CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY®

Research Note

July 31, 2024

RESEARCH NOTE NO.73 – 2023 (RN/73/24)

Macroeconomic Indicators Support a Hold on Monetary Policy Stance

Highlights

The Monetary Policy Committee (MPC) of the Central Bank of Kenya at its meeting scheduled for **6th August 2024** is expected to maintain its monetary policy stance; anchored on five key macroeconomic developments:

- First, headline inflation remains within the target range, and inflationary expectations are well anchored;
- Second, economic growth remains resilient despite slowing global growth and weak private sector sentiments;
- Third, private sector credit continues to decelerate, reflecting tighter credit supply conditions mainly driven by deteriorating credit risk;
- Fourth, both short- and long-term market interest rates remain elevated in tandem with sustained tight monetary policy conditions;
- Fifth, the Kenya Shilling remains stable, supported by increased foreign exchange inflows from key exports and steady inward remittances. Emerging Government financing risks continue to pose risks to the stability of the exchange rate; further delaying the easing of interest rates;

Considering these developments, and the balance of risks, we argue that maintaining the current monetary policy stance – in keeping the CBR unchanged at 13.0 percent - would be appropriate.

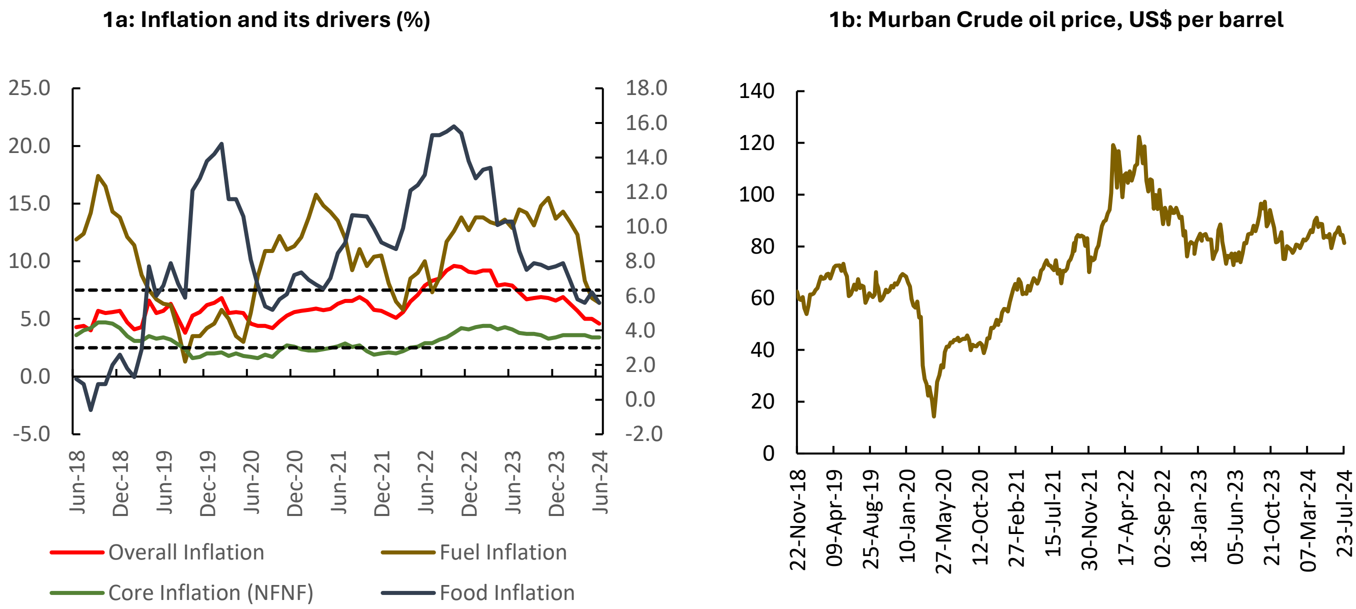
Amidst stable inflation, resilience in economic growth performance, the fragility of the exchange rate in the wake of emerging Government financing risks call for sustenance of the current tight monetary policy stance.

Background

The MPC at its meeting scheduled for **6th August 2024** is expected to navigate a delicate balance of domestic and global macroeconomic developments to arrive at a policy decision that would seek to anchor inflation expectations within the government's target range, safeguard economic performance and sustain the current stability in the exchange rate. To this end, five key developments are expected to underpin the decision of the Committee:

First, headline inflation remains within the target range, and inflationary expectations are well anchored. Headline inflation in June declined to 4.6% - the lowest level since October 2020 when it stood at 4.8% - driven by lower food prices on favourable weather conditions, a drop in domestic fuel pump prices and a relatively stronger Shilling. Food inflation declined to 5.6 % in June from 7.9% in January 2024 **(Figure 1a)**, while fuel inflation moderated to 6.4 %, as core (non-food non-fuel) inflation remained muted at 3.4% over the period. Additionally, international oil prices stood steady, notably depicting a declining trend bias (**Figure 1b**)[1].

Figure 1: Inflation trends and drivers



Source: *Central Bank of Kenya & Oilprice.com*

At the global scene, the IMF's World Economic Outlook (WEO)[2] shows a global disinflation momentum slowing down **(Figure 1c)**, particularly driven by goods prices. However, going forward, the inflation path in the short to medium term remains tilted to the upside **(Figure 1d),** mainly **on** the risks attributed to pass-through effects of global shocks, particularly the geopolitical tensions/conflicts and their effects on global oil prices.

Second, economic growth remains resilient despite slowing global growth and weaker private sector sentiments. Global growth is projected at 3.2% in 2024 and 3.3% in 2025, with notable slowdowns in the US and Japan, and recovery in Europe and China **(Figure 3a)**. These economic growth trajectories could have material impact on the domestic economic growth, both directly and indirectly through trade and financial linkages, with potential amplifications via exchange rate movements and asset repricing. Domestically, the first quarter of 2024 grew by 5.0 % largely on strong performance of agriculture and service sectors. The agriculture sector grew by 6.1% over the period, mainly driven by favourable weather conditions and supportive government interventions in fertilizer

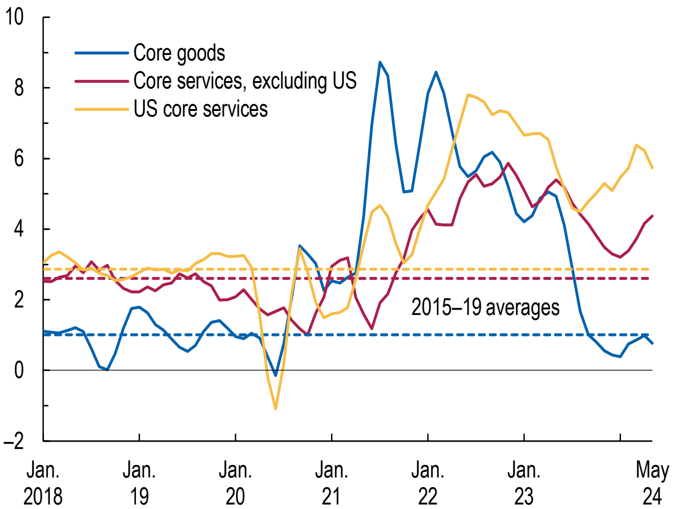
[1] The Murban oil prices has consistently oscillated between US$ 77.49 and US$ 91.09, with the peak having recorded in April 2024, after which it settled on lower figures.

[2] World Economic Outlook (WEO) accessed on the link: https://www.imf.org/en/Publications/WEO/Issues/2024/07/16/world-economic-outlook-update-july-2024)

subsidies, as the services sector grew by 6.2%. Industrial sector performance, however, remained subdued, with growth of the sector decelerating further to 0.1% - compared to 1.5% in the first quarter of 2023 **(Figure 3b) -** on higher input costs and slower demand.

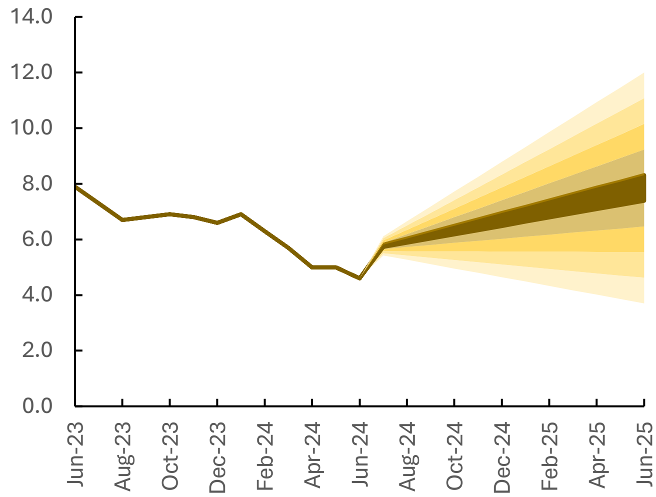
Figure 2: Inflation outlook

2a: Global outlook of core Inflation (%)



Source: IMF World Economic Outlook (July 2024)

2b: Forecast of Kenya's overall inflation path



Source: KBA staff Computation

Even so, private sector sentiments depict fragile optimism about the economy's outlook in the near-term. For instance, the Purchasing Managers' Index™ (PMI™) declined to 47.2 in June 2024 **(Figure 3c)**; an indication of deteriorating business conditions. At the sub-components level, the PMI decline points to rising input costs and a drop in output levels in the manufacturing sector. Moreover, there was also a decline in new orders; a pointer to a drop in consumer purchasing power. However, optimism was anchored on activity at the Nairobi Securities Exchange (NSE) that depicted some mild recovery, with the NASI and NSE 20 Share indices rising marginally on a month-on-month basis **(Figure 3d)**.

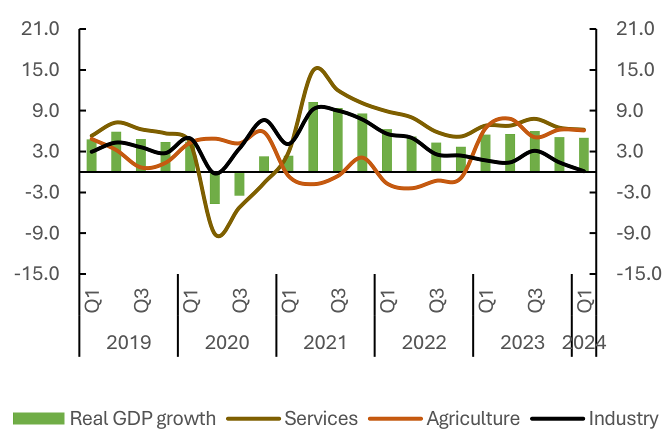
Figure 3: Trends in Economic growth and Market sentiments

3a: World economic outlook projections

	Year over Year			
			Projections	
	2022	2023	2024	2025
World Output	**3.5**	**3.3**	**3.2**	**3.3**
United States	1.9	2.5	2.6	1.9
Euro Area	3.4	0.5	0.9	1.5
Japan	1.0	1.9	0.7	1.0
United Kingdom	4.3	0.1	0.7	1.5
Canada	3.8	1.2	1.3	2.4
China	3.0	5.2	5.0	4.5
India	7.0	8.2	7.0	6.5
Russia	−1.2	3.6	3.2	1.5
Brazil	3.0	2.9	2.1	2.4
Nigeria	3.3	2.9	3.1	3.0
South Africa	1.9	0.7	0.9	1.2

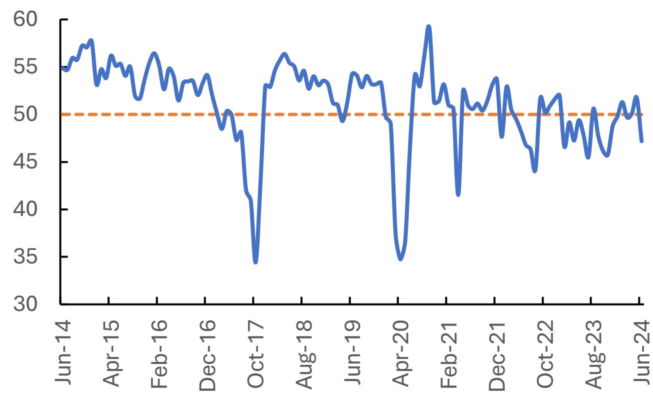
Source: IMF World Economic Outlook (July 2024)

3b: Quarter-on-quarter Sectoral and aggregate GDP Growth rates (%)



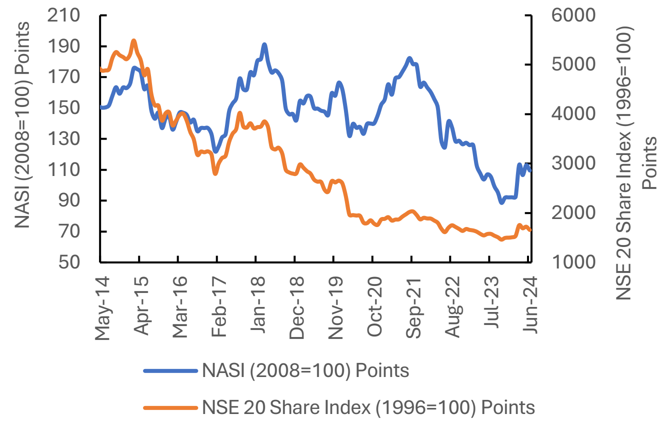
Source: KNBS

3c: Sentiments from the manufacturing sector- Purchase Managers Index



Source: IHS Markit®

3d: Investors sentiments

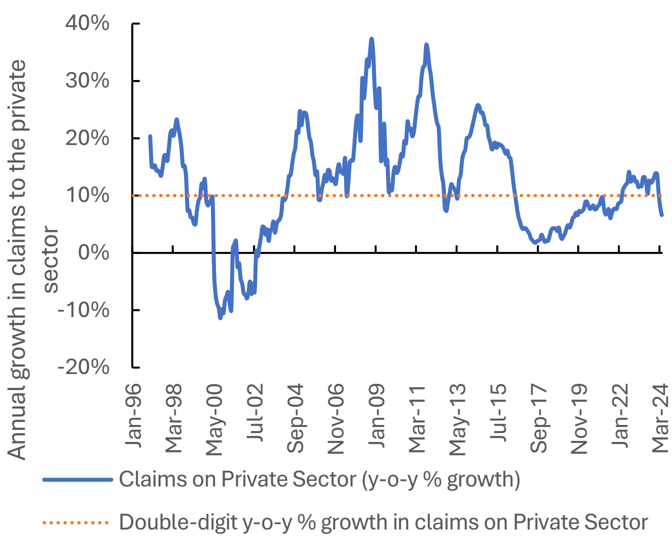


Source: NSE

Third, private sector credit continues to decelerate, reflecting tighter credit supply conditions mainly driven by deteriorating credit risk. Private sector credit growth eased to 6.6% in April 2024, down from 7.9% in March 2024 **(Figure 4a);** mirroring a deterioration in the industry asset quality with the non-performing loan (NPL) ratio rising to 16.1% in April from 15.5% in February 2024 **(Figure 4b).** Most notable deteriorations in the portfolios were in agriculture, real estate, tourism, restaurant and hotels, trade and building and construction sectors. Going forward, any further slowdowns in economic growth and elevation of inflationary pressures in the near-term are likely to exacerbate credit risks, thereby constraining private-sector credit growth.

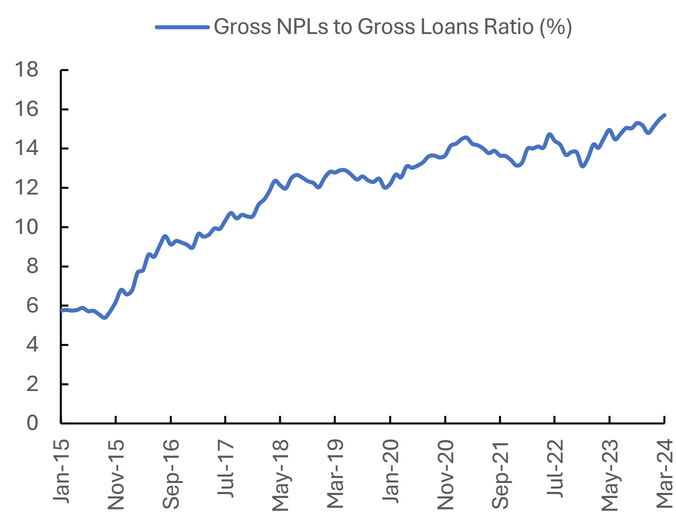
Figure 4: Credit market dynamics

4a: Year-on-year growth in private sector credit



Source: CBK

4b: Movement in industry Asset quality

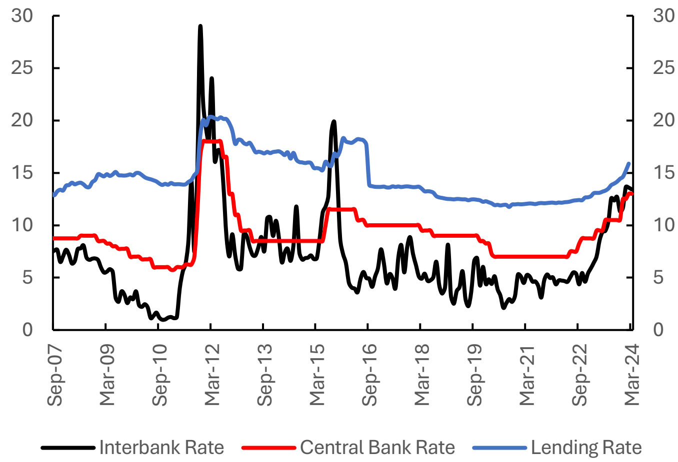


Source: CBK

Fourth, both short- and long-term market interest rates remain elevated in tandem with sustained tight monetary policy conditions. As of 26 July 2024, the interbank rate stood at 13.2%, a pattern mirrored by the lending rates as a reflection of the signal provided by the Central Bank Rate **(Figure 5a)**. Going forward, with major advanced economies becoming more cautious about the start and pace of policy easing, the effect of elevated global interest rates **(Figure 5a)** is expected to delay any easing of interest rates in the domestic market. Consequently, interest rates remaining higher-for-longer would continue constraining the demand for loans in the near term.

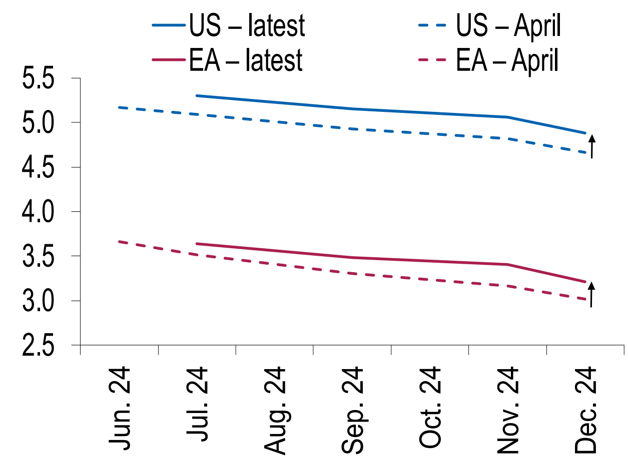
Figure 5: Trends in policy and market rates

5a: Interbank Rates, Lending Rates and CBR (%)



Source: CBK

5b: Global Economy Market-implied policy Rates

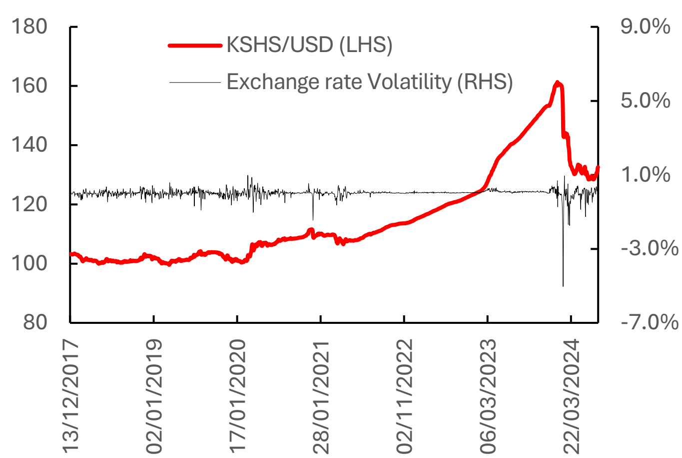


Source: IMF

Fifth, the Kenya Shilling remains stable, supported by increased foreign exchange inflows from key exports and steady inward remittances. Emerging Government financing risks continue to pose risks to the stability of the exchange rate; further delaying the easing of interest rates. The Kenya shilling has strengthened to exchange against the dollar at Ksh 132.57 on 26 July 2024 **(Figure 6a)**, mainly supported by strong export earnings from horticulture, coffee and tea, stronger tourist arrivals that rose to 128,057 in March 2024 compared to 118,738 tourists over a similar period in 2023, and resilient inward remittances flows. The official foreign exchange reserves held by the Central Bank stood at USD 7,311 million as of 26 July 2024, which represents an equivalent of 3.8 months of import cover, and it is slightly below the required minimum of 4.0 months of imports cover to provide adequate buffer against short term shocks in the foreign exchange market.

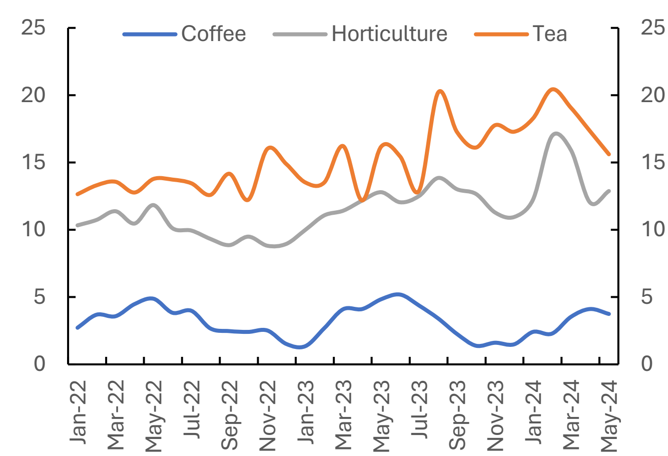
Figure 6: Exchange Rate movement and its drivers

6a: Trends in KES/USD exchange rate



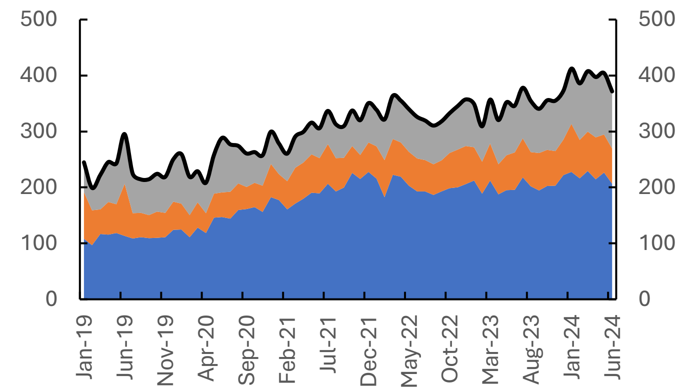
Source: CBK

6b: Trends in Key exchange rate earners in Ksh Billion



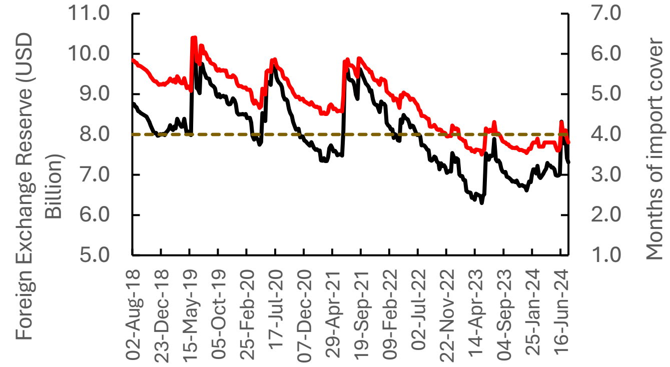
Source: KNBS

6c: Sources of Diaspora Remittance Inflows



Source: CBK

6d: Foreign exchange reserve and months of Import Cover



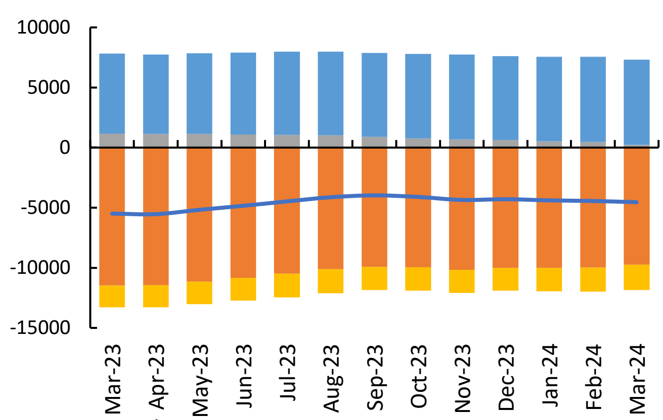
Source: NSE

There were notable improvements on the external sector, with the overall balance of payments position improving to a surplus of USD 195.3 million in March 2024 and depicting a sustained surplus position for the fifth consecutive month. The current account deficit narrowed slightly to USD 5,477.7 million in March 2024, down from USD 5,489 million in March 2023.

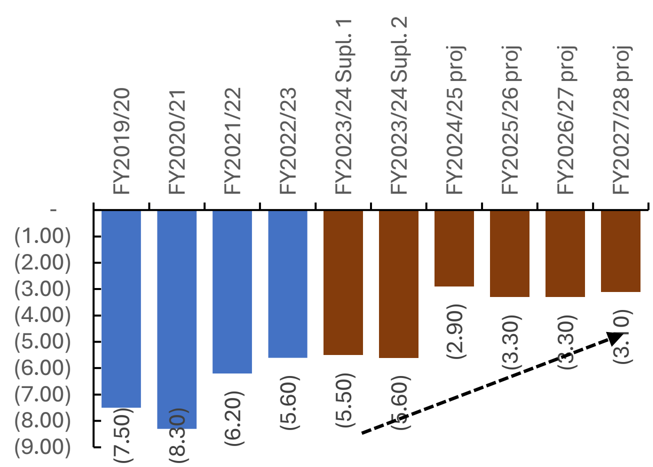
From a Government financing standpoint, fiscal policy management faced a number of negative headwinds from two main fronts. First, the Finance Bill 2024 - which contained drastic fiscal adjustment measures for FY2024/25 to boost government's capacity to implement revenue-based fiscal consolidation - was withdrawn as the public protested its contents. Second, was the downgrade of Government's local and foreign-currency long-term issuer ratings and foreign-currency senior unsecured debt ratings to Caa1 from B3 by Moody's Ratings. The later has the implication of a much slower narrowing fiscal deficit and risk constraining external funding options even more, including diminishing support from multilateral creditors which have been the largest source of external financing since 2020. These headwinds present heavy financing risks for the Government; indirectly exerting pressure on the exchange rate to depreciate and calling for sustained high domestic interest rates.

Figure 5: Trends in market rates

5a: Trends in Current account balance and its drivers



5b: Actual and expected fiscal deficit (% of GDP)



Source: KNBS and The National Treasury

Conclusion

Our assessment of the current macroeconomic conditions shows that: headline inflation remains within the target range, and inflationary expectations are well anchored; and economic growth remains resilient despite slowing global growth and weak private sector sentiments. Private sector credit continues to decelerate, reflecting tighter credit supply conditions mainly driven by deteriorating credit risk as both short- and long-term market interest rates remain elevated in tandem with sustained tight monetary policy conditions. The Kenya Shilling remains stable, supported by increased foreign exchange inflows from key exports and steady inward remittances. However, emerging Government financing risks continue to pose risks to the stability of the exchange rate; further delaying the easing of interest rates.

In view of these developments, and the balance of risks, we argue that maintaining the current monetary policy stance – in keeping the CBR unchanged at 13.0 percent - would be appropriate.

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