Centre for Research on Financial Markets and Policy®

Research Note

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A Call To Sustain the Monetary Policy Stance Amidst a Balance of Risks

Highlights

The CBK Monetary Policy Committee (MPC) is expected to take a decision on the policy stance for the near- to medium term during its meeting on **9th August 2023**, amidst inflationary pressures, sustained uncertainties and headwinds from the global and domestic economy. The decision is expected to be underpinned by four key macroeconomic developments and considerations:

- First, though inflationary pressures have softened to the Government target range, risks are imminent and inflation expectations remain elevated on account of the new tax measures in the Finance Act 2023;
- Second, economic growth momentum remains fragile, with its fragility driven by sustained rise in production input costs, rising interest rates and projected slowdown in demand as depicted by higher frequency economic activity indicators in the second quarter of 2023;
- Third, the ongoing transmission of higher interest rate policy signal announced in late June 2023 continues to trigger cautious and tighter lending conditions by banks as the industry monitors the evolution of non-performing loans amidst elevated cost of living for borrowers and a slowdown in economic activity. This is expected to ease private sector credit growth in the economy;
- Fourth, the external sector developments remain fragile on headwinds from the war in Ukraine, further tightening of the financial conditions in global markets, and a sustained wide current account deficit that continues to fundamentally exert pressure on the exchange rate to weaken.

In view of the above developments, particularly the balance of risks between decisively driving down inflation levels and protecting some economic activity, and the need to allow the transmission of the policy signal effected in late June 2023 to filter through, the KBA Research Centre argues that the sustenance of the current monetary policy stance – *in keeping the CBR unchanged at 10.50 percent - would be appropriate.*

"..the balance of risks between decisively driving down inflation levels and protecting some economic activity, and the need to allow the transmission of the policy signal effected in late June 2023 to filter through, there is need to sustain the current monetary policy stance by keeping the CBR unchanged.."

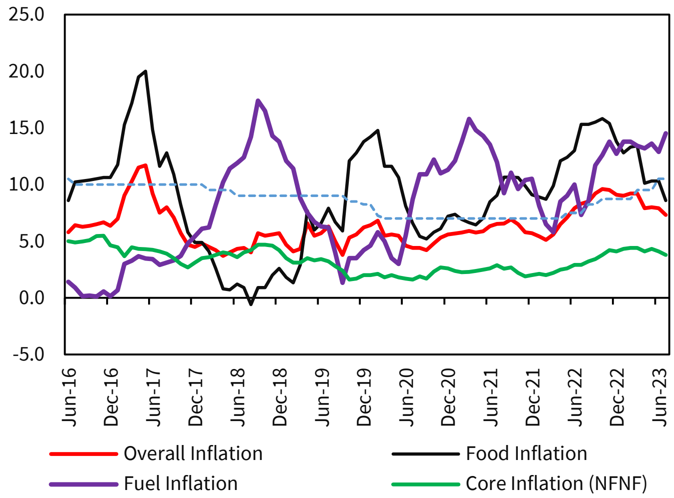
Background

The Central Bank of Kenya's Monetary Policy Committee (MPC) decision in its meeting of 9th August 2023 is expected to reflect a balance of risks particularly the need to anchor inflation expectations on one hand and protect economic activity that remains fragile on the other. This Research Note, prepared by the KBA Centre for Research on Financial Markets and Policy® provides a brief review of four key macroeconomic developments and considerations that are expected to underpin the decision of the MPC:

First, though inflationary pressures have softened to the Government target range, risks are imminent and inflation expectations remain elevated on account of the new tax measures in the Finance Act 2023. Headline inflation in July 2023 sustained its moderation to 7.3% from 7.9% and 8.0% in June and May 2023, respectively. Easing inflationary pressures have been driven by lower food inflation and a moderation in the non-food-non-fuel (NFNF) inflation during the period, despite fuel inflation remaining elevated. In particular, food and NFNF inflation respectively declined to 8.6% and 3.8% in July from 10.3% and 4.1% in June. This more than offset fuel inflation that rose to 14.5% from 12.9% during the period (**Figure 1a**) that reflected the fuel pump price hikes on account of an increase in VAT on petroleum products from 8% in June to 16% in July 2023. The moderation in NFNF inflation reflects a moderation in demand pressures in the economy partly on account of the decisive monetary policy tightening effected since the beginning of the second half of 2022 and augmented in late June 2023. Despite these developments, higher inflationary expectation risks are likely to materialize driven by the pricing in of the new tax measures from July 2023 and the knock on effects of higher fuel prices on other commodity prices.

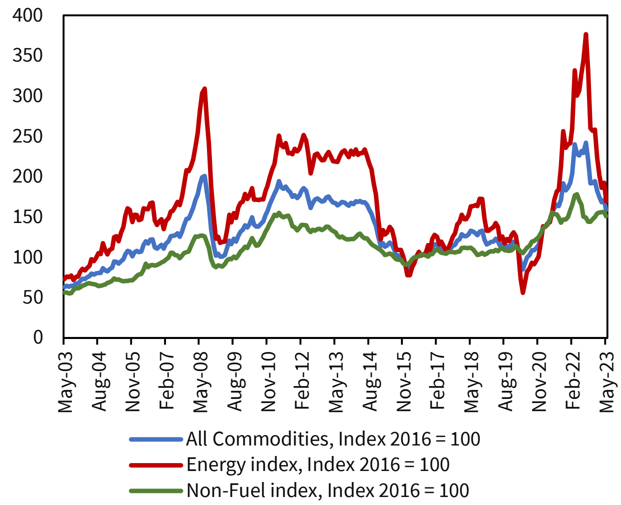
Figure 1: Inflation Drivers and Policy Rate Dynamics

Figure 1a. Inflation drivers and CBR (%)



Source: CBK

Figure 1b. Evolution of Global Prices



Source: IMF Commodities Prices Database

At the global commodity market, the commodity prices have softened **(Figure 1b);** potentially offering some reprieve for expected domestic prices. This , together with expected lower food prices as maize harvest season sets in, in the third and fourth quarter of the year, will continue to moderate the inflationary pressures in the economy arising from oil price increases, new tax measures and the global supply disruptions arising from the ongoing war in Ukraine.

Second, economic growth momentum remains fragile (Figure 2a), with its fragility driven by sustained rise in production input costs, rising interest rates and projected slowdown in demand as depicted by higher frequency economic activity indicators in the second quarter of 2023. In the first quarter of 2023, Kenya's economy grew by 5.3% - slower than 6.2% recorded in the first quarter of 2022 – driven mainly by a

5.8% expansion in the agriculture sector and a 6.5% growth in the services sector. During the period, however, the industrial sector expanded by a modest 3.6%, much slower than a growth of 5.6% over a similar quarter in 2022 **(Figure 2b).** With the waning economic activity, the economy, going forward, is likely to post slower-than-projected growth rates (of 6.2% by CBK and 5.0% by the World Bank posted in early 2023), particularly with the deployment of stronger policies to tame inflationary pressures.

Figure 2: Economic Growth indicators

Figure 2a: ***Economic recovery indices compared across sectors***
(Base Period: Fourth Quarter 2019 *GDP=100*)

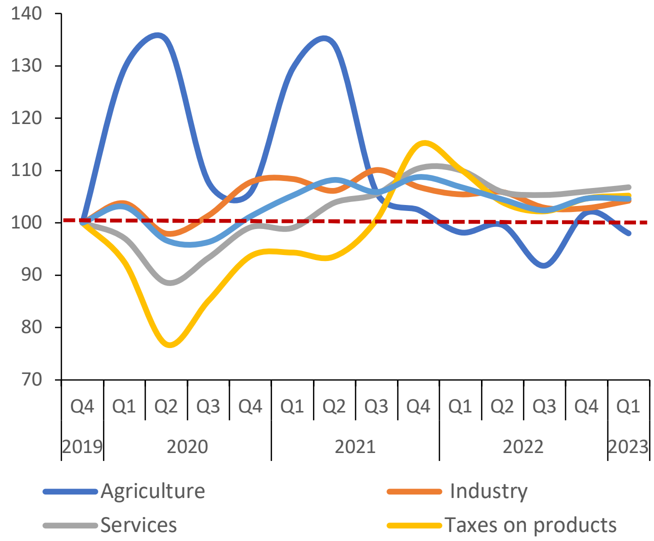
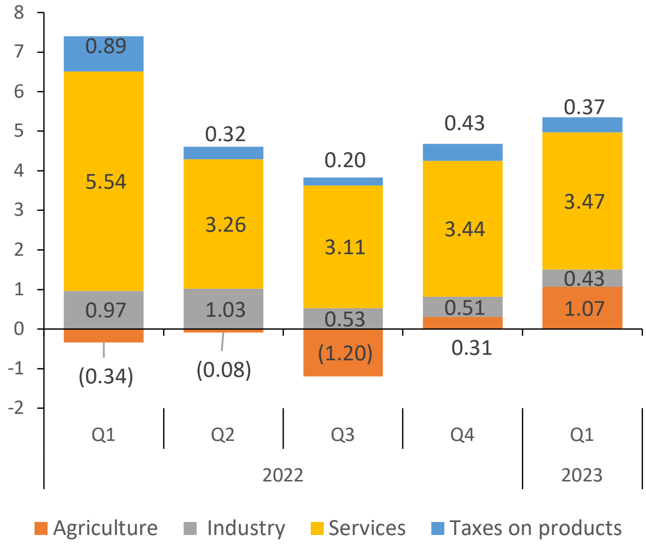


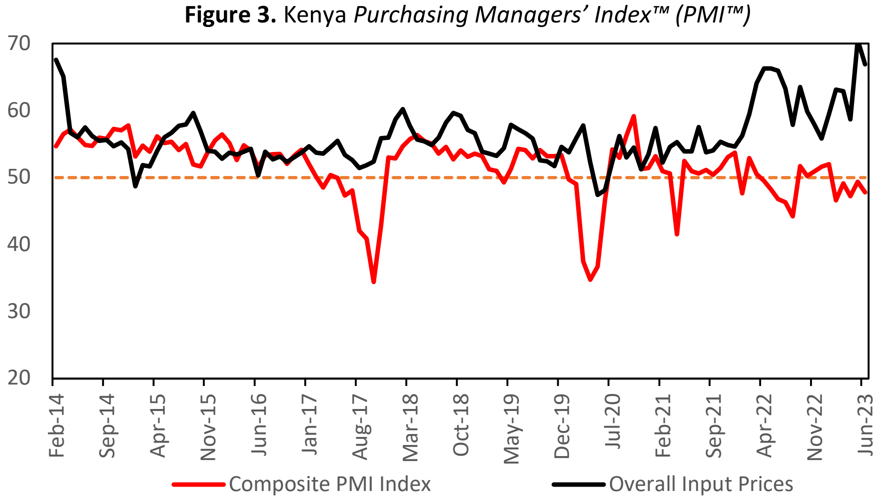
Figure 2b: ***Sectoral Contribution to GDP (Quarter 1 of 2023)***



Source: KNBS & KBA Computations

Economic growth outcomes face downside risks from emerging drought conditions over some parts of the country, waning global growth, uncertainties from the war in Ukraine, and dimming business confidence. According to the IHS Markit® Purchasing Managers' Index™ (PMI™), economic activity on a month-after-month tracking continues to soften, with the composite PMI index remaining below the 50.0 threshold mark for the fifth month in a row in June. The PMI Index in fact dropped to 47.8 in June from 49.4 in May **(Figure 3),** reflecting sustained declines in overall output and new orders, and increases in input prices.

Figure 3. Kenya *Purchasing Managers' Index™ (PMI™)*



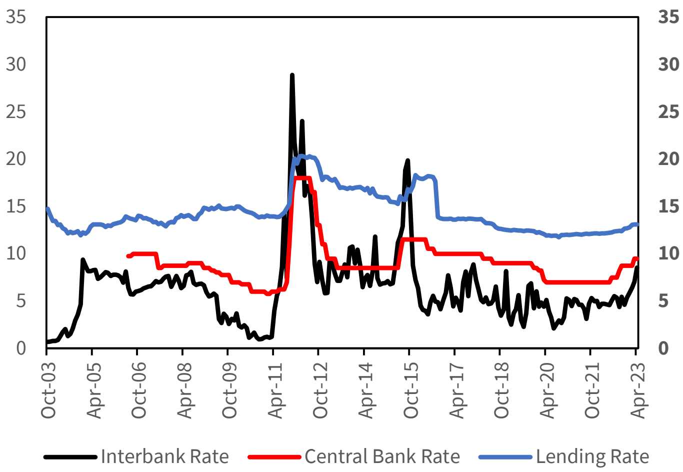
Source: IHS Markit

Third, the ongoing transmission of higher interest rate policy signal announced in late June 2023 continues to trigger cautious and tighter lending conditions by banks as the industry monitors the

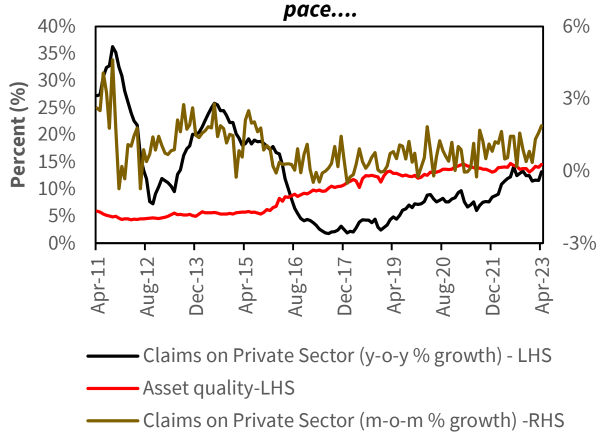
evolution of non-performing loans amidst elevated cost of living for borrowers and a slowdown in economic activity. This is expected to ease private sector credit growth in the economy. In view of the monetary policy tightening and the expected transmission, interest rates have edged up. The average interbank interest rate rose to 14.84% in the week ending July 28 from 10.02% in the week ending June 29 and 9.25% in the week ending 25 May 2023. The transmission of higher interest rate signals has also been effected along the yield curve. For instance, commercial banks average lending rate remained on a steady rise trajectory since October 2022 through May 2023 **(Figure 4a).** Nonetheless, credit growth has remained on a double-digit growth trajectory – at 13.2% in both April and May 2023, despite the tightening monetary policy conditions and deteriorated asset quality. This reflects ongoing structural challenges impeding the implementation of risk-based pricing and banks largely adopting loan restructures (in terms of extension of loan tenures) to support customer repayments of existing loan facilities with elevated credit risk in the market. Going forward, expectations of a slowdown in economic growth and the rising interest rates are likely to further exacerbate credit risk, thereby slowing down private-sector credit loan growth in the near- to medium term.

Figure 4: Dynamics in interest rates and credit to private sector

4a. Trends in policy rate, interbank and lending rates



4b. Double-digit growth in credit to the private Sector is sustained albeit at a decelerating pace....

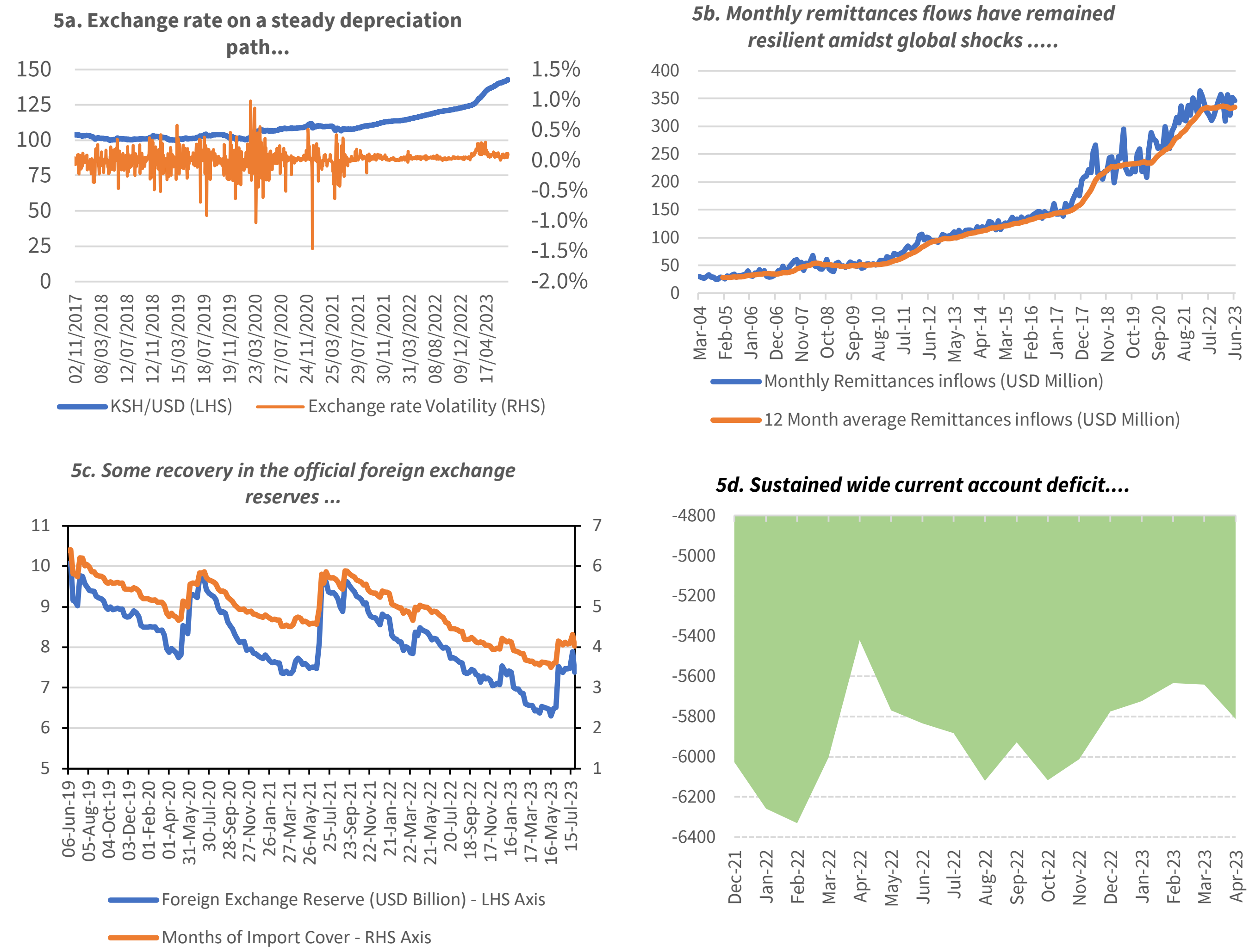


Source: CBK

Fourth, the external sector developments remain fragile on headwinds from the war in Ukraine, further tightening of the financial conditions in global markets, and a sustained wide current account deficit that continues to fundamentally exert pressure on the exchange rate to weaken. The Kenya shilling exchange rate has sustained its depreciating trend against the US dollar **(Figure 5a)**, driven fundamentally by a sustained wide current account deficit **(Figure 5d),** and the relatively high differential between the domestic and foreign interest rates that continue to support investments in US dollar. This depreciation pressure has, however, been moderated by steady improvement in the inflows of diaspora remittances **(Figure 6b),** and some improvement in market confidence with the recovery in the official foreign exchange reserves to USD 7,377 million (4.03 months of import cover) as of 27th July 2023 from USD 6,476 million (3.60 months) as at end of May 2023. There is an anticipated improvement in the current account deficit with projected growth in export earnings - particularly with the recovery in tourism activities -amidst anticipated moderation in the import bill as the economy slows down.

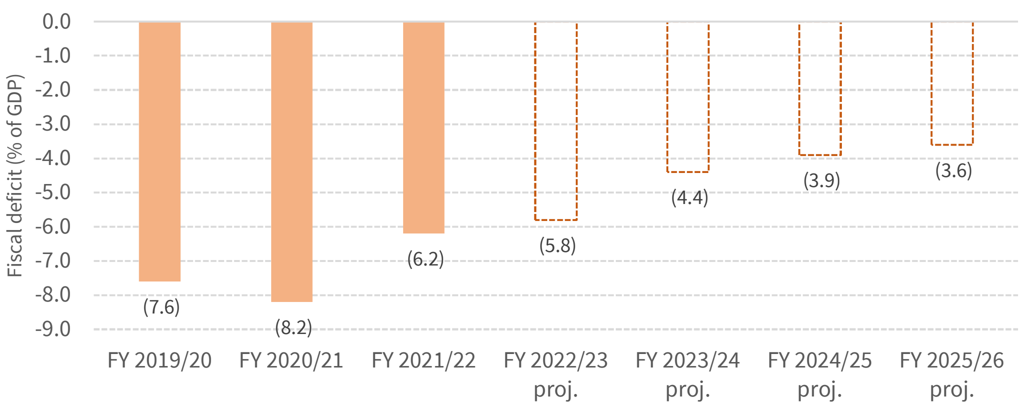
On the domestic front, the Government's focus and strong commitment to a fiscal consolidation path seeking to consistently reduce the fiscal deficit to GDP ratio to 3.6% in the medium term **(Figure 7)** and leaning both on expenditure rationalization and enhanced revenue mobilization, is expected to reduce debt vulnerabilities and support domestic macroeconomic stability. With the domestic borrowing programme on course, government expenditures will be expected to improve in the near term to moderate liquidity gridlocks in the market and eliminate pressure on the local currency interbank market, thereby moderating the increases in the interbank market interest rates.

Figure 5: External sector developments



Source: CBK

Figure 6: Fiscal deficit (% of GDP)



Source: National Treasury - Kenya

Conclusion

The Central Bank of Kenya's MPC meeting of 9th August 2023 is expected to announce the monetary policy stance to be adopted in the near to medium term. In view of the above developments, particularly the balance of risks between decisively driving down inflation levels and protecting some economic activity, and the need to allow the transmission of the policy signal effected in late June 2023 to filter through, the KBA Research Centre argues that the sustenance of the current monetary policy stance – *in keeping the CBR unchanged at 10.50 percent - would be appropriate.*

This *Research Note* is a publication of the Kenya Bankers Association Centre for Research on Financial Markets and Policy®. The Centre was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and initiate dialogue on critical policy matters that impact the financial sector. Through these activities, the Centre acts as a platform for intellectual engagement between experts on financial markets, banking industry players and policy makers.

Comments on this *Research Note* can be forwarded to research@kba.co.ke