CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

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There is scope for as stronger interest rate cut to support private sector credit growth

Highlights

The decision of the Monetary Policy Committee (MPC) of the Central Bank of Kenya at its meeting scheduled for **5th December 2024** on its monetary policy stance is expected to be underpinned by four key macroeconomic developments:

- **First,** overall inflation remains low, and inflation expectations are well anchored below 5%;
- **Second**, economic growth despite depicting resilience – anchored on steady performance of services sector - faces risks from constrained financing, particularly of private sector activity;
- **Third**, Credit markets face challenges, with private sector credit growth dipping largely on structural rigidities constraining a faster decline in interest rates;
- **Fourth,** strong external sector performance is expected to persist in the short to medium term, supported by declining oil prices, recovery in tourism, and sustained robust performance of remittances.

In view of these developments, and the need to reverse the decline in private sector credit growth, we argue for a further cut in the Central Bank Rate to provide a stronger signal to the market for lending rates to decline.

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There is scope for the Central Bank of Kenya to augment interest rates to reverse the declines in private sector credit growth and support economic activity.

Background

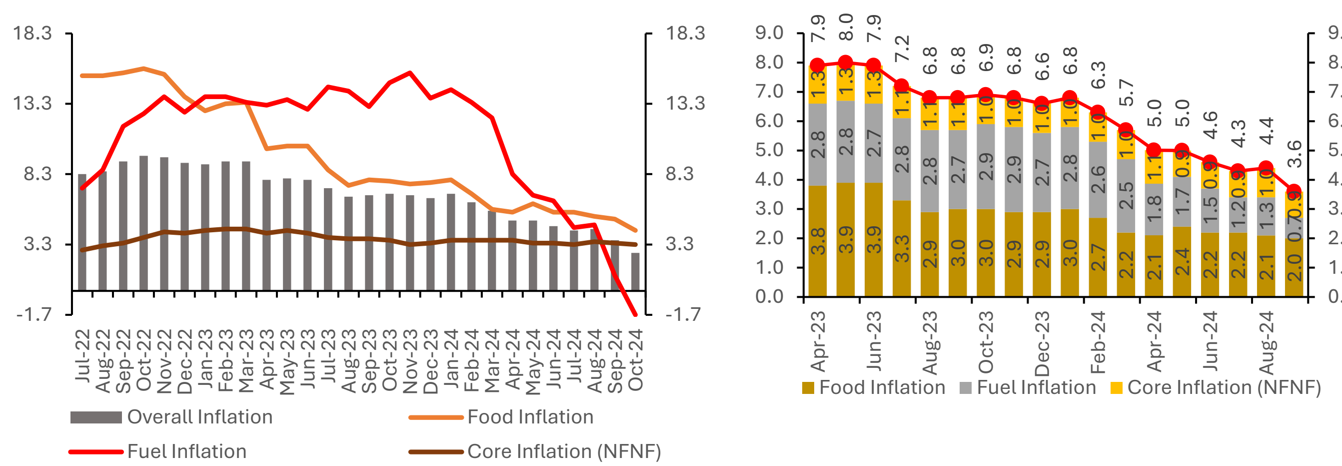
At its meeting on 5th December 2024, the Monetary Policy Committee (MPC) is expected to take a decision on the monetary policy stance for the near term, anchored on the following four key developments:

First, overall inflation remains low, and inflation expectations are well anchored below 5%. The year-over-year inflation rate slowed to 2.7 % in October 2024, down from 3.6 % in September 2024; driven by lower food and fuel inflation, that respectively eased to 4.3 % and -1.7 % from 5.1% and 1.1 % in September 2024. Core (Non-food-non-fuel) inflation remained muted at 3.3 % **(Figures 1a & 1b)** reflecting lower demand pressures in the economy.

Figure 1: Domestic inflation trends

1a: Inflation and its drivers (%)

1b: Contribution to overall inflation (%)



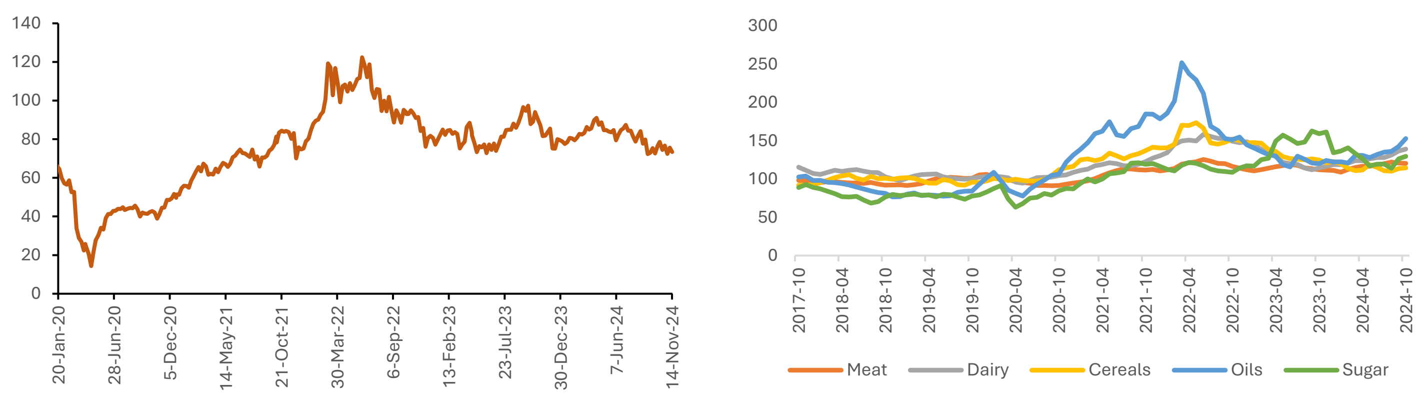
Source: *Central Bank of Kenya*

Global and domestic inflation trends remain significantly exposed to external factors, including geopolitical tensions that would have implications on fuel and other commodity prices. However, the pass-through effects of external pressures on domestic inflation have remained relatively low, largely on continued decline in global crude oil prices— asurban crude oil prices have remained below USD 80.0 per barrel, standing at USD 75.56 per barrel as of November 21, 2024 (**Figure 2a**). Additionally, global food commodity prices have steadied, as reflected by the FAO food price sub-indices (**Figure 2b**).

Figure 2: Crude oil and commodity price Movements

2a: Murban Crude oil price, US$ per barrel

2b: FAO Food Commodity Price Indices



Source: Oilprice.com

Source: FAO

Second, economic growth despite depicting resilience – anchored on steady performance of services sector - faces risks from constrained financing, particularly of private sector activity. While the IMF projects global economic growth to slow to 3.2 % in 2024 and 2025, Kenya is expected to grow at 5.0%, supported primarily by the service sector (**Table 3a**). However, the country faces some headwinds, as the latest GDP data for the second quarter 2024 shows growth slowing to 4.6 % from 5.6 % over a similar period in 2023 (**Table 3b**).

A critical headwind includes the performance of the global economy which is expected to affect the trajectory of the local economy from financing and exchange rate stability standpoints. The Global Economic Policy Uncertainty (GEPU) Index remains elevated since the start of the 2024 anchored on the just concluded U.S. elections. The spikes in the index correlate significantly with declines in the NSE 20 Share Index (**Figure 3c**), signalling heightened market volatility. The Trump administration's policy shifts are expected to add further uncertainty, potentially affecting financial markets and economic growth outcomes across many emerging and frontier countries.

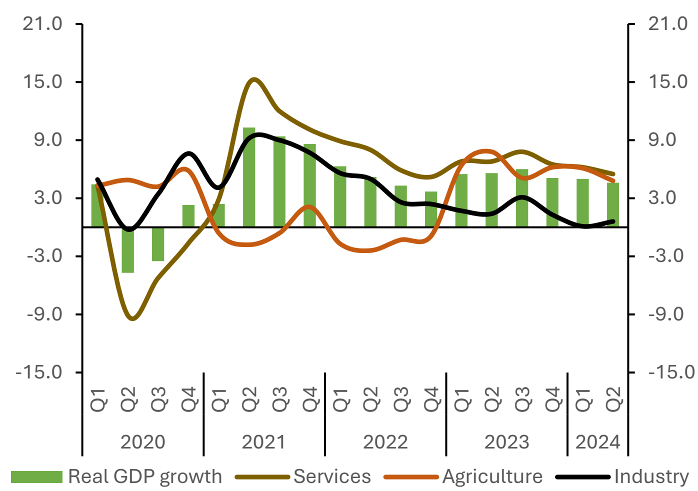
Figure 3: Economic growth outlook

3a: World Economic Outlook Projections

		October 2024 Projections	
	2023	2024	2025
World Output	**3.3**	**3.2**	**3.2**
Advanced Economies	**1.7**	**1.8**	**1.8**
United States	2.9	2.8	2.2
Euro Area	0.4	0.8	1.2
Japan	1.7	0.3	1.1
United Kingdom	0.3	1.1	1.5
Emerging and Developing Economies	**4.4**	**4.2**	**4.2**
China	5.2	4.8	4.5
India	8.2	7.0	6.5
Brazil	2.9	3.0	2.2
Sub-Saharan Africa			
Nigeria	2.9	2.9	3.2
Kenya	5.6	5.0	5.0
South Africa	0.7	1.1	1.5

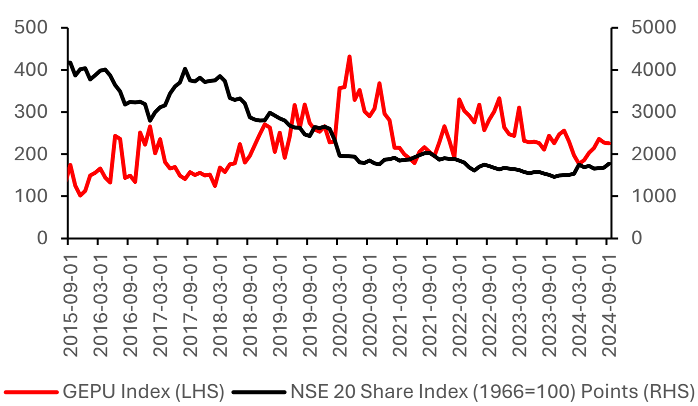
Source: Federal Reserve Bank

3b: Sectoral and aggregate GDP Growth rates (%)



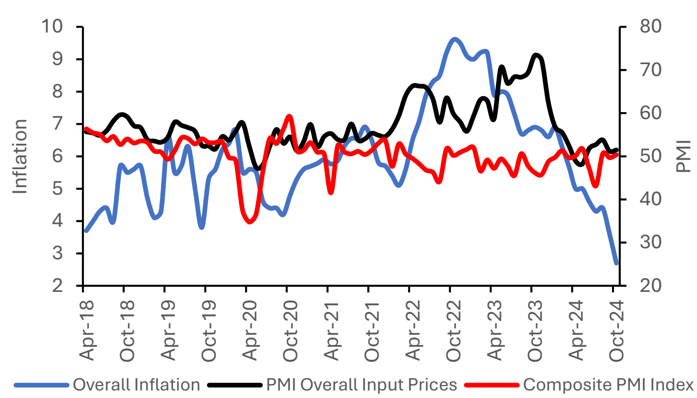
Source: IMF World Economic Outlook (WEO)

3c: Global Economic Policy Uncertainty Index and NSE-20 Index



Source: KNBS

3d: Trends in Kenya PMI and inflation trends



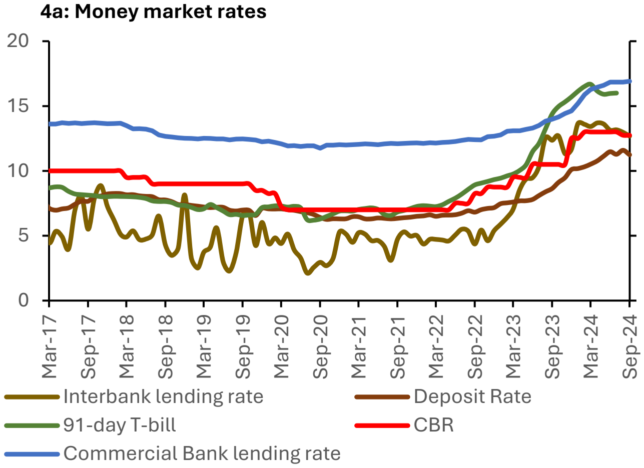
Source: IHS Markit

Additionally, the Kenyan private sector continues to depict cautious optimism amongst key actors. The October 2024 Purchasing Managers' Index™ (PMI®) rose to 50.4 (**Figure 3d**), reflecting a marginal improvement in business conditions in October and representing a recovery of activity from the contraction in September. The modest and fragile recovery mirrored some return in new orders and increased client interest, particularly in agriculture, construction, and retail. Expected output index depicted fragility; dropping in August and September and partially recovering in October 2024.

Third, Credit markets face challenges, with private sector credit growth dipping largely on structural rigidities constraining a faster decline in interest rates. In 2023 and early 2024, the Central Bank of Kenya (CBK) implemented successive policy rate hikes to tame persistent domestic inflationary pressure. These interest rate adjustments significantly increased short term/ money market interest rates (**Figure 4a)**, and extended to Treasury bill (T-bill) yields, which also increased in tandem. The rise in T-bill rates drove up borrowing costs - amidst elevated non-performing loans (NPL) ratio on private sector loans at 16.5% in October 2024 - constrained extension of credit to the private sector. Faced with tighter liquidity and heightened default risks in the private sector, banks tightened lending standards to avert a further deterioration in asset quality; prioritizing investments in less risky assets such as government securities. Consequently, bank lending to the private sector growth declined to 0.4% in September and near zero in October (**Figure 4b)**.

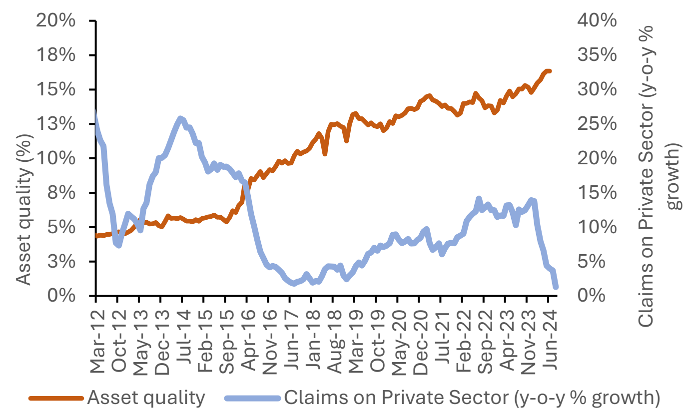
Figure 4: Credit markets dynamics

4a: Money market rates



Source: Central Bank of Kenya

4b: Trends in Private sector credit and Asset quality

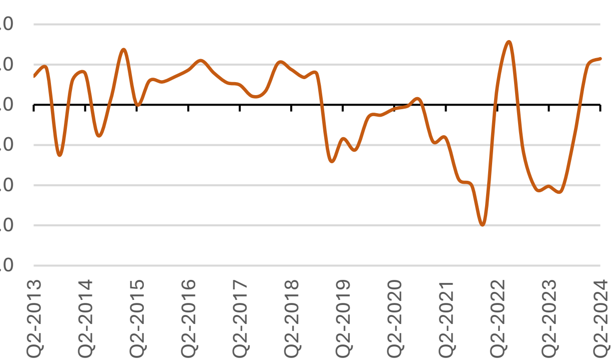


Source: IMF World Economic Outlook (WEO)

4c: Drivers of deteriorating Asset Quality

Driver	Description
High Cost of Funds	Elevated costs of funds, driven by competition on deposits from investments in high-yielding government securities, make it difficult for banks to offer competitive lending rates.
Delayed payment strain	MSMEs engaged in government tenders face delayed payments, which strain their cash flows and increase the risk of loan default.
Decreased disposable Incomes	Fiscal policies – that increased taxes and statutory deductions (such as housing levy, SHIF), have reduced disposable incomes of salaried employees, impacting borrowers' ability to repay loans.

4d: Trends in house market prices



Source: KBA House Price Index (% change)

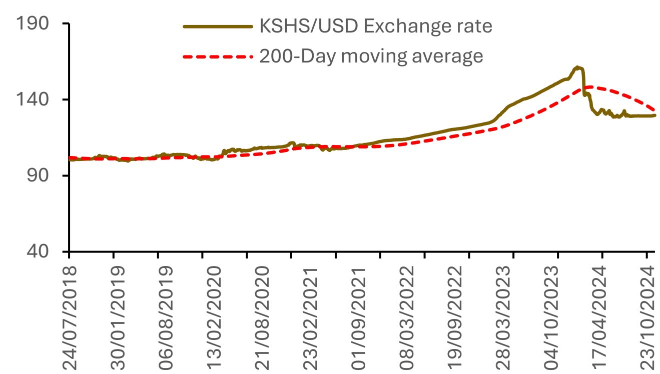
The high-NPL-driven deterioration in banking sector asset quality points to broader economic challenges, such as reduced business activity, rising pressure on household incomes from elevated taxes (and deductions), the prevailing high cost of credit, and further delays in the resolution of Government pending bills, that continue to increase customers inability to service existing loans(**Table 4c**). The housing market, as measured by the Kenya Bankers Association Housing Price Index (KBA HPI), mirrors these dynamics, with the recent data indicating subdued growth in housing prices, highlighting weaker demand linked to restricted credit access and diminished consumer purchasing power (**Figure 4d)**.

Fourth, strong external sector performance is expected to persist in the short to medium term, supported by declining oil prices, recovery in tourism, and sustained robust performance of remittances. Exchange rate has remained relatively more stable since June 2024 (**Figure 5a**), supported by robust remittance inflows, a sustained recovery in total tourist arrivals (**Figure 5b**), that have anchored a steady current account deficit (**Figure 5c**). From a confidence standpoint, usable foreign exchange reserves as of 21 November 2024 stood at $9,144 million (4.8 months of import cover). The current account deficit stood at USD -4,258.1 million (approximately 3.8 % of GDP) in the 12 months to August 2024 from 3.7% in the 12 months to August 2023. Amidst declining crude oil prices, the current account deficit is expected to remain sustainable; at 4.5% of GDP by end 2024 and 5.5% in 2025.

The ongoing implementation of the fiscal consolidation **(Figure 5d)** in the short to medium term – aimed at reducing debt vulnerabilities while moving the fiscal deficit/GDP ratio to about 2.8% in FY2028/2029, if shielded from any fiscal slippages, will also support the sustainability of the current account deficit. Risk, however, could emerge from rising demands on increased expenditure by the Government for infrastructure development, and economic slowdown that could constrain revenue collections and trigger additional borrowing.

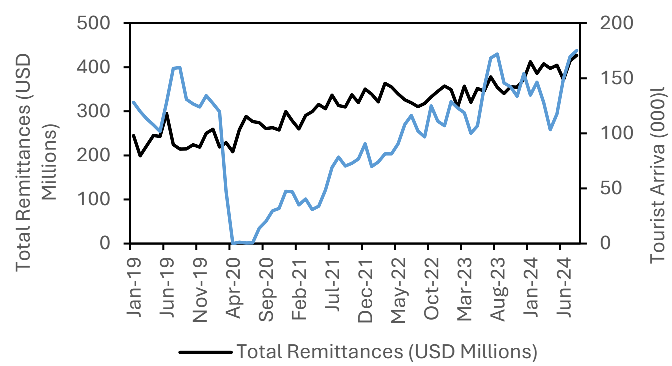
Figure 5: The external sector and fiscal space

5a: Trends in exchange rates



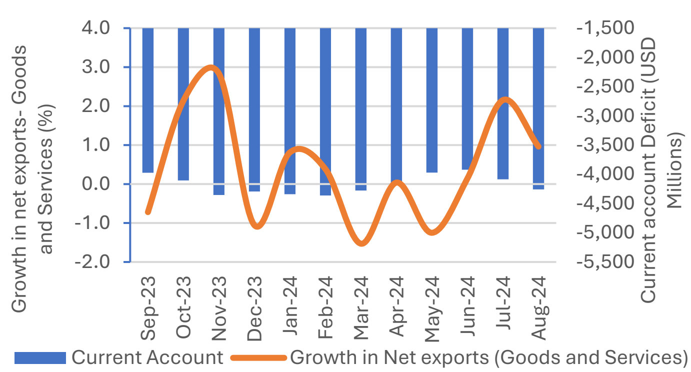
Source: CBK

5b: Trends in remittances and total tourists arrivals



Source: CBK

5c: Net export growth and current account balances



Source: KNBS

5d: Fiscal Deficit (% of GDP) on the Fiscal Consolidation path

Source: The National Treasury

Conclusion

In view of the fact that inflation has remained low and its expectations well anchored; and exchange rate less volatile with no foreseeable threats to its stability, there is merit in pursuing enhancement of economic activity through a recovery in private sector credit growth. We therefore view that there is scope to effect a significant central bank rate cut to provide a stronger signal to the market and facilitate declines in market interest rates.

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