CENTRE FOR RESEARCH ON
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Research Note

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Calling for a Hold on the Monetary Policy Stance amidst Downside Risks on the Economic Outlook

Highlights

The Central Bank of Kenya's Monetary Policy Committee (MPC) meeting is expected to take place on **6th February 2024,** amidst easing inflationary pressure, persistent weakening of the Kenya shilling against the US dollar and softening economic performance. This Research Note provides a brief review of five key macroeconomic developments and considerations that are expected to underpin the decision of the MPC:

- First, a continued easing of inflationary pressure, with the overall inflation declining from 7.9% in June 2023 to 6.6% in December 2023;
- Second, despite the latest data published for the third quarter of 2023 showing a strong economic performance, the outlook depicts a softening of economic performance;
- Third, market interest rates continue to rise, consistently reflecting the policy signal communicated in the December 2023 MPC meeting when the Central Bank Rate (CBR) was raised by 200 basis points;
- Fourth, as credit continues to post strong growth, concerns remain on banking sector asset quality deterioration, with the industry's Non-Performing Loan (NPL) ratio to gross loans rising to 15.3% in October 2023 up from 14.7% in July 2023;
- Fifth, the external sector vulnerabilities continue to linger, fundamentally exerting pressure on the exchange rate to weaken. However, pressure on the exchange rate is expected to ease going forward particularly with improved liquidity in the interbank foreign exchange interbank market, narrowing current account deficit and prospects for enhanced market confidence with the Government commitment to settle maturing Eurobond in June 2024.

"Easing inflationary pressure call for a hold on the CBR to allow its recent adjustments to be fully transmitted through the market and protect the fragile economic activity".

In view of the above developments and a balance of risks on inflation and the direction of the exchange rate; we argue for a maintenance of the current stance of monetary policy – in keeping the CBR unchanged; allowing the 200 basis points upward adjustment effected in December 2023 to be fully transmitted in the market and protect the fragile economic activity.

Background

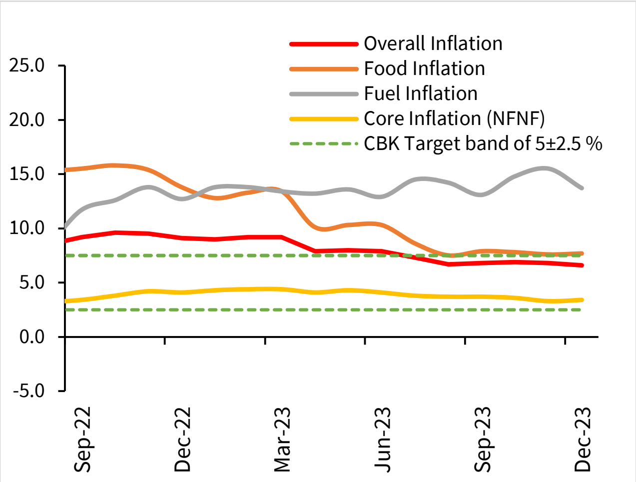
This Research Note outlines five key developments that are expected to underpin the decision of the MPC in its meeting on 6th February 2024:

First, a continued easing of inflationary pressure, with the overall inflation declining from 7.9% in June 2023 to 6.6% in December 2023. The decline in overall inflation (**Figure 1a**) has been driven primarily by easing food inflation that dropped from 10.3% in June 2023 to 7.7% in December 2023, reflecting the positive impact of increased rains in the second half of the year on supply of key food items. As a decline in food prices moderated the effect of elevated – though on a declining trend- fuel inflation, core inflation remained low and stable; reflecting muted demand pressures in the economy. Going forward, however, there is expected easing of fuel inflation with the recent two successive reductions in domestic pump prices in November and December 2023. These fuel price reductions were directly reflected in lower fuel inflation, at 13.7% in December down from 15.5% in November 2023.

Concerns, however, remain on the elevated global commodity prices (**Figure 1b**) mainly driven by weaker-than-expected oil supply from the OPEC+ oil producers that risk driving global prices upwards in the near term. Other risks to inflation include the current geopolitical conflicts that continue to disrupt supply channels with potential of being transmitted to local prices. The evolution of global commodity prices and inflation will, however, depend largely on the impact of policy actions taken by advanced global markets.

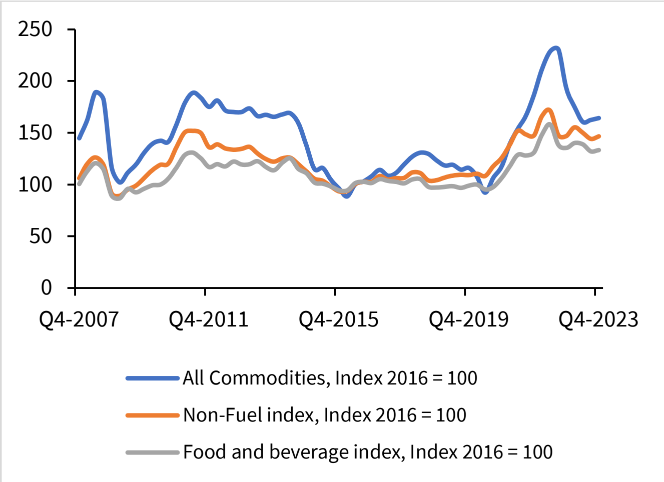
Figure 1: Inflation drivers

1a: Inflation and its components



Source: Central Bank of Kenya

1b: Commodity prices

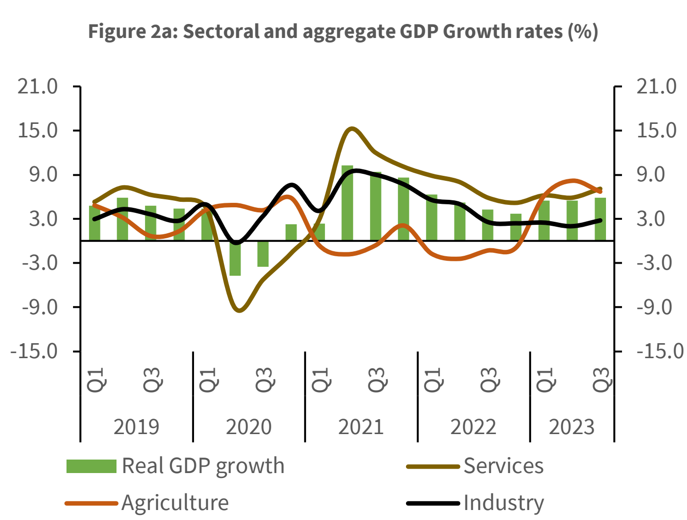


Source: IMF Commodities prices database

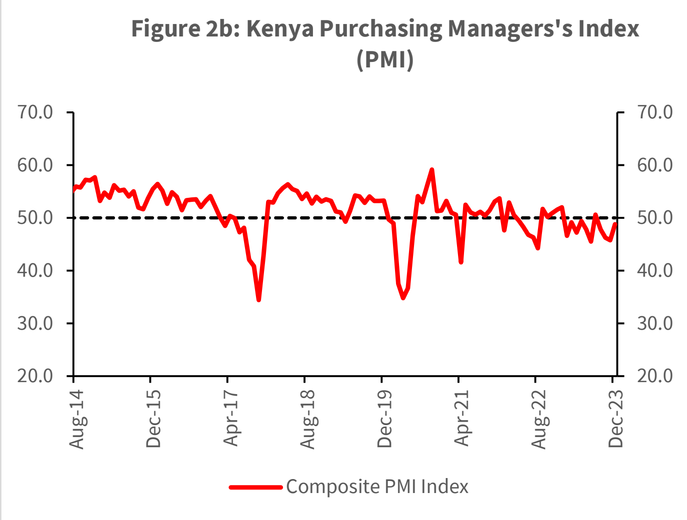
Second, despite the latest data published for the third quarter of 2023 showing a strong economic performance, the outlook depicts a softening of economic performance. The domestic economy remains vulnerable to the challenges facing the global economy – spanning high inflation, tighter financial conditions, weak trade growth and lower business confidence – particularly evident in the advanced economies of US and Europe (**Figure 2a**). Despite the domestic economy depicting strong growth in the third quarter; growing by 5.9 percent quarter on quarter – driven by a strong rebound in agriculture (that grew by 6.7 percent) and services sector that expanded by 7.1% over the same period – (**Figure 2b**), more recent leading economic indicators show a softening economic performance.

There are weak sentiments in the manufacturing sector, with the Purchasing Manager's Index remaining below the 50 mark over the last four months of 2023 (**Figure 2c**); generally reflecting softening economic activity. This trend is mainly attributed to elevated production costs and depressed consumer demand (as new orders remained low). Other concerns on the performance of the economy remain centred on the rising domestic debt to GDP ratio (**Figure 2d**) and the implementation of fiscal consolidation by the Government; a weaker exchange rate constraining imports including of capital goods and low business sentiment anchored on high cost of doing business.

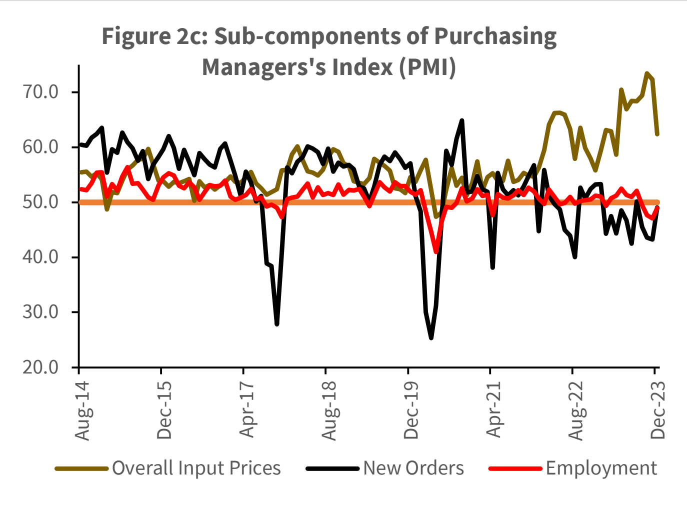
Figure 2: Global and domestic growth prospects



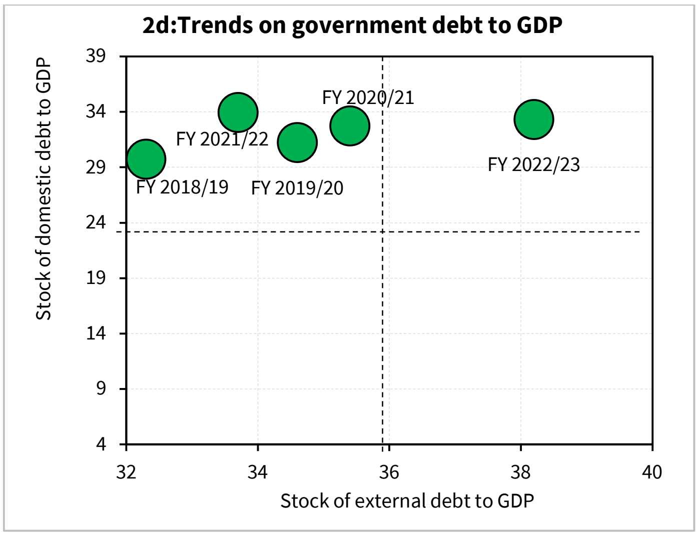
Source: Kenya National Bureau of Statistics



Source: IHS Markit®



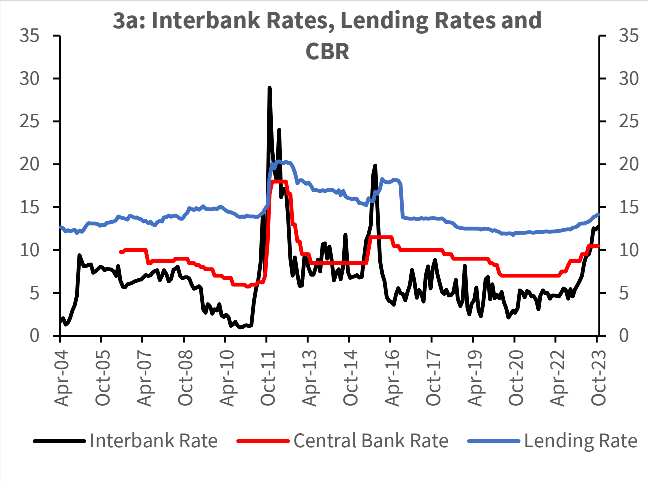
Source: IHS Markit®



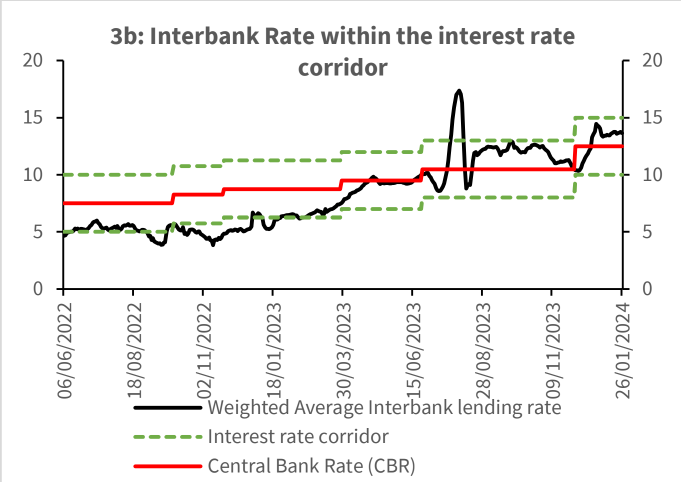
Source: The National Treasury

Third, market interest rates continue to rise, consistently reflecting the policy signal communicated in the December 2023 MPC meeting, when the Central Bank Rate (CBR) was raised by 200 basis points. The effects of the monetary policy tightening announced on 5th December 2023, continue to be transmitted through the market; manifested in notable increases in both interbank and lending interest rates (**Figure 3a** & **Figure 3b**). In particular, the average interbank rate rose from 10.5% on 4th December 2023, to 13.7% on 26th January 2024. The interbank rate remained within the upper range of the interest rate corridor; indicating tight liquidity conditions that is consistent with the stance of monetary policy adopted in December 2023.

Figure 3: Trends in the Money Market Rates



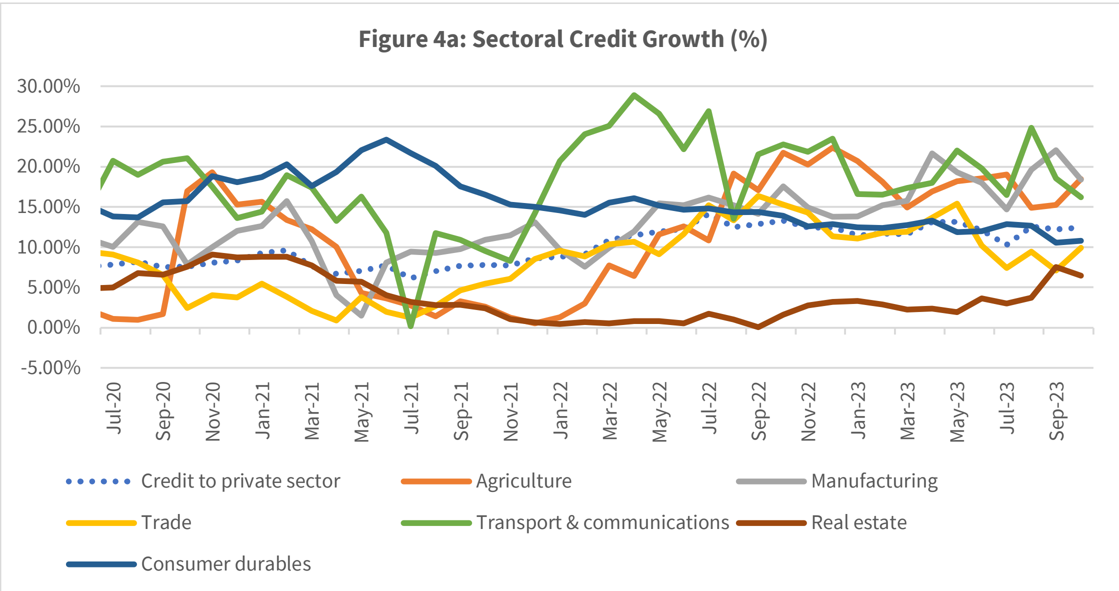
Source: Central Bank of Kenya



Source: Central Bank of Kenya

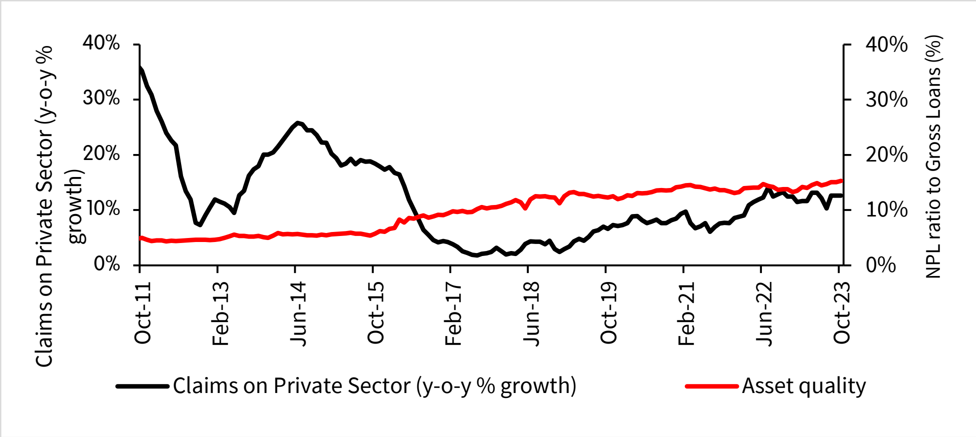
Fourth, as private sector credit continues to post strong growth, concerns remain on banking sector asset quality deterioration with the industry's Non-Performing Loan (NPL) ratio to gross loans rising to 15.30% in October 2023 from 14.7% in July 2023. In July 2023, private sector credit growth eased to 10.3% before rebounding to 12.6% in August 2023; a pace that was sustained through September and October 2023. This upswing was driven by rapid credit expansion to the manufacturing and agricultural sectors, which respectively grew by 18.5% and 18.4% as well as to transport and communication (16.2%) and consumer durables (10.8%) (**Figure 4a**). Concerns in the credit market mainly include the deteriorating quality of loans, with the ratio of Non-Performing Loans (NPL) to gross loans rising to 15.30% in October from 14.7% in July 2023 **(Figure 4b)** and its impact on credit growth as well provisions for expected credit losses going forward.

Figure 4a: Trends in sectoral credit growth, Percent (%)



Source: Central Bank of Kenya

Figure 4b: Private Sector Credit Growth and Asset Quality Trends

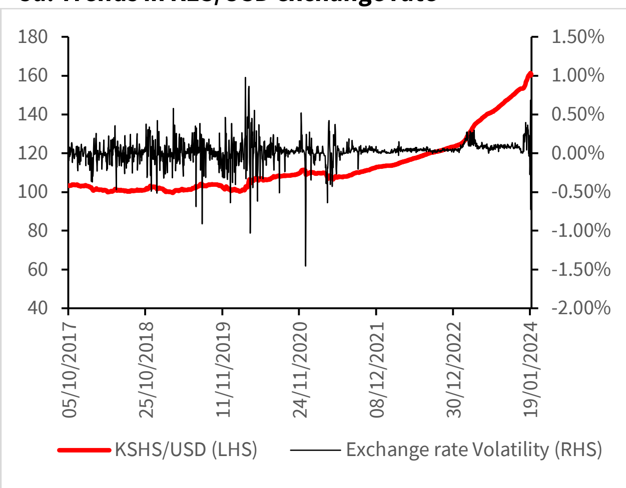


Source: Central Bank of Kenya

Fifth, the external sector vulnerabilities continue to linger, fundamentally exerting pressure on the exchange rate to weaken. However, pressure on the exchange rate is expected to ease going forward particularly with improved liquidity in the interbank foreign exchange market. The Kenya Shilling depreciated by an estimated 18.7% against the US dollar in 2023 (**Figure 5a**), with direct knock-on effects on inflation (**Figure 5b**). Global policy stance appears to have peaked with the US Federal Reserve Bank maintaining the policy rate for the third consecutive month in December, with the anticipation of multiple cuts in 2024. These developments offer some relief going forward in moderating further depreciation of the local currency and by extension its effects on inflation. Moreover, the foreign exchange market is expected to be cushioned by strong growth in diaspora remittance inflows, at 4.3% in December 2023 (reaching USD 372.6 million compared to USD 357.29 million in December 2022) (**Figure 5c**), narrowing current account deficit (estimated at 3.9% of GDP in 2023 down from 5.0% in 2022 (**Figure 5e**) and prospects for enhanced market confidence in the market with the Government commitment to settle maturing Eurobond in June 2024. The stock of foreign exchange reserves continues to dwindle, at USD 7.02 billion as of 25th January 2023 which is equivalent to 3.75 months of import cover (**Figure 5d**), raising concerns on the adequacy of the reserves to cushion the economy against any short-term shocks in the foreign exchange market.

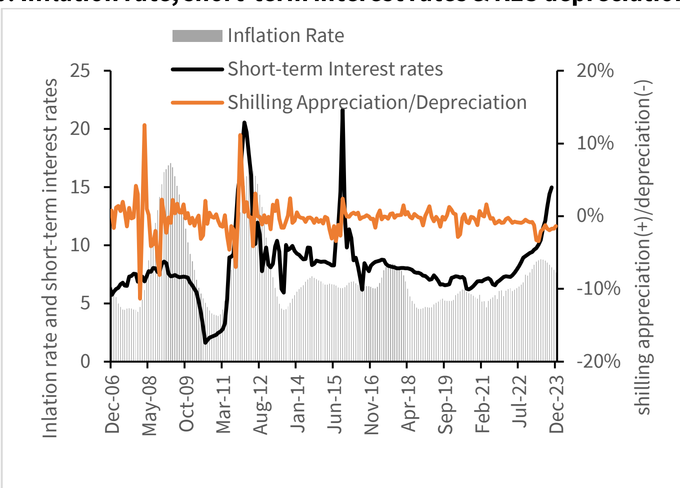
Figure 5: The external sector dynamics

5a: Trends in KES/USD exchange rate



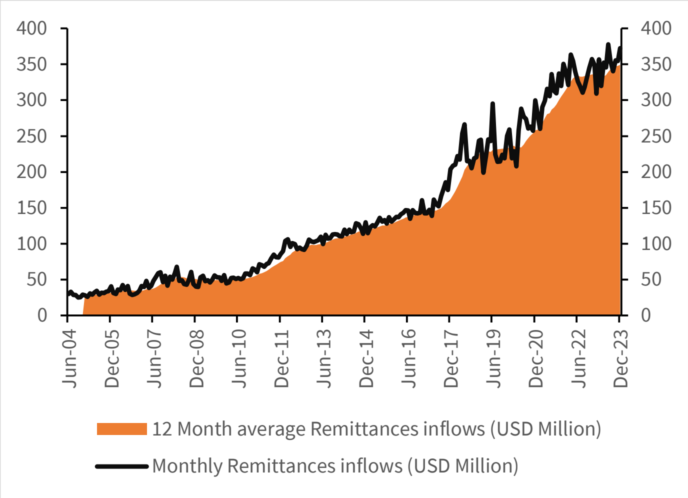
Source: Central Bank of Kenya

5b: Inflation rate, short-term interest rates & KES depreciation



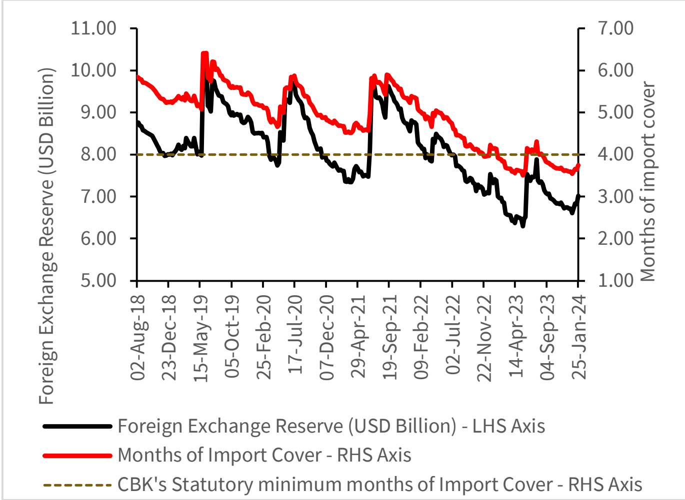
Source: Central Bank of Kenya

5c: Remittances flows



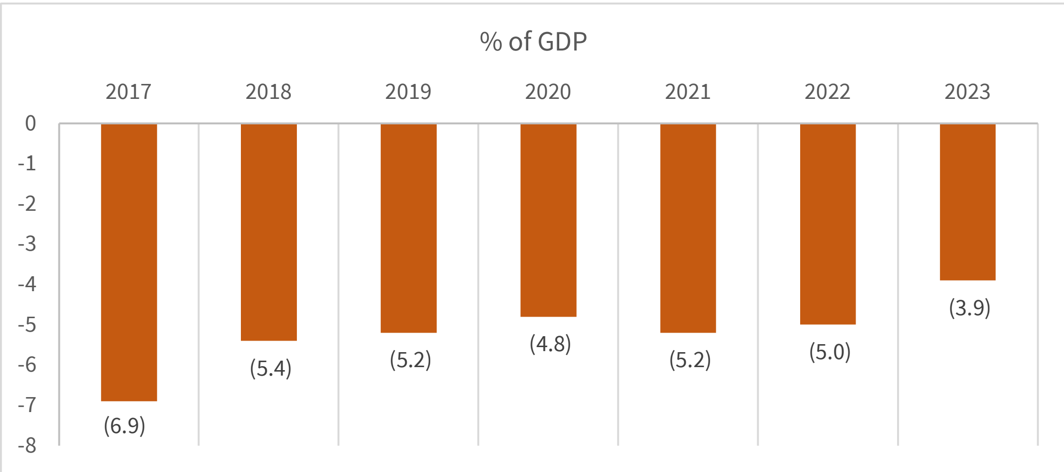
Source: Central Bank of Kenya

5d: Foreign Exchange Reserves



Source: Central Bank of Kenya

5e: Trends in Current Account Deficit



Source: Central Bank of Kenya

Conclusion

The Central Bank of Kenya's MPC meeting of **6th February 2024** is expected to announce the monetary policy stance to be adopted in the near to medium term. Five developments are likely to underpin the decision of the MPC; ranging from easing inflationary pressure, softening economic activity, rising market interest rates, sustained credit growth amidst deteriorated quality of assets in the banking sector and protracted vulnerabilities in the external sector. In view of the above developments and a balance of risks on inflation and the direction of the exchange rate; we argue for a maintenance of the current stance of monetary policy – in keeping the CBR unchanged; allowing the 200 basis points upward adjustment effected in December 2023 to be fully transmitted in the market and protect the fragile economic activity.