciation since the last meeting primarily driven by dollar inflows from investors abroad into the local debt and equity markets, amid cheap market valuations and a relatively stable business environment, brought about by a non-violent election	Kenya's forex reserves currently stand at USD 7.5 bn (equivalent to 5.0 months of import cover), with the country's current account deficit expanding by 38.5% y/y to USD 4.6 bn in April 2017 from USD 3.3 bn previously, on the back of the country's increased maize importation. Despite this, we expect the currency to remain relatively stable against the dollar, supported by the CBK, which has sufficient reserves, and the low global oil prices	**Neutral**	**Neutral**
GDP Growth	GDP growth to come in at between 4.7% - 5.2% in 2017, from 5.8% recorded in 2016	GDP growth for Q1'2017 came in at 4.7%, primarily on account of subdued performance in the agriculture sector and financial intermediation	GDP growth is expected to recover over the remaining part of 2017, from the depressed 4.7% experienced in Q1'2017, and come in at 4.7% - 5.2%, following the long rains between March and May, albeit depressed, which has served to ease the food shortage in the country	**Neutral**	**Neutral**
Private Sector Credit Growth	Private sector credit growth expected to remain at low levels, below the government set target of 18.3%	The latest data from CBK indicates that private sector credit growth slowed to 2.1% in May 2017, from 11.1% recorded the same time last year, which is below the government set target of 18.3%	Private sector credit growth has remained low, reaching 2.1% in the month of May, and is projected to remain low as the interest rate cap has made it difficult for banks to lend to risky borrowers, who have been priced out of funding	**Negative**	**Negative**
Liquidity	Liquidity expected to remain high given heavy maturities of government securities and following the capping of interest rates	The money market has been relatively liquid since July, with bank's excess reserves at Kshs 11.9 bn and the average interbank rate remaining low and relatively unchanged at 5.3% from the last meeting. The CBK has been active in the Repo market in a bid to mop up the excess liquidity in the market	(i) Money supply growth is high, at 23.6% as at April, and the trend could be inflationary (ii) There are heavy maturities of government securities leading to more liquidity in the market	**Negative**	**Negative**

Conclusion

Of the six factors that we track, four are neutral, with two negative, as the economic indicators remained unchanged since the last MPC meeting in July. With inflation having eased to 8.0% from 9.2% since the last meeting and the currency having appreciated by 1.0% over the same period of time, we believe that the MPC should adopt a wait and see approach, given the macro-economic environment is relatively steady and improving, and we therefore expect the MPC to hold the CBR at 10.0%. The key risk lies in the depressed economic growth that came in at 4.7% in Q1'2017, lower than the 5.8% in 2016, coupled with the subdued private sector credit growth, that came in at 2.1% in May, from 3.3% in March, and this trend may well impact adversely on economic growth, which we believe will be a key driver in future monetary policy decisions.