CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Research Note

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Despite easing inflationary pressure, macroeconomic vulnerabilities justify the need to sustain the current stance of Monetary Policy

Highlights

The CBK Monetary Policy Committee (MPC) is expected to take a policy stance for the near term during its meeting scheduled for 5th December 2023. The decision is expected to be shaped by five key macroeconomic developments and considerations:

- First, despite inflation remaining within the target band of 5$\pm$ 2.5 % , it edged up in October to 6.9% from 6.8% in September and 6.7% in August 2023, reflecting imminent upside risks;
- Second, while global economic prospects are expected to remain dampened in 2023, better prospects are projected for 2024. On the domestic front, economic growth momentum is also easing on rising input costs and a slowdown in consumption spending;
- Third, the tight monetary policy stance adopted since mid-2022 continues to be transmitted through the market, with market interest rates steadily rising ;
- Fourth, private sector credit growth – despite remaining strong at double digits - has decelerated in response mainly to the rising interest rates and escalation in market credit risk that continues to call for a further tightening of credit standards by banks;
- Fifth, Kenya's external sector remains highly vulnerable to global shocks and policy measures taken by advanced markets aimed at curbing inflation.

> *"With upside risks on inflation, a slowing down economy and continuing transmission of previous monetary policy actions, sustaining the current stance of monetary policy is justified, particularly on market stability considerations."*

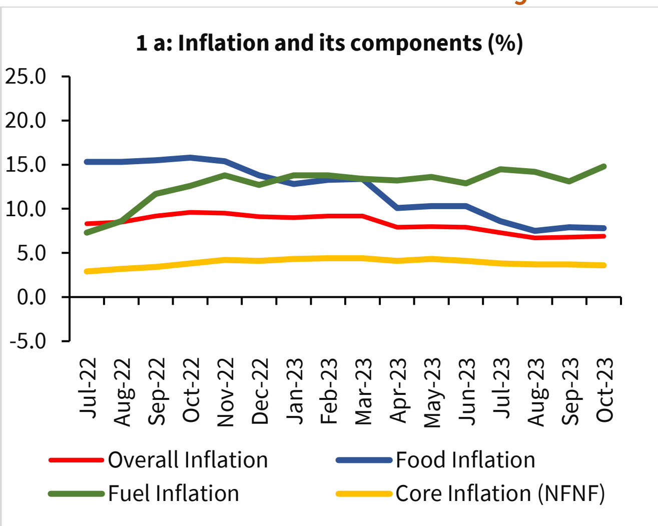
In view of these macroeconomic developments, and a balance of risks associated with alternative policy actions, we view that sustaining the current monetary policy stance is justified. A further rate hike to tame potential inflationary pressures – if implemented fully by banks - would further escalate credit risk in the market and a build-up in non-performing loans with detrimental effects on the industry's stability.

Background

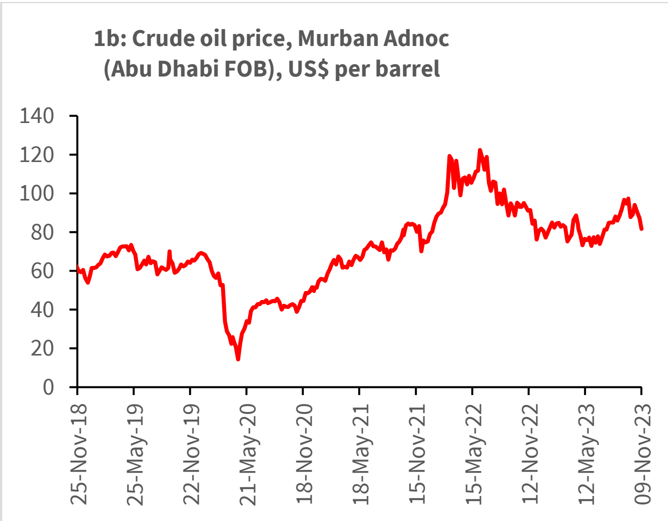
The forthcoming Monetary Policy Committee (MPC) meeting, set for **5 December 2023,** is poised to face a challenging balancing act, among competing policy objectives ranging from taming potential inflationary pressures to protecting economic activity and further to sustaining banking sector stability amidst rising credit risk. Five considerations are likely to shape the policy decision to be taken.

First, despite inflation remaining within the target band of $5 \pm 2.5\,\%$, it edged up in October to 6.9% from 6.8% in September and 6.7% in August 2023, reflecting imminent upside risks. As the headline inflation rose, core inflation that reflects demand pressures in the economy, eased marginally to 3.6% in October from 3.7% in September. Similarly, food inflation declined to 7.8% in October from 7.9% in September. However, concerns were on fuel inflation that continued to rise over the period, to 14.1% in October up from 13.1% in September (Figure 1a). The rise in fuel inflation was recorded amidst a decline in Murban Crude oil prices (Figure 1b). The risks to inflation outlook going forward will largely be the evolution of global commodity prices – especially oil, the pace of exchange rate depreciation, local fuel pump prices as well as looming post-harvest losses on food as a result of the ongoing El-Nino rains across most parts of the country.

Figure 1: Inflation Drivers



Source: CBK

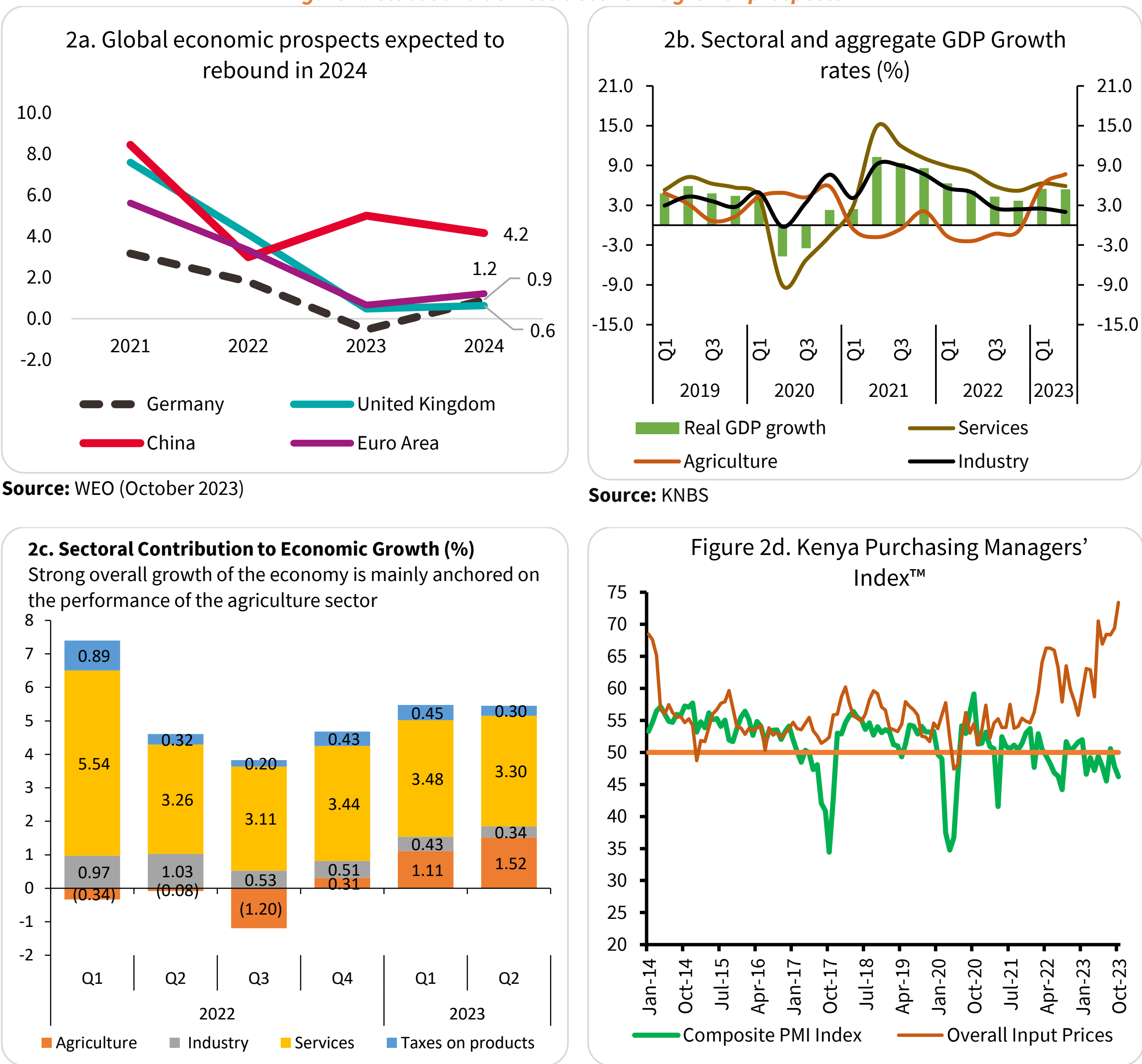


Source: Oilprice.com

Second, while global economic prospects are expected to remain dampened in 2023, better prospects are projected for 2024 (Figure 2a). On the domestic front, economic growth momentum is easing particularly in the second half of 2023 from a strong growth of 5.4% in the second quarter compared to 5.2% growth recorded over a similar period in 2022 (Figure 2b). This strong growth in the second quarter was supported by the continued rebound of the agriculture sector, which grew by 7.7% driven by favourable weather patterns coupled with depressed activity over a similar period in 2022 when the sector contracted by 2.4%. Agriculture contributed 1.52 percentage points to the growth of the economy in the second quarter. The services sector maintained its strong growth, mainly supported by financial and insurance, real estate, wholesale and trade, information and communication, and accommodation and food services sectors. The overall contribution of services sector to the overall economic performance stood at 3.30 percentage points in the second quarter (Figure 2c).

Analyses of higher frequency leading economic growth indicators– based on the Purchasing Managers' Index™ (PMI™) for October - point to a deterioration in the economic activity in the second half of the year, with the composite index falling in October to 46.2 from 47.8 in September (Figure 2d). The index also shows a softening business optimism and a renewed contraction in output which points to the possibility for a further easing of growth momentum. Amidst these developments, demand has continued to soften on account of cost pressures being passed over to the consumers because of the rising overall input prices.

Figure 2: Global and domestic economic growth prospects



Source: WEO (October 2023)

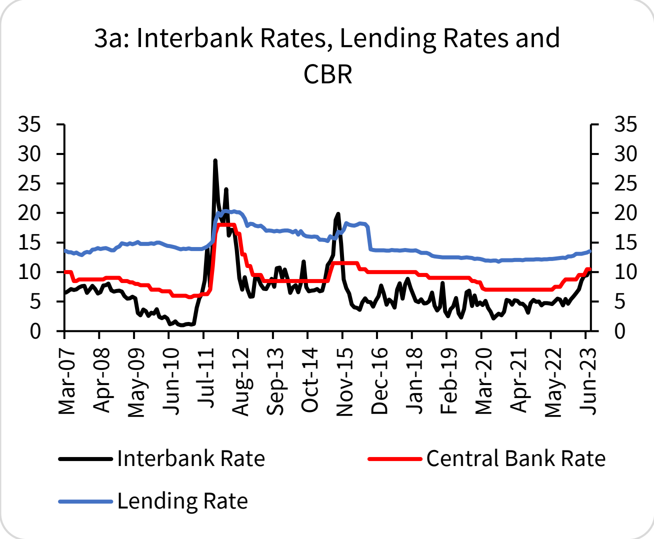
Source: KNBS

Source: KNBS

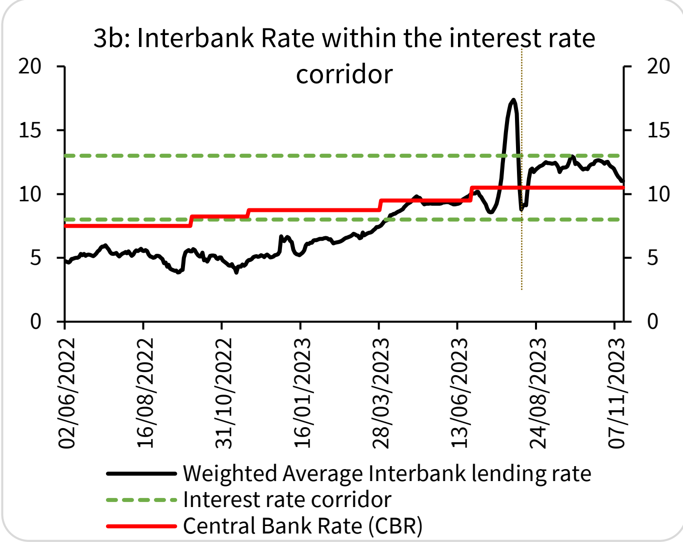
Source: IHS Markit®

Third, the tight monetary policy stance adopted since mid-2022 continues to be transmitted through the market, with market interest rates steadily rising. Between March and October 2023, the Central Bank of Kenya responded to escalating inflationary pressures by raising the Central Bank Rate by 150 basis points. Consequently, this triggered a surge in interbank market rates and the commercial banks' lending rates within the banking sector (Figure 3a). Tighter liquidity conditions were evident in the market as depicted by the interbank interest rate consistently remaining around the upper limit of its corridor (Figure 3b). This outcome calls for CBK liquidity injections to ease pressure on the interbank interest rates and drive the interbank rate to oscillate around the CBR; the signal for the appropriate stance of monetary policy.

Figure 3: Trends in the Money Market Rates and the Interbank Interest Rate Corridor



Source: Central Bank of Kenya

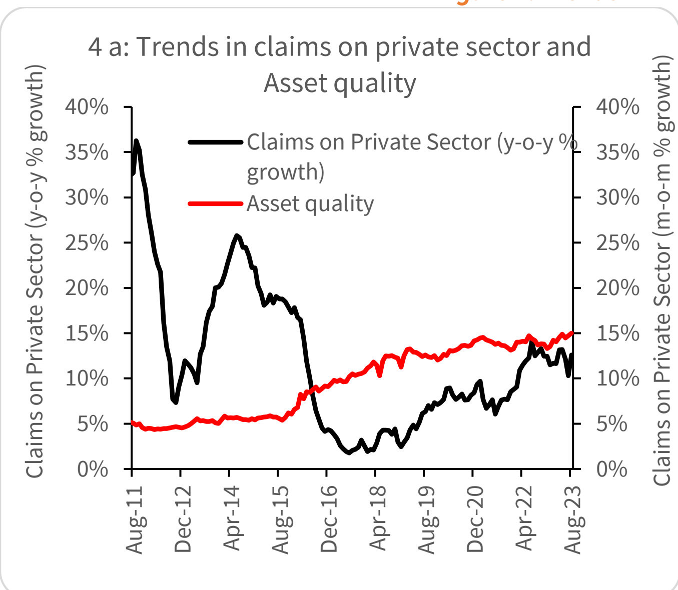


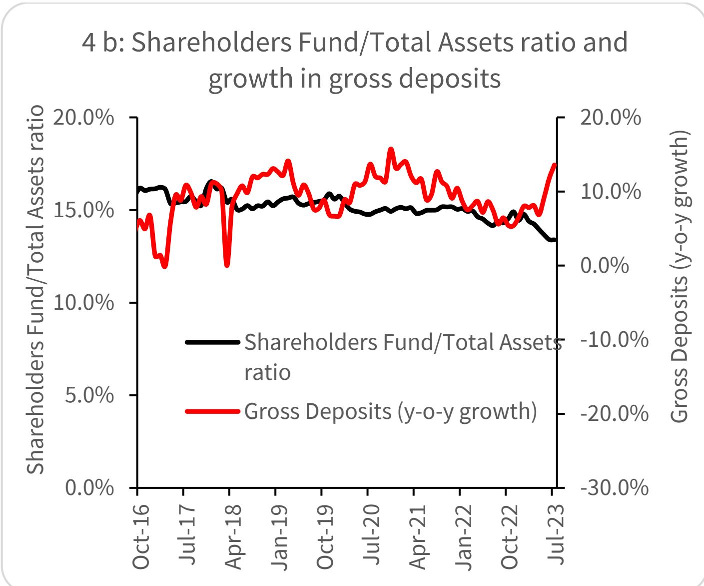
Source: Central Bank of Kenya

Fourth, private sector credit growth – despite remaining strong at double digits - has decelerated in response mainly to the rising interest rates and escalation in market credit risk that continues to call for a further tightening of credit standards by banks. Private sector credit growth rose to 12.6% in August from 10.3% in July 2023, mainly driven by stronger credit absorption by manufacturing, transport and communication sectors which respectively edged up by 19.6% and 24.9% (Figure 4a). Despite the strong growth in credit, the banking industry's asset quality continues to deteriorate as credit risk is elevated.

In particular, the ratio of non-performing loans (NPL) to gross loans stood at 15.0% in August 2023 compared to 14.7% in July 2023 relative to 13.3% in December 2022. Going forward, banks are likely to adopt tighter credit standards to tame rising NPLs. Nonetheless, the banking industry remains stable and sound, with adequate liquidity and capital adequacy ratios, and posting strong shareholders' equity-to-total assets ratio. In addition, the industry continues to mobilize more deposits to boost its liquidity profile with the year-on-year deposit growth rising to 11.8% in June 2023 and 13.6% in July 2023, from a single digit growth before May 2023 (Figure 4b).

Figure 4: Trends in Private Sector Credit

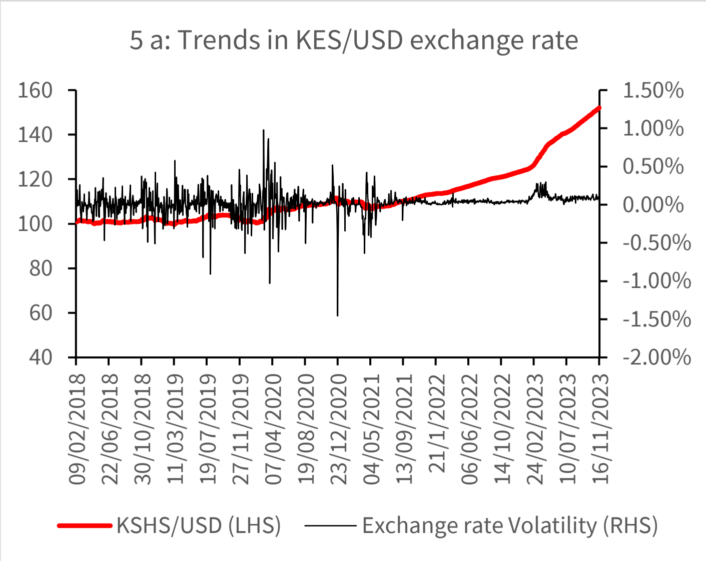




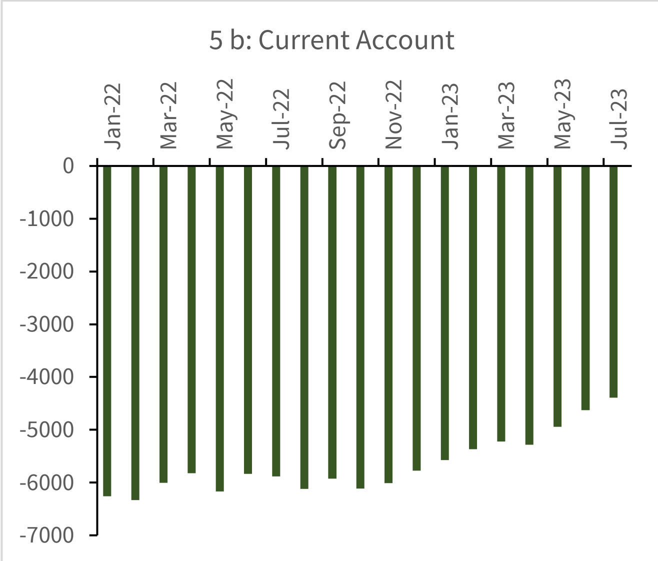
Source: CBK

Fifth, Kenya's external sector remains highly vulnerable to global shocks and policy measures taken by advanced markets aimed at curbing inflation. This vulnerability has notably manifested in local exchange rate movements with the Shilling on a trend depreciation against the US dollar (Figure 5a). The main drivers of the weakening of the currency have been a sustained wide current account deficit, relatively high interest rates particularly adopted by the US Federal reserve bank, waning confidence on the ability of the country to deal with emerging short term foreign exchange market shocks with the dwindling foreign exchange reserves and expectations of a stronger demand for the US dollar in the run-up to Eurobond maturity in June 2024. Nonetheless, the current account deficit slightly improved to US$4.3 million in July 2023 compared to a deficit of US$5.9 million in July 2022, driven by on a slowdown in imports (Figure 5b). Moderating the current account deficit has been steady immigrant remittances that grew by 6.9% in October 2023 to stand at USD 355.6 million (Figure 5c). The official foreign exchange reserves of the country stood at USD 6.78 billion as of November 16, 2023, which is equivalent to 3.64 months of import cover (Figure 5d), slightly below the CBK's minimum statutory requirement of 4.0 months.

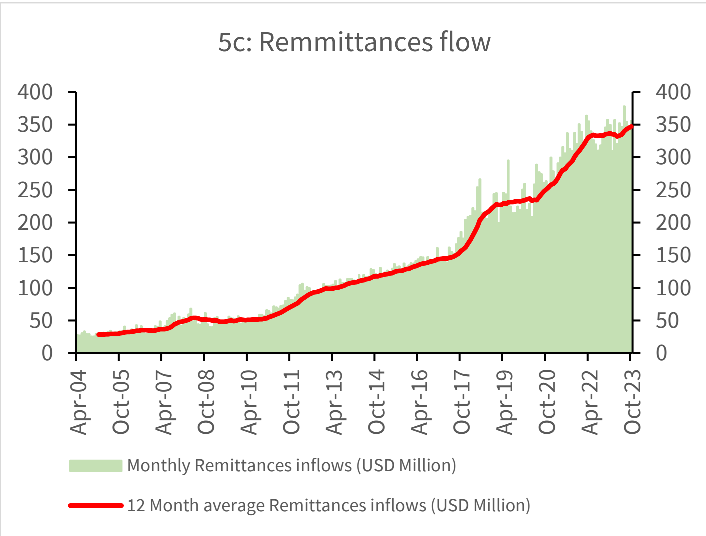
Figure 5: The external Sector dynamics



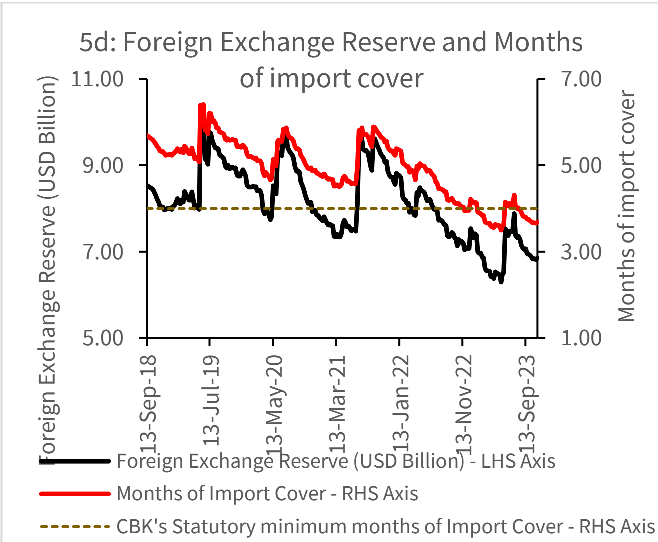
Source: Central Bank of Kenya



Source: Central Bank of Kenya



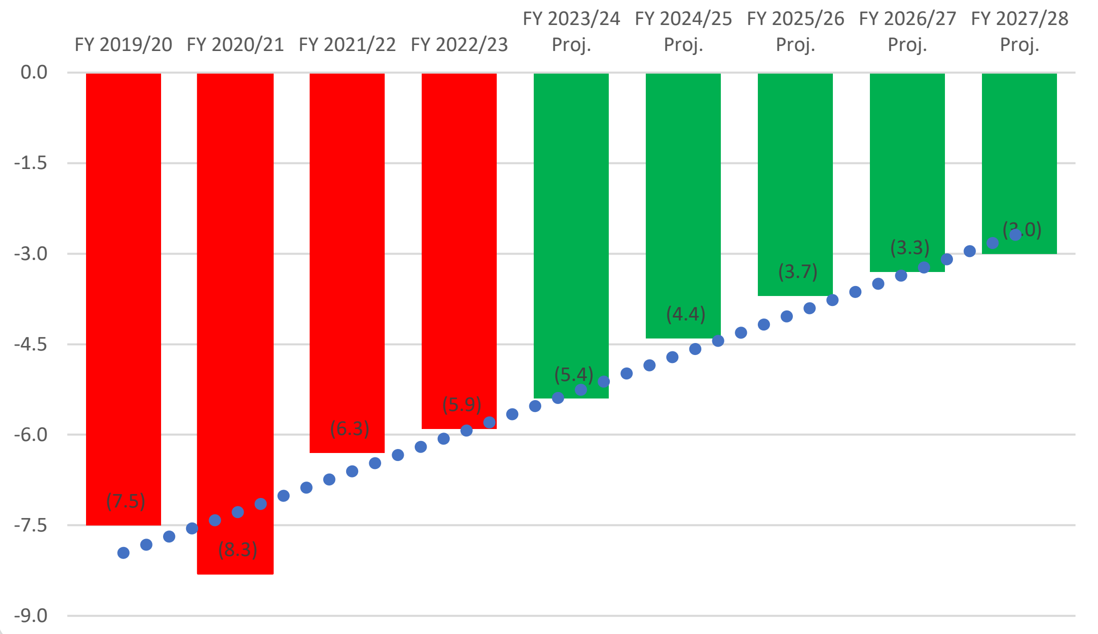
Source: Central Bank of Kenya



Source: Central Bank of Kenya

On the domestic front, the other development of relevance to monetary policy has been the evolution of the public budget deficit, that has an implication on public debt sustainability and the local market evolution of interest rates. The Government's focus to tame the growth in public debt and anchor sustainability in its borrowing program, through its fiscal consolidation path (Figure 6) leans more on revenue mobilisation. The Government projects its fiscal deficit to decline to 5.4 percent in FY 2023/24, and further downwards to 4.4 percent in FY 2024/25. This is, however, contingent on the performance of the economy – and by extension revenues – amidst possible escalation of spending pressures associated with protection and mitigation measures of the effects of the ongoing El-Nino rains. This may trigger possible fiscal spillages.

Figure 6. Fiscal deficit (% of GDP)



Source: Central Bank of Kenya

Conclusion

In view of these macroeconomic developments, and a balance of risks associated with alternative policy actions, we view that sustaining the current monetary policy stance, in keeping the CBR unchanged at 10.5%, is justified. A further rate hike to tame potential inflationary pressures – if implemented fully by banks - would further escalate credit risk in the market and a build-up in non-performing loans with detrimental effects on the industry's stability.

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