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Research Note

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Economic Fundamentals Support a stronger Policy Rate Cut

Highlights

The Monetary Policy Committee (MPC) of the Central Bank of Kenya at its meeting scheduled for **8th October 2024** is expected to ease its monetary policy stance; anchored on five key macroeconomic developments:

- **First**, inflation remains on a declining trend and below the mid-point of the target range, with food and fuel prices continuing to decline;
- **Second**, global economic uncertainty is rising, driven by geoeconomic fragmentation, impacting investments and market volatility;
- **Third**, private sector credit growth remains low on high interest rates and elevated non-performing loans, and threatens to slow economic growth, going forward;
- **Fourth**, central banks in global and advanced markets have kicked off monetary policy easing streaks; signalling their intentions to solidify economic growth in respective markets amidst anchored inflationary pressures; and
- **Fifth**, the Kenya Shilling exchange rate against major global currencies remains stable anchored on fundamentals, despite external risks.

In view of these developments, and a well anchored inflationary pressure, there is scope to effect a decisive policy rate cut to protect and facilitate support a stronger economic growth through a recovery in private sector credit growth.

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Well anchored inflationary pressure and muted risks on the exchange rate movements, call for a rate cut to support economic growth …

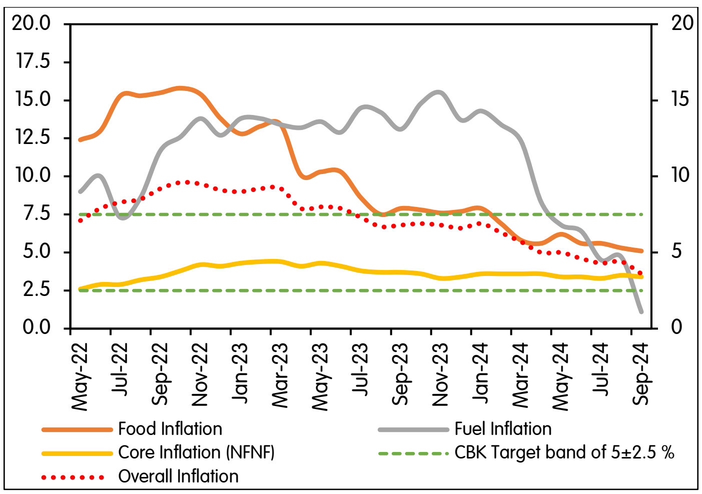
Background

At its 8th **October 2024** meeting, the MPC is expected to take a decision on the monetary policy stance for the near term. In our view, five key developments are expected to underpin the Committee's decision:

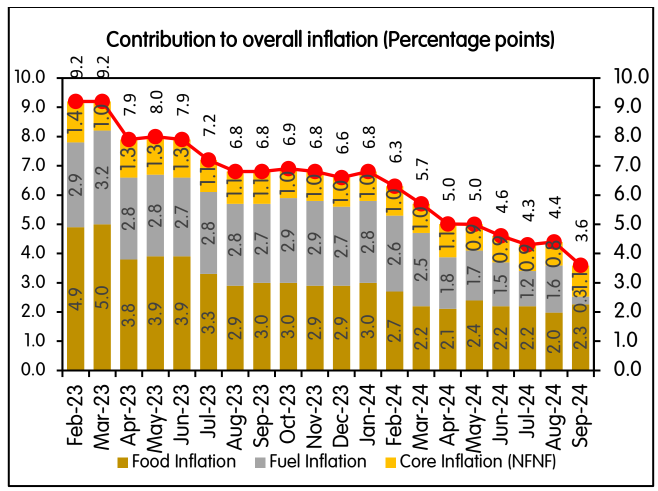
First, inflation remains on a declining trend below the mid-point of the target range. In September 2024, headline inflation declined further away from the target midpoint to 3.6% from 4.4 % in August, on account of lower food and fuel prices and muted demand pressures. In particular, food and fuel inflation declined to 5.1% and 1.1% from 5.3% and 4.7% in August 2024, respectively as core (Non-food-non-fuel) inflation remained muted **(Figure 1a).** Virtually all categories of inflation sustained their declining contributions to overall inflation **(Figure 1b)**.

Figure 1: Inflation trends and drivers

1a: Inflation and its drivers (%)



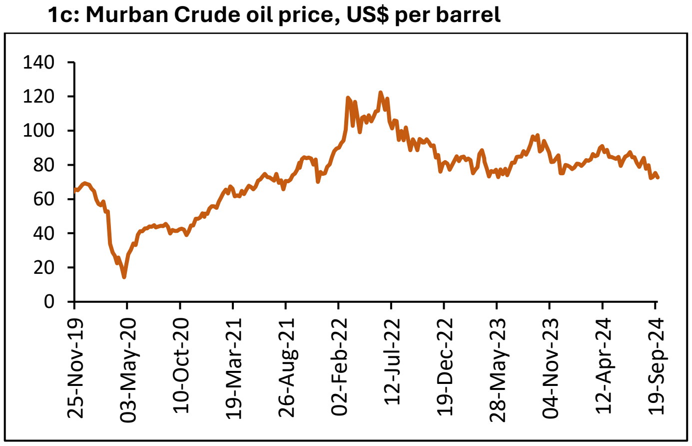
1b: Contribution to overall inflation (%)



Source: *Central Bank of Kenya*

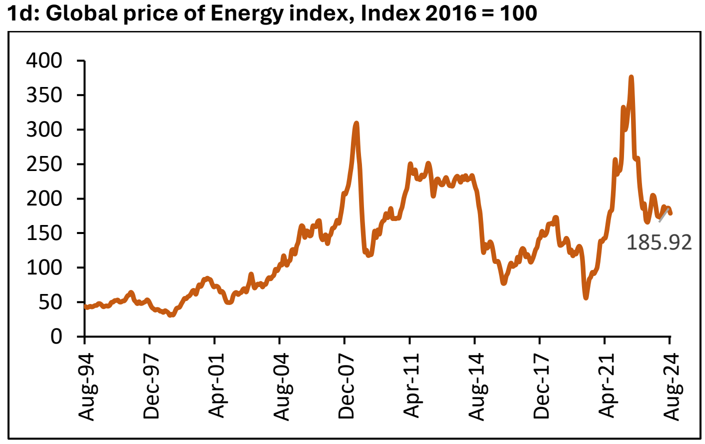
Global energy prices have eased significantly, with the Murban crude oil prices dropping to US$ 74.6 per barrel by 2nd October 2024 from US$ 91.1 per barrel on 11th April 2024, and overall Energy Price Index declining from 376.4 in August 2022 to 185.9 in August 2024 **(Figure 1c)**. Similarly, the global Food Price Index increases have softened, largely due to a drop in the prices of cereals, from 131.6 in January 2023 to 120.7 in August 2024 **(Figure 1d)**. These global fuel and food price developments, amidst ample local food supplies, continue to ease inflationary pressures in Kenya. However, inflationary risks could arise from potential external shocks, supply disruptions with the continuing war in Ukraine, and a global rise in demand with the synchronized monetary policy easing.

1c: Murban Crude oil price, US$ per barrel



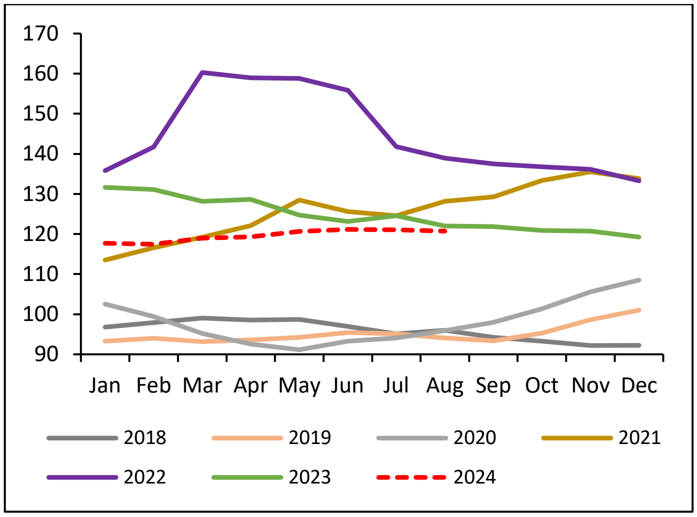
Source: Oilprice.com

1d: Global price of Energy index, Index 2016 = 100



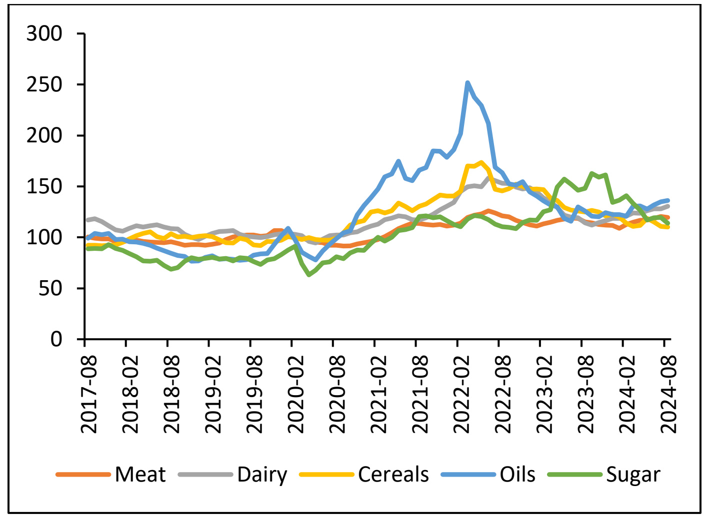
Source: IMF Commodity prices

1e: FAO Food Price Index



Source: FAO

1f: FAO Food Commodity Price Indices



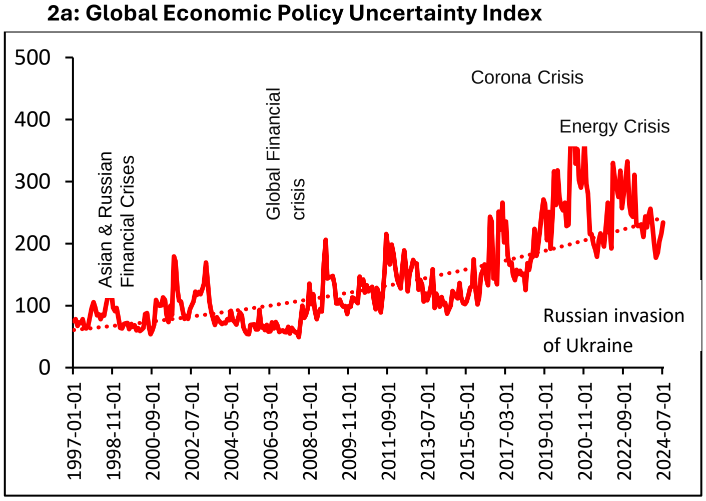
Source: FAO

Second, global economic uncertainty is rising, driven by geoeconomic fragmentation, impacting investments and market volatility. The global Economic Policy Uncertainty index published by the US Federal Reserve Bank shows policy uncertainty rising across most countries, exerting pressure on investments and increasing risks **(Figure 2a)**. As geoeconomic fragmentation accelerates in 2024, geopolitics will fuel volatility in the global economy (87%) and stock markets (80%), incentivise localization (86%), strengthen economic blocs (80%), and deepen the North-South divide (57%) through 2026.

Domestically, the economy depicting resilience, amidst the disruptions caused by social unrests across the country during the quarter, grew by 4.6% in the second quarter of 2024, down from 5.6% over a similar period in 2023, supported by a moderate growth in Agriculture (which grew by 4.8%), real estate (6.0%), financial and insurance activities (5.1%), wholesale and retail trade (4.4%) and manufacturing (3.2%). The Purchasing Managers Index (PMI) saw a delicate recovery to 50.6 in August 2024 **(Figure 2b)**, reflecting a slight improvement in business activity manifested in new orders and input purchases. Despite this, expectations of stronger economic growth remain muted, as confidence in future business activity hit a record low, with only 5% of companies expecting growth over the next 12 months under the baseline. The fragile economic growth would require a stimulus policy action to elevate it towards its potential level.

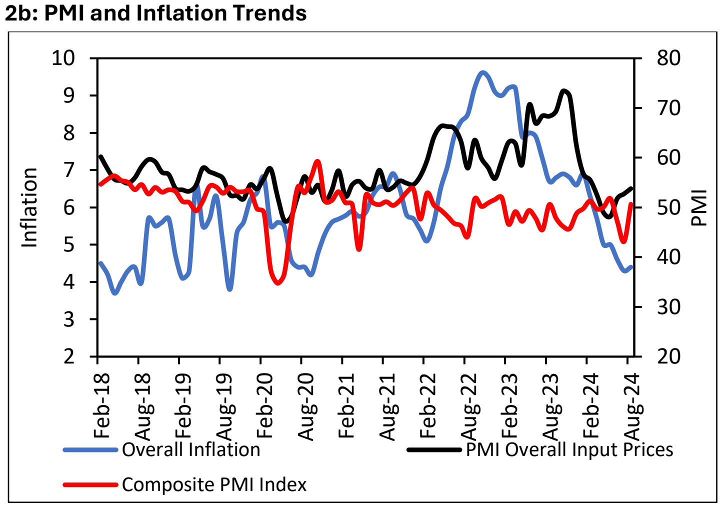
Figure 2: Economic growth outlook

2a: Global Economic Policy Uncertainty Index



Source: Federal Reserve Bank

2b: PMI and Inflation Trends

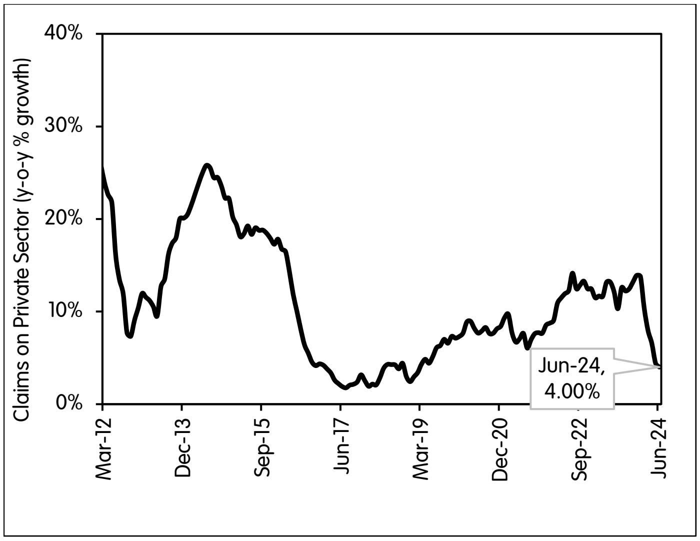


Source: IHS Markit

Third, private sector credit growth remains low on high interest rates and elevated non-performing loans, and threatens to slow economic growth, going forward. Private sector credit growth slowed to 4.0% in June 2024, down from 7.9 % in March **(Figure 3a)**, triggering deterioration in non-performing loans (NPLs) ratios to 16.34% from 15.5% in February **(Figure 3b)**. However, notable decreases in NPLs were observed in real estate, manufacturing, trade and building, agriculture and transport and communication sectors. Market concerns linger on the prospects of a further deterioration in NPL ratios should a high interest rates regime be prolonged.

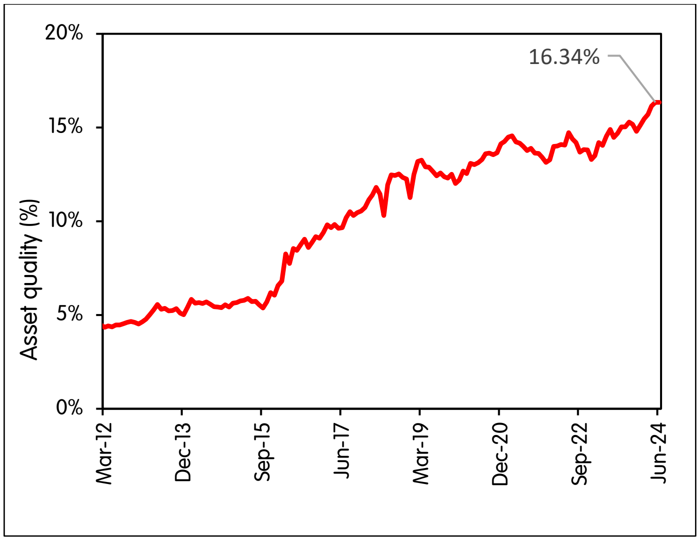
Figure 3: Credit market dynamics

3a: Year-on-year growth in private sector credit



Source: CBK

3b: Movement in industry Asset quality



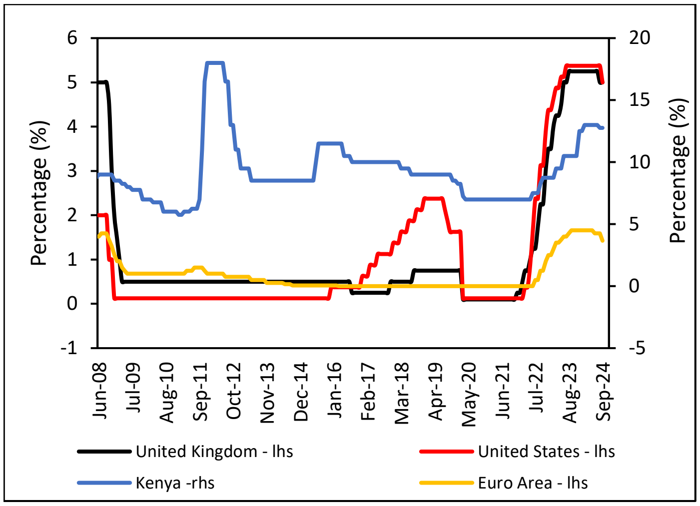
Source: CBK

Fourth, central banks in global and advanced markets have kicked off monetary policy easing streaks; signalling their intentions to solidify economic growth in respective markets amidst anchored inflationary pressures. The European Central Bank lowered its deposit facility rate by 25 bps to 3.5%, citing a more optimistic inflation outlook and improved policy transmission. Similarly, in September 2024, the US Federal Reserve Bank implemented its first rate cut since March 2020, reducing the target range for the Fed funds rate by a substantial 50 bps to 4.75%-5% and signalled further successive cuts in 2024 through 2026. The Bank of England also cut rates by 25 bps in August and maintained the Bank Rate at 5% during its September meeting, with ongoing deliberations over further cuts **(Figure 5a)**.

Locally, following the CBK policy rate cut to 12.75 percent in August 2024, short-term interest rates continue to closely track the Central Bank Rate (CBR) within the set interbank interest rate corridor set at CBR ± 1.50% **(Figure 5b);** reflecting a well-aligned market outcome. Thus, with the synchronized easing across major economies, and prospects of further cuts in the near to medium term, there is ample scope to effect a policy rate cut and offer support to economic growth without any adverse risks on exchange rate movements.

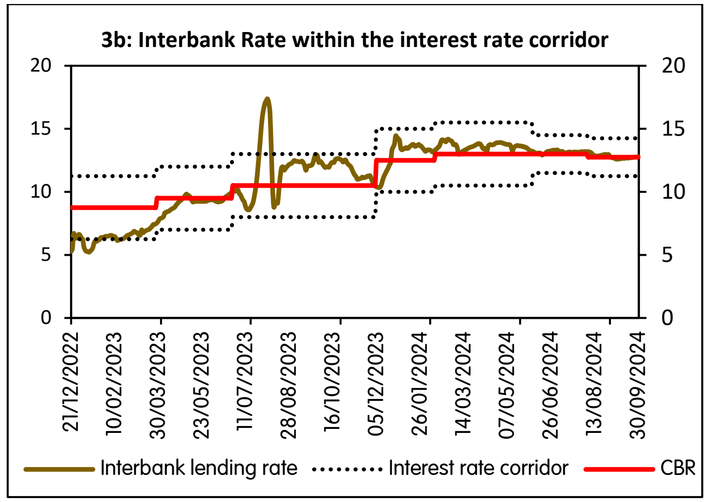
Figure 5: Trends in policy and market rates

5a: Central Bank Rates in Selected Markets



Source: BIS

5b: Interbank lending rate and the Interest rate corridor



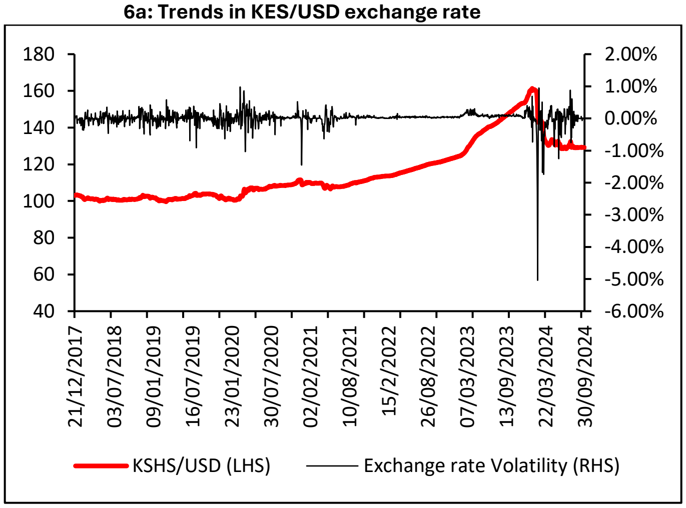
Source: CBK

Fifth, the Kenya Shilling exchange rate against major global currencies remains stable anchored on fundamentals, despite external risks. The Kenya Shilling exchange rate against the US dollar has sustained its appreciation bias since February 2024 reflecting improvements in economic fundamentals (**Figure 6a**) - particularly sustained diaspora inward remittances (**Figure 6b**) and improvements in the balance of payments outturns (**Figure 6d**). From a market confidence standpoint, the official foreign exchange reserves stood at USD 8,027 million as of 26 September 2024, providing 4.1 months of import cover (**Figure 6c**)—slightly above the statutory minimum of 4.0 months required to cushion against any short-term foreign exchange market shocks.

Going forward, two notable risks could impact Kenya's external sector. First, the ongoing fiscal liquidity challenges may dampen investor sentiment and erode their confidence, potentially exerting pressure on the Kenya Shilling. Second, while the current-account deficit in 2024 is expected to depict a sustainable balance, rising import demand going forward, could slightly outweigh gains from any improvements in exports, and also exert pressure on the exchange rate.

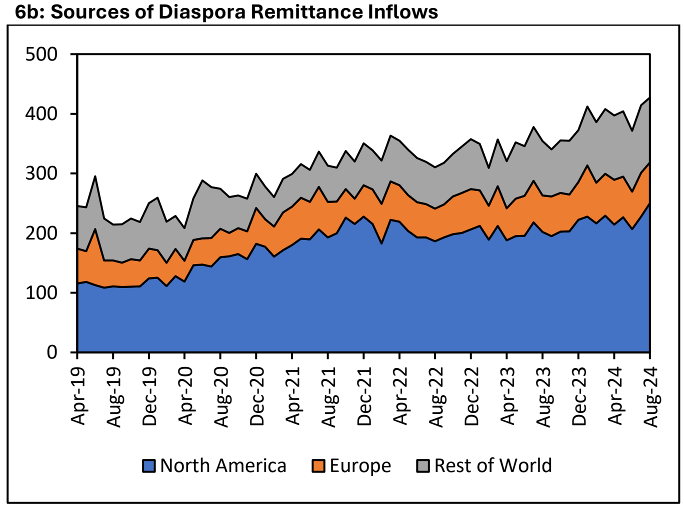
Figure 6: Exchange Rate movement and its drivers

6a: Trends in KES/USD exchange rate



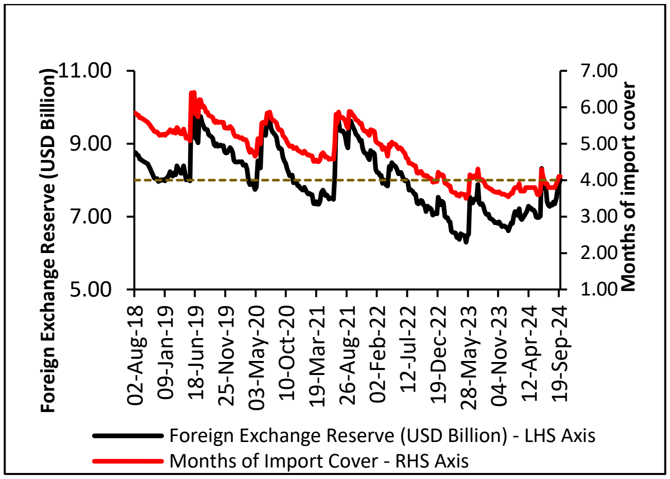
Source: CBK

6b: Sources of Diaspora Remittance Inflows



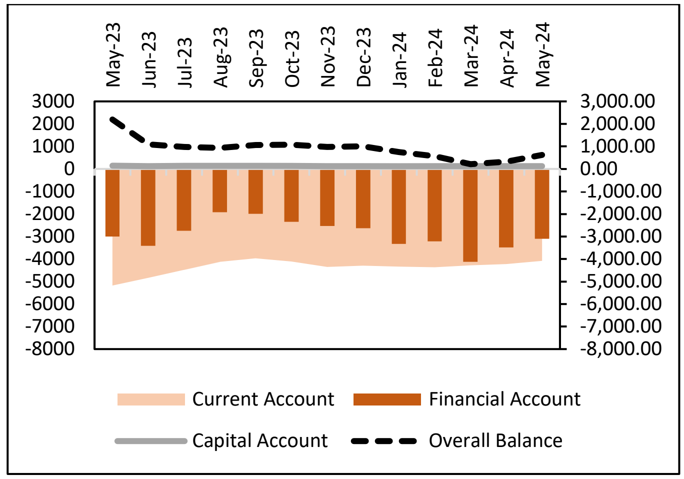
Source: CBK

6c: Foreign exchange reserve and months of Import Cover



Source: CBK

6d: Balance of Payments Developments



Source: CBK

Conclusion

In view of the above developments, and a well anchored inflationary pressure, there is scope to effect a decisive policy rate cut to protect and support a stronger economic growth through private sector credit recovery.

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