CENTRE FOR RESEARCH ON
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# Persistent inflationary pressure amidst tightening global financial conditions calls for a further policy rate hike

## Highlights

In its meeting on 30 January 2023, the Central Bank of Kenya's Monetary Policy Committee (MPC) is expected to announce the appropriate monetary policy stance, driven mainly by four macroeconomic developments:

- **First, inflation continues to ease slowly, but remains considerably high above the government's upper target of 7.5%,** bursting perceptions that inflationary pressures would be transitory. At the global scene, major economies such as the U.S and UK, and regional peer economies such as South Africa, have increased and continue to project further interest rate hikes in 2023 to tame inflationary expectations;

- **Second, the economy's growth momentum, both globally and on the domestic front continues to soften**; with the softening attributed to volatilities in global financial markets, the adverse effects of the war in Ukraine, and the policy measures taken to tame inflationary pressure;

- **Third, private sector credit growth remains strong and within the double-digit territory for seven months in a row**. This is despite a monetary policy tightening effected incrementally since May 2022;

- **Fourth, vulnerabilities on the external sector continue to persist driven by the policy measures taken to tame inflationary pressure in advanced economies as well as protracted war in Ukraine.** Going forward, volatilities in the external sector are expected to be sustained with advanced countries remaining upbeat to effect interest rate hikes to tame persistent inflationary pressure; measures that would have direct implications on the foreign exchange markets.

*A further rate hike will provide a stronger impetus in taming inflationary pressures in the domestic market and protect the financial market stability even as the impact of the previous rate hikes is yet to be fully transmitted in the market.*

On account of the developments in the global and domestic economy, particularly the unexpected persistence in inflationary pressure and the policy measures taken to tame inflation as well as projected rate hikes going forward, we view that there is scope for a further tightening of monetary policy. This will provide a stronger impetus in taming inflationary pressures in the domestic market and protect the financial market stability even as the impact of the previous rate hikes is yet to be fully transmitted in the market.

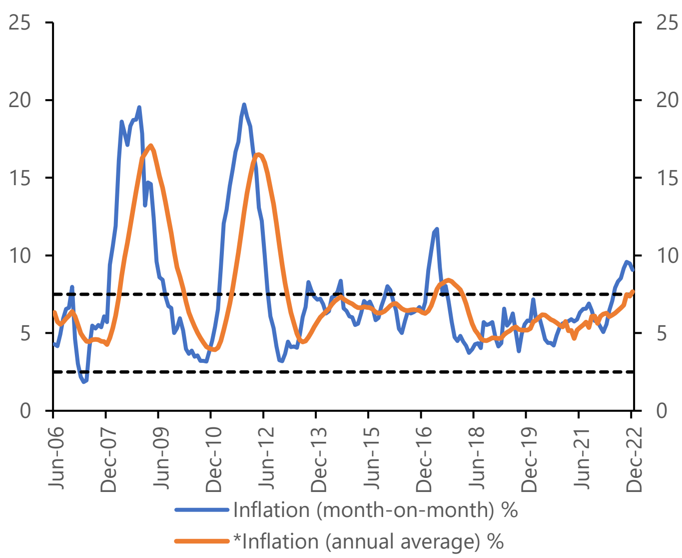
## Background

At its meeting scheduled for **30 January 2023**, the Monetary Policy Committee (MPC) of the Central Bank of Kenya is expected to announce a policy decision anchored on four main macroeconomic developments:

- **First, inflation continues to ease slowly, but remains considerably high above the government's upper target of 7.5% (Figure 1)**; bursting perceptions that inflationary pressures would be transitory. In December 2022, overall inflation stood at 9.1%, slightly lower than 9.5% in November and 9.6% in October 2022, driven by a broad-based decline in its sub-components (**Figure 2**). Food inflation despite remaining high, declined to 13.8% in December on increased food supplies at the end of the year, from 15.4% and 15.8% in November and October, respectively. Similarly, fuel inflation eased back to 12.7% in December, down from 13.8% in November, towards 12.6% recorded in October. Core inflation – which represents demand pressures in the economy – remained largely unchanged at 4.1% in December – relative to 4.2% in November - reflecting elevated demand pressures in the economy when compared with 3.8% in October 2022.

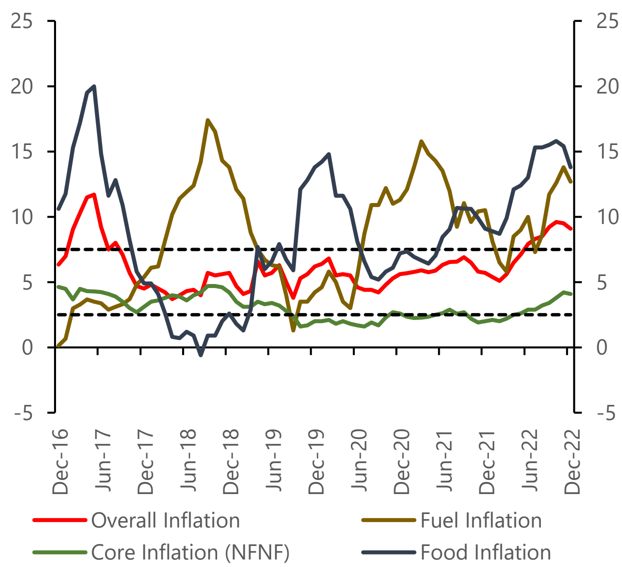
At the global scene, central banks in major economies such as the U.S and UK, and regional peer economies such as the South Africa, have increased their policy rates and continue to project further rate hikes in 2023 to tame inflationary pressures and expectations.

**Figure 1: Trends in inflation**




**Source:** CBK

**Figure 2: Trends in inflation by broad categories**




**Source:** CBK

A few additional developments continue to shape the inflation outturn in the country. For instance, with the notable consistent decline in international oil prices (**Figure 3**)[1], the government's move to reduce fuel subsidy (**Figure 4**)[2] continues to keep fuel prices elevated, exerting pressure on local commodity prices given the role of oil in the production and transportation process of virtually all commodities. Nonetheless, a sustained decline in the global oil prices going forward would be translated to lower domestic fuel pump prices and provide some reprieve on the increases in prices of other consumer goods.

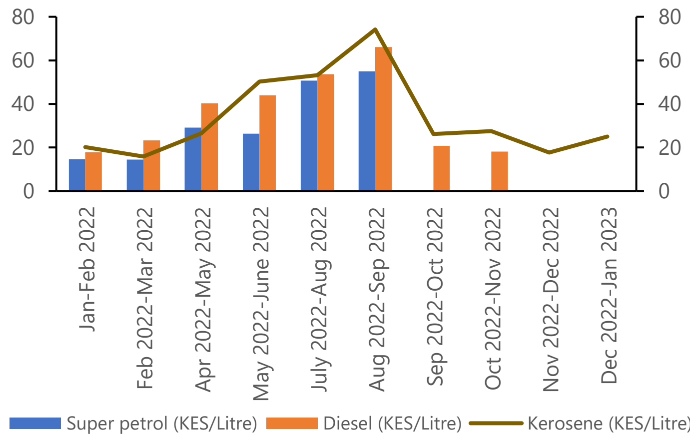
[1] The Murban oil prices seemed to have stabilized at approximately USD 81.00 per barrel in December 2022, before dropping to USD 77.19 per barrel as of 5 January 2023.

[2] The average landing cost of imported Super petrol, Diesel and Kerosene have been on the rise, with 2.65%, 5.65% and 6.01% increases, respectively, registered from October 2022 to November 2022 ( https://www.epra.go.ke/maximum-retail-petroleum-prices-in-kenya-for-the-period-15th-december-2022-to-14th-january-2023/).

**Figure 3: Trends in Murban crude oil Prices**


**Source:** Oilprice.com

**Figure 4: Trends in Government subsidy on fuel**

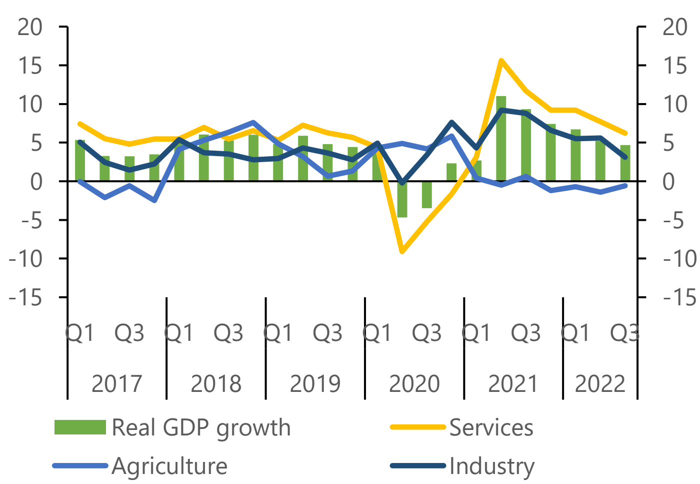



**Source:** EPRA

- **Second, the economy's growth momentum, both globally and on the domestic front continues to soften.** According to the World Bank (2023), the global growth is projected at 1.7% in 2023, described as "*the third-weakest pace in nearly three decades, overshadowed only by the 2009 and 2020 global recessions*". The softening global growth has been attributed to heightened volatilities in global financial markets, the adverse effects of the war in Ukraine, and the policy measures taken to tame inflationary pressure.

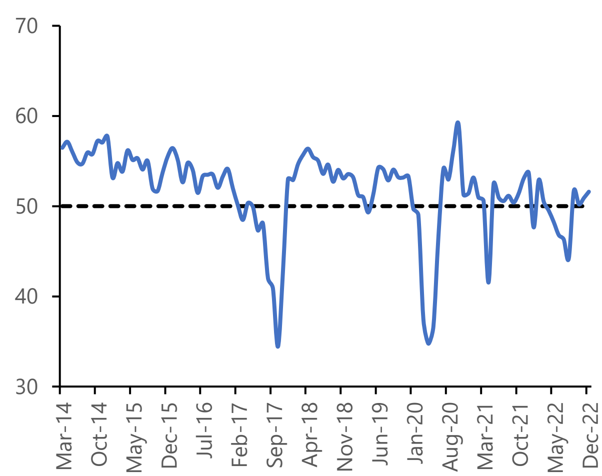
  On the domestic front, economic growth is also softening. During the third quarter of 2022, the domestic economy grew at 4.7% compared to 5.2% during the second quarter (**Figure 5**). While modest the growth was broad-based expansion. During the third quarter growth in the services sector (6.2%) was buoyed by accommodation and restaurant (22.9%), wholesale and retail trade (9.1%) and Professional, Administration & Support Services (8.7%). While the manufacturing sector grew at a modest 2.4% during the third quarter, unfavourable weather conditions in many parts of the country during the quarter continued to chock growth in the agriculture sector, consequently leading to a contraction of 0.6% in agricultural output. Overall, the Kenyan economy is estimated to have grown at 5.5% in 2022 with baseline growth further projected to soften to 5% in 2023[3].

**Figure 5: Sectoral and aggregate Real GDP growth (%)**




Source: KNBS

**Figure 6: Trends in PMI index**



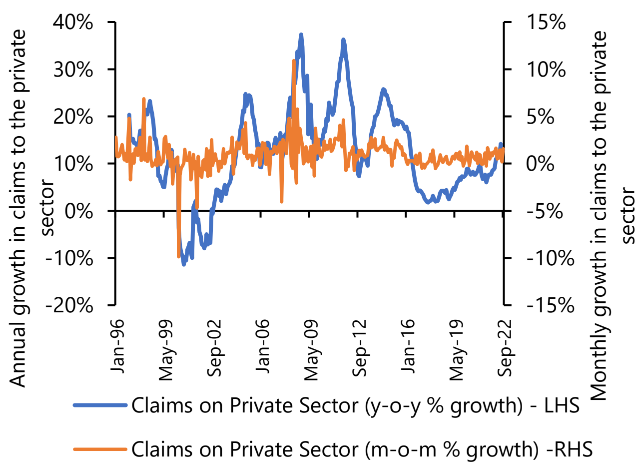

Source: IHS Markit ®

[3] World Bank (2023). Global Economic Prospects. https://www.worldbank.org/en/publication/global-economic-prospects

Analyses of higher frequency leading indicators of economic activity as captured by the Purchasing Managers Index (PMI) report, showed improved business conditions in the fourth quarter of 2022. The PMI index picked up to a three-month high of 51.6 in December 2022, having risen from 50.9 in November and 50.2 in October 2022 **(Figure 6**), indicating sustained overall improvements in economic activities on a consecutive month-after-month basis supported by higher demand, favourable weather conditions and softer price pressures. Nonetheless, the PMI report revealed varied sectoral performances, with uplifts reported by firms in the agriculture, manufacturing and wholesale and retail sectors, as activity in the construction and services sectors recorded a decline.

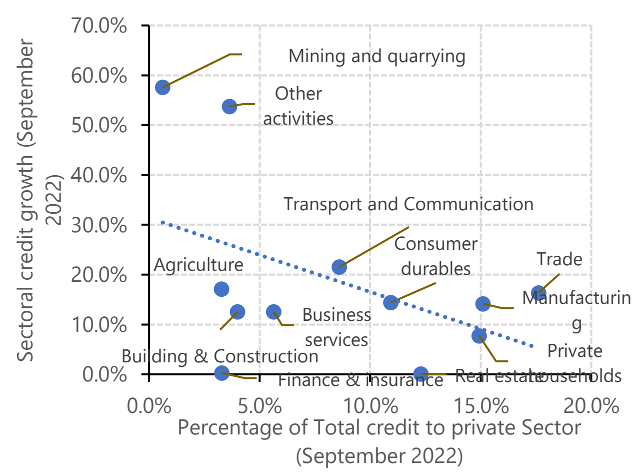
- **Third, private sector credit growth remained strong and within the double-digit territory for seven months in a row**. The year-on-year private sector credit growth stood at 12.86% in September 2022, slightly up from 12.47% in August 2022 **(Figure 7)**. An assessment of credit growth across the sectors in September 2022 reveals that strong credit growth was absorbed by transport and communication (21.54%), agriculture (17.09%), trade (16.36%), consumer durables (14.40%), manufacturing (14.16%), building and construction (12.52%) and business services (12.51%) (**Figure 8).** Going forward, it is expected that the impact of the policy tightening effected since May 2022 will start to filter through to market interest rates and moderate the growth in private sector credit in the near term. Already, there is evidence of an increase in the short-term interbank interest rates, as shown in **Figure 9,** that is expected to be followed by an increase in the longer-term interest rates. This has been supported by the considerable progress of the market in transitioning to risk-based credit pricing regime, that allows banks to price loans in line with the evolution of risk and policy signals.

**Figure 7: Credit growth to the Private Sector (%)**



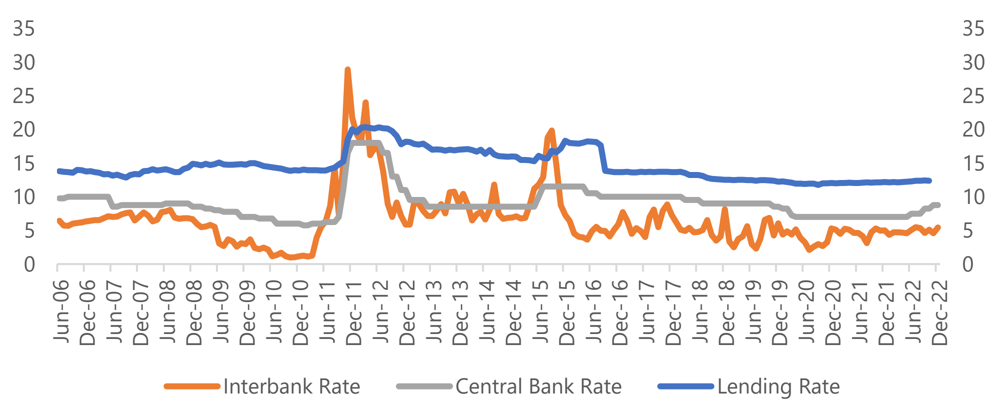

Source: CBK

**Figure 8: Sectoral Credit growth to the Private Sector**




Source: CBK

**Figure 9: Trends in the Interest rates (%)**




**Source:** CBK

- **Fourth, vulnerabilities on the external sector continue to persist driven by the policy measures taken to tame inflationary pressure in advanced economies as well as protracted war in Ukraine.** Recent developments in the external sector show a sustained steady depreciation of the Shilling vis-à-vis the US dollar (**Figure 10**), driven largely by an elevated current account deficit, even with a slight improvement in the financial account of the balance of payments (**Figure 12**). The depreciation continues to be moderated by resilient inflows of diaspora remittances and a steady increase in tourism earnings.

  Meanwhile, the usable official foreign exchange reserves position improved to stand at USD 7,415 million (or 4.15 months of import cover) as of 12 January 2023, from USD 7,075 million (3.96 months of import cover) on 15 December 2022. This reflects a slight improvement in the country's buffers to deal with any emerging short-term shocks in the foreign exchange market. Going forward nonetheless, volatilities in the external sector are expected to be sustained with advanced countries remaining upbeat to effect interest rate hikes to tame persistent inflationary pressure. This measures would trigger a further appreciation of the US dollar in the global foreign exchange markets with direct implications on the domestic markets.

**Figure 9: Nominal exchange rate (KES/USD)**

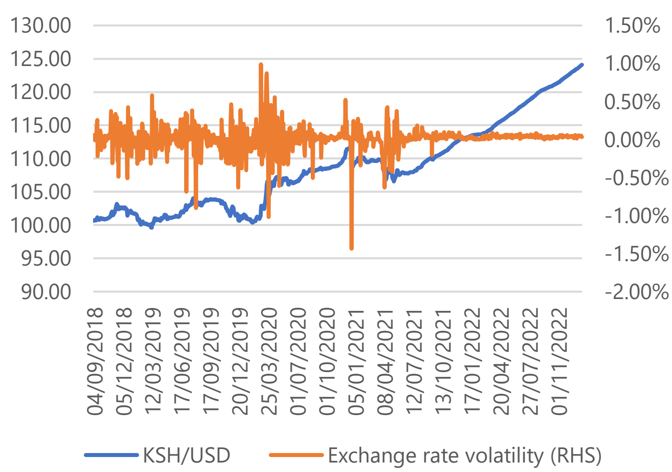



**Figure 10: Remittances Inflows**

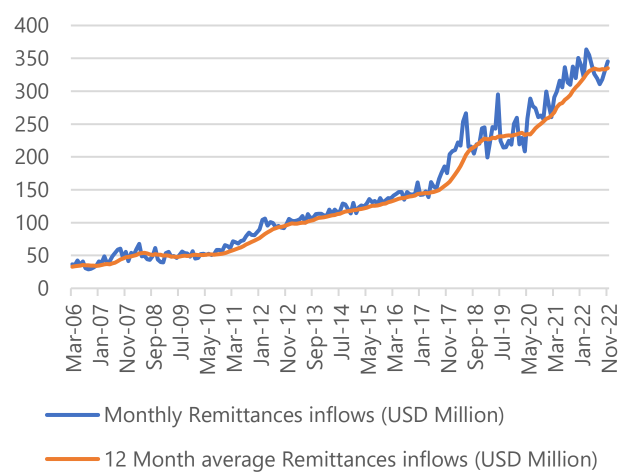



**Figure 11: FX Reserves and Import Cover**

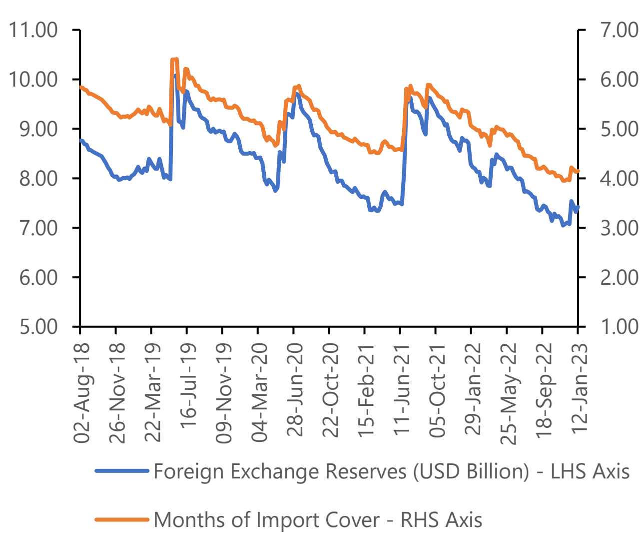
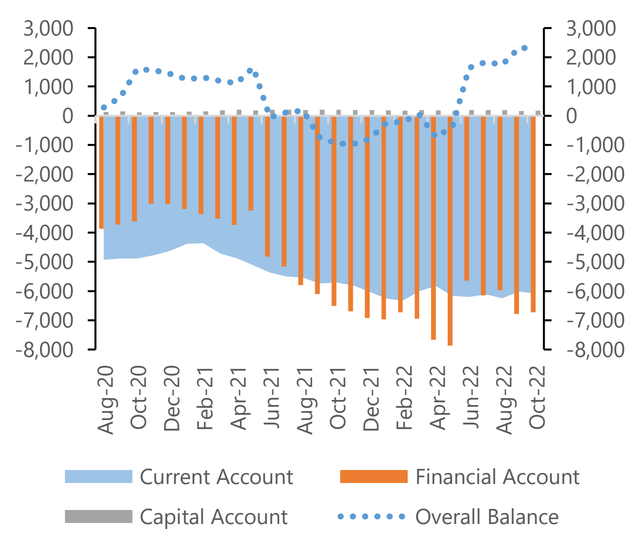



**Figure 12: Developments in the Balance of payments USD Millions (net balances)**




**Source:** CBK

## Conclusion

At its meeting scheduled for 30 January 2023, the MPC is expected to review a number of macroeconomic developments to inform the policy stance for the next two months. These developments include persistent inflationary pressure at both the global and domestic market; easing recovery of the economy; and elevated vulnerabilities in global markets.

Following an assessment of the macroeconomic developments and the balance of risks particularly on the financial markets with anticipated further tightening of monetary policy stance in advanced economies in 2023, we view that there is scope for a further tightening of monetary policy. This will provide a stronger impetus in taming inflationary pressures and protect the domestic financial market stability even as the impact of the previous rate hikes is yet to be fully transmitted in the market.

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