Research Note

September 27, 2023

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A call to effect a further tightening of the monetary policy stance, with rising inflationary expectations, to protect macroeconomic stability

Highlights

The CBK Monetary Policy Committee (MPC) is expected to take a policy stance for the near term during its meeting on **3 October 2023**, amidst uncertainty on the path of inflation going forward and tightening liquidity and credit conditions in the market. The decision is expected to be underpinned by five key macroeconomic developments and considerations:

- First, amidst a slight slowdown in inflationary pressure in August, there are risks to inflation rising in the coming months driven by the upward adjustment in fuel pump prices, depreciation of the exchange rate and the impact of the forecasted heavy rains on food produce.
- Second, there is softening economic growth anticipated in the last quarter of 2023 on account of elevated cost of living and the adverse effects of new taxes on consumer demand, amidst the continuing implementation of fiscal consolidation;
- Third, interest rates continue to edge upwards in response to the existing tight monetary policy stance. Higher interest rates are expected to raise the cost of funds and cost of credit thereby moderate credit demand;
- Fourth, despite elevated credit risk, credit growth remains strong with delayed transmission of a tight monetary policy signal; continuing strong credit demand by customers to finance economic activities as the economy remains on the path of recovery from the depressing effects of COVID-19 in 2020 and 2021; and
- Fifth, Kenya's external sector remains heavily exposed to the global shocks, and the effects of policy measures taken by advanced markets to tame inflationary pressures. These developments have been manifested fundamentally in exchange rate movements locally.

"Amidst the risk of rising inflationary pressures in the near term, the need to achieve macroeconomic stability – in softening exchange rate depreciation and moderating credit demand – call for a further tightening of the monetary policy stance, preferably by a narrow margin to avert a buildup in non-performing loans with the elevated credit risk ….

In view of these developments, we argue that a further (moderate) monetary policy tightening would support measures taken previously to tame inflationary pressures and rising inflationary expectations, cool off credit demand (and supply) while averting a sharper build up in non-performing loans, help achieve a moderation in the trend depreciation of the exchange rate, all for enhanced macroeconomic stability.

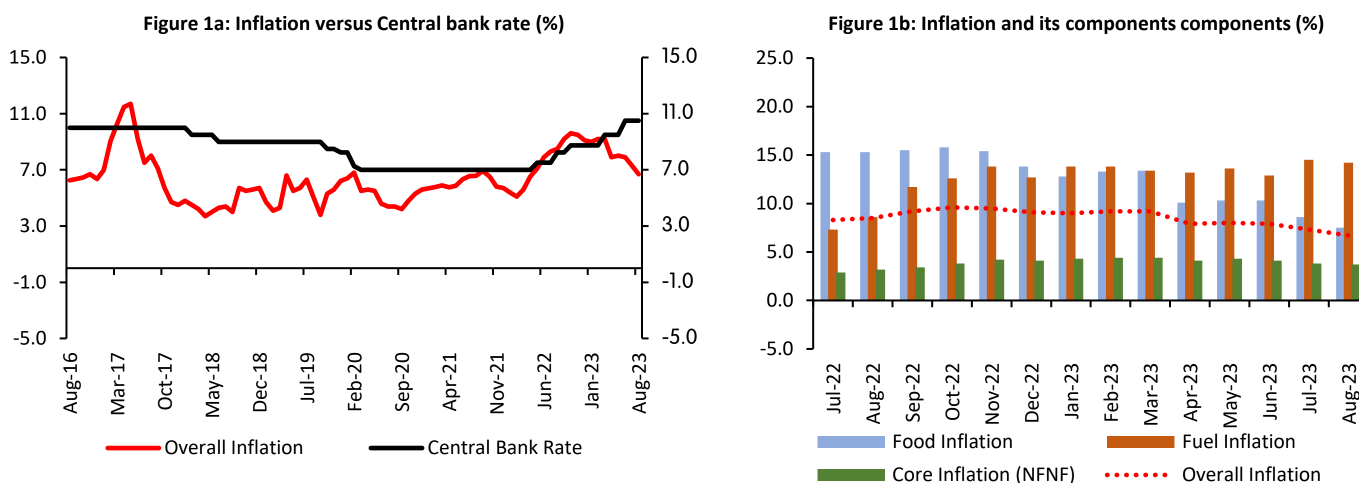
Background

The decision of the MPC in its meeting scheduled for Tuesday 3 **October 2023,** is expected to be underpinned by five major developments.

First, amidst a slight slowdown in inflationary pressure in August, there are risks to inflation rising in the coming months driven by the upward adjustment in fuel pump prices, depreciation of the exchange rate and the impact of the forecasted heavy rains on food produce. The headline inflation in August declined to 6.7% from 7.3% in July (**Figure 1a**) on eased food prices and a moderation in core inflation over the period. As food inflation declined to 7.5% from 8.6% in July, core inflation dropped marginally to 3.7% from 3.8% over the period.

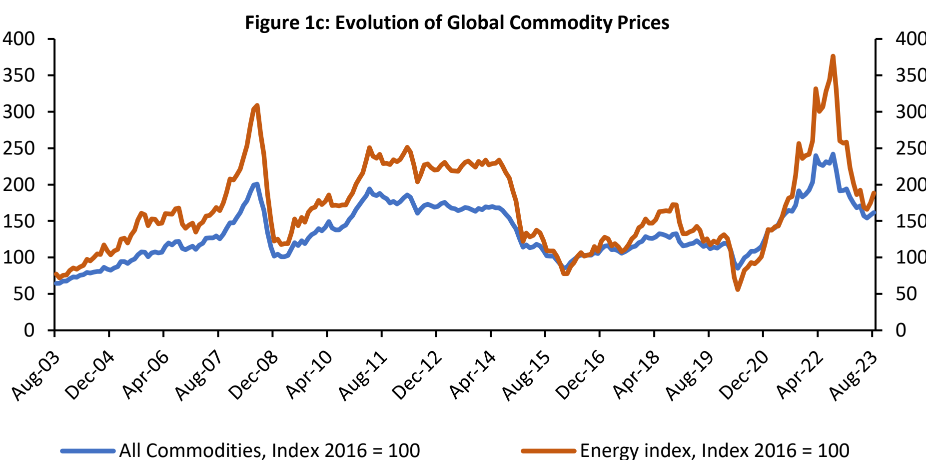
However, fuel inflation remained elevated at 14.2% in August reflecting sustained oil price pressures in the economy (**Figure 1b**). With the recent sharp upward adjustment by EPRA in local fuel pump prices in mid-August – driven by rising global oil prices (**Figure 1c**) with the Murban Crude oil prices edging up from US$ 88.91 at end August to US$ 95.04 per barrel on 27th September, local fuel price inflation is expected to increase, and potentially drive-up other commodity prices in the near to medium term given that oil is an intermediate good. Other risks to inflation include Russia's suspension of its participation in the Black Sea Grain Initiative and the forecasted El Nino rains causing destruction of food produce in the fourth quarter of 2023.

Figure 1: Inflation Drivers and Policy Rate Dynamics



Source: Central Bank of Kenya

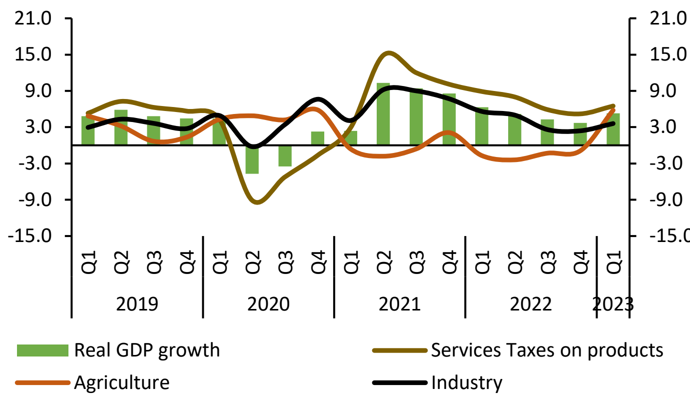
Source: IMF Commodities prices database



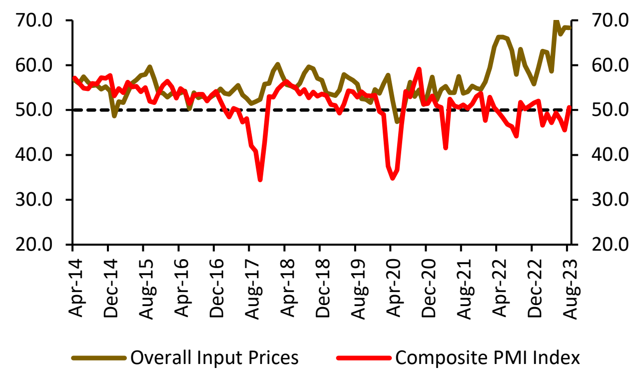
Source: IMF Commodities prices database

Second, there is softening economic growth anticipated in the last quarter of 2023 on account of elevated cost of living and the adverse effects of new taxes on consumer demand, amidst the continuing implementation of fiscal consolidation. Beyond the strong first quarter growth (**Figure 2a**), leading indicators of economic performance in the second and third quarters of 2023 show depressed activity. In particular, the Purchasing Managers' Index™ (PMI™) remained below the 50.0 mark consistently after March; only showing a recovery of economic activity in August when the index stood at 50.6 (**Figure 2b**). The main factor behind the depressed activity is cited as elevated input prices. In addition, a tightening monetary policy impact on cost of credit and concerns of slowdown in consumption patterns with rising cost of living, as well as the implementation of fiscal consolidation by the Government to mitigate debt vulnerabilities, continue to pose risks to stronger economic growth prospects.

Figure 2: Economic Growth Performance Indicators



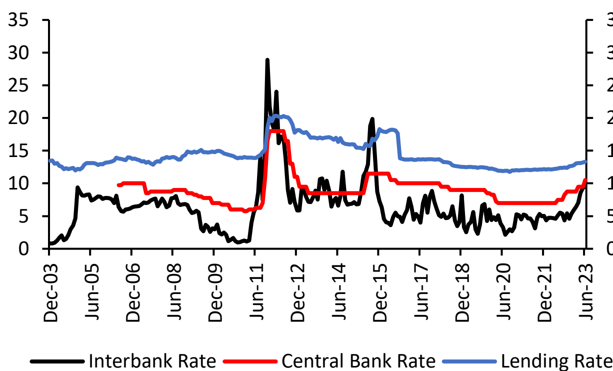
Source: KNBS



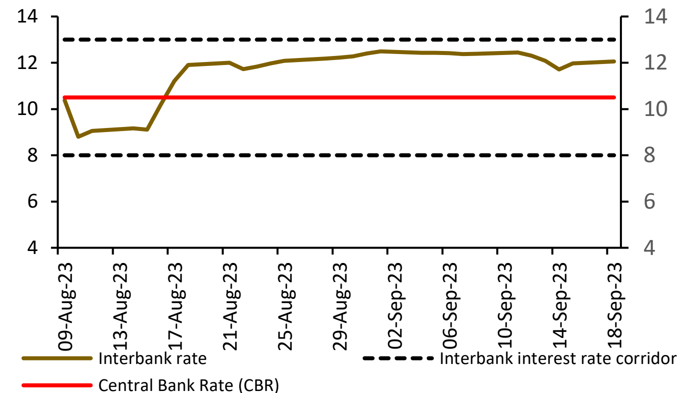
Source: IHS Markit®

Third, interest rates continue to edge upwards in response to the existing tight monetary policy stance. Higher interest rates are expected to raise the cost of funds and cost of credit, thereby moderate credit demand. The MPC gradually tightened the monetary policy stance since June 2022; raising the CBR from 7.5% to 10.5% over the period to early August 2023 (**Figure 3b)**. The implication of this has been an increase in money market yields and an increase in interbank market rates. Banking sector average lending rates have also increased suggesting that the effects of the tight monetary policy continue to be felt in the credit market (See **Figure 3a**). During the MPC meeting on 9th August 2023, the central bank introduced an interest rate corridor framework to guide monetary policy operations and market outcomes. The corridor provided for a targeting of the interbank rate to oscillate within $\pm$ 250 basis points around the CBR, with the aim of enhancing the effectiveness of the bank's policy. The has been since been achieved (**Figure 3b**). However, there remain concerns of weaker transmission of the policy signal from the interbank market to other longer term market interest rates, particularly the lending rates, that would otherwise effectively trigger the anticipated faster slowdown in credit supply.

Figure 3: Trends in the Money Market Rates



Source: Central Bank of Kenya

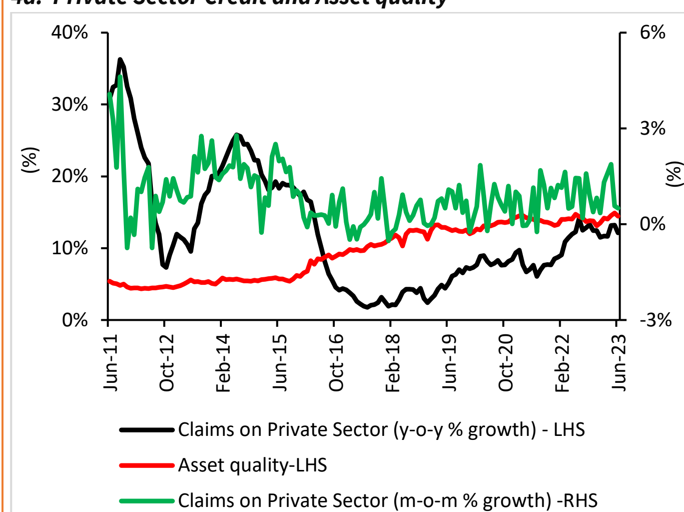


Source: Central Bank of Kenya

Fourth, despite elevated credit risk, credit growth remains strong with delayed transmission of a tight monetary policy signal; continuing strong credit demand by customers to finance economic activities as the economy remains on the path of recovery from the depressing effects of COVID-19 in 2020 and 2021. Credit growth stood at double digits consistently since March 2022 reflecting strong financing of economic activities and recovery from the depressing effects of COVID-19 pandemic. Latest data shows that overall private sector credit growth in July 2023 stood at 10.3%, depicting a slowdown from 12.2% in June. The slowdown is partly attributed to the tightening monetary conditions and an elevated credit risk (**Figure 4a**). A sectoral disaggregation of commercial banks' credit to the private sector in July showed that credit growth to agriculture (19.0%) was the strongest, followed by mining & quarrying activities (16.7%), transport and communication (16.4%), manufacturing (14.7%), consumer durables (12.9%) and business services (10.7%) (**Figure 4b**). The notable strong credit growth, in an environment of tightened monetary policy stance, reflect a weaker transmission of policy signals to lending rates. This is partly attributed to structural challenges associated with the restrictions in the implementation of risk-based credit pricing by banks.

Figure 4: Trends in credit to the private sector

4a: Private Sector Credit and Asset quality



Source: Central Bank of Kenya

4b: Sectoral Growth in Private Sector Credit

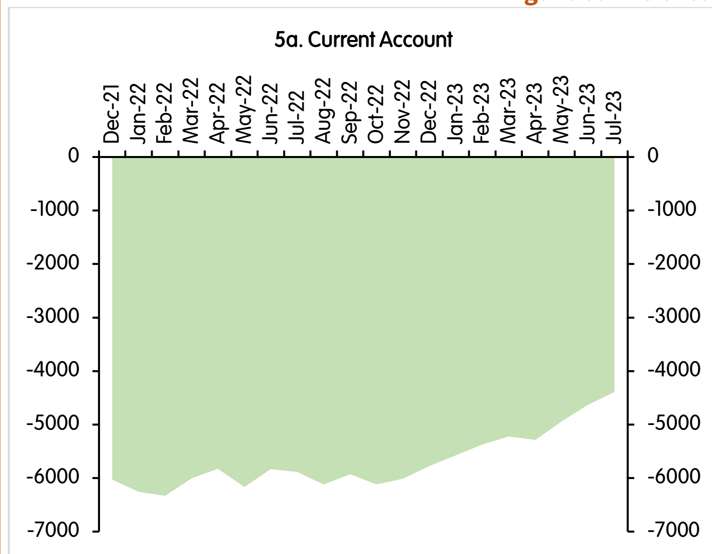
Sector	Jul/22	Aug/22	Dec/22	Mar/23	Jun/23	Jul/23
Agriculture	10.8	19.2	22.3	14.9	18.6	19.0
Manufacturing	16.1	15.2	13.8	15.8	18.0	14.7
Trade	15.2	13.3	11.4	11.9	10.2	7.4
Building and construction	**14.1**	**11.5**	**8.2**	**5.8**	**4.9**	**1.9**
Transport & communications	27.0	13.5	23.5	17.4	19.8	16.4
Finance & insurance	2.8	1.2	7.6	28.4	29.7	35.4
Real estate	1.7	1.0	3.2	2.3	3.7	3.0
Mining and quarrying	78.6	97.2	31.3	83.2	24.0	16.7
Private households	7.6	7.8	8.2	7.2	8.4	7.0
Consumer durables	14.8	14.3	12.9	12.7	12.0	12.9
Business services	16.9	16.1	13.7	9.3	12.1	10.7
Other activities	69.8	60.8	41.8	11.9	8.7	0.5
Growth in credit to the private sector (%)	**14.2**	**12.5**	**12.5**	**11.6**	**12.2**	**10.3**

Source: Central Bank of Kenya

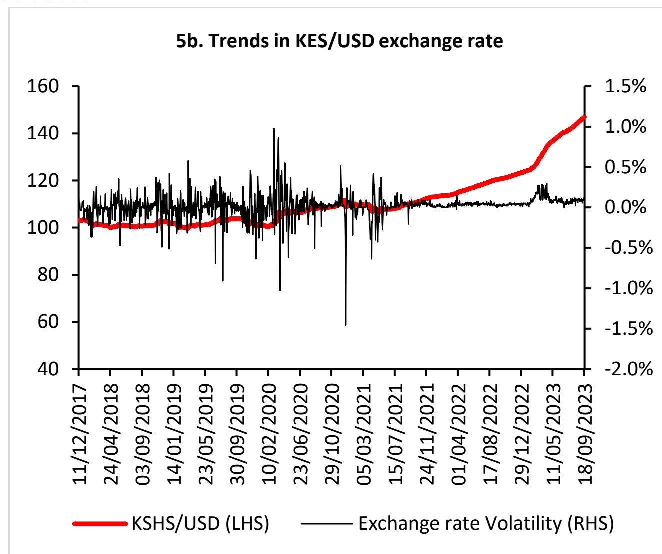
Fifth, Kenya's external sector remains heavily exposed to the global shocks, and the effects of policy measures taken by advanced markets to tame inflationary pressures. These developments have been manifested fundamentally in exchange rate movements locally. The Shilling exchange rate to the US dollar continues on a stronger trend depreciation path (**Figure 5b**) driven partly by rising global interest rates that have made US dollar investments more attractive compared to the domestic Shilling investments and expectations by economic agents of a further depreciation in the near term. This is despite a trend narrowing of the cumulative overall current account deficit (**Figure 5a**).

Going forward, the risk of a reversal in the current account deficit may be driven by rising global oil prices, sustained high interest rates in advanced markets that continue to attract investors towards US dollar denominated investments. However, this depreciation continues to be tempered by resilient diaspora remittances inflows (**Figure 5c**) - which grew by 14.15% in the 12 months to August 2023 over a similar period to August 2022. The country's foreign exchange reserves have been moderate, standing at USD 6.96 billion as of 21 September 2023 (**Figure 5d**), which is equivalent to 3.80 months of import cover; just within CBK's minimum statutory requirement of 4.0 months of import cover.

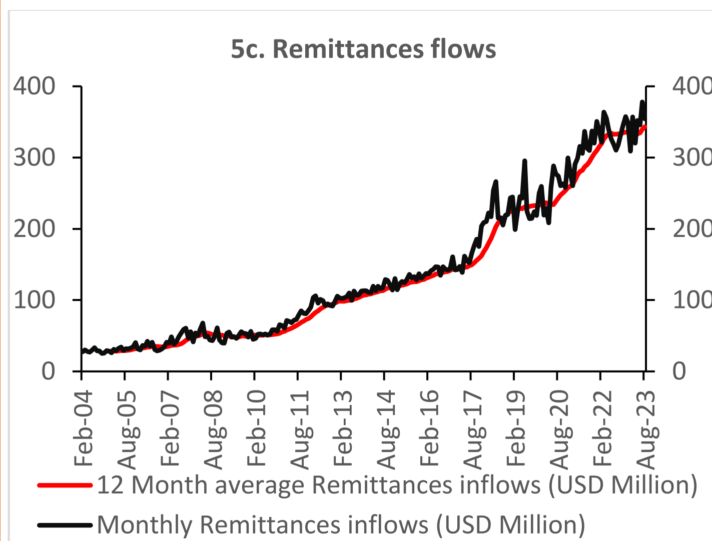
Figure 5: The external Sector



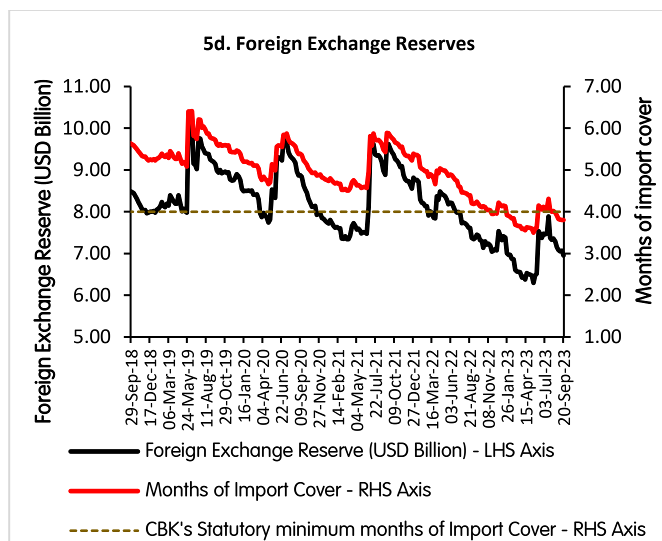
Source: Central Bank of Kenya



Source: Central Bank of Kenya



Source: Central Bank of Kenya



Source: Central Bank of Kenya

Conclusion

In view of these developments, we argue that a further (moderate) monetary policy tightening would support measures taken previously to tame inflationary pressures and rising inflationary expectations, cool off credit demand (and supply) while averting a sharper build up in non-performing loans, help achieve a moderation in the trend depreciation of the exchange rate, all for enhanced macroeconomic stability.

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