Research Note

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A call for a further Central Bank Rate cut to stimulate credit-led economic activity

Highlights

The Monetary Policy Committee (MPC) of the Central Bank of Kenya at its meeting scheduled for **5th February 2025** is expected to further ease its monetary policy stance; anchored on four key macroeconomic developments:

- **First,** inflation remains stable within its target band, and inflation expectations are well anchored, supported by easing food and fuel prices, and muted demand pressures in the economy;

- **Second,** elevated non-performing loan ratios continue to delay adjustments in lending rates consistent with risk-based credit pricing by banks, thereby constraining credit growth**;**

- **Third,** economic growth slowed to 4.0% in the third quarter of 2024, weighed down by weaker growth in credit, dimmed positive sentiment and global uncertainties during the period. However, prospects for a stronger recovery have emerged;

- **Fourth,** the exchange rate remains stable supported by a steady current account deficit anchored on robust remittances and inflows from tourism, and strong official foreign exchange reserves.

In view of these developments, and the growing need to reverse the deceleration in private sector credit, we call for a further cut in the Central Bank Rate (CBR) to provide additional impetus to the ongoing downward adjustments in the commercial banks' lending rates.

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> *Amidst stable inflation and exchange rate, stimulating credit growth would be important to spur economic activity.*

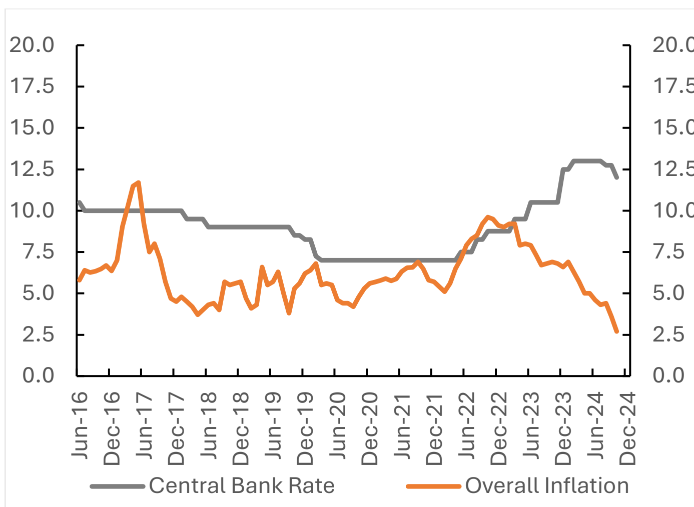
Background

Four macroeconomic developments are expected to underpin the decisions of the Monetary Policy Committee (MPC) in its meeting scheduled for 5th February 2025**:**

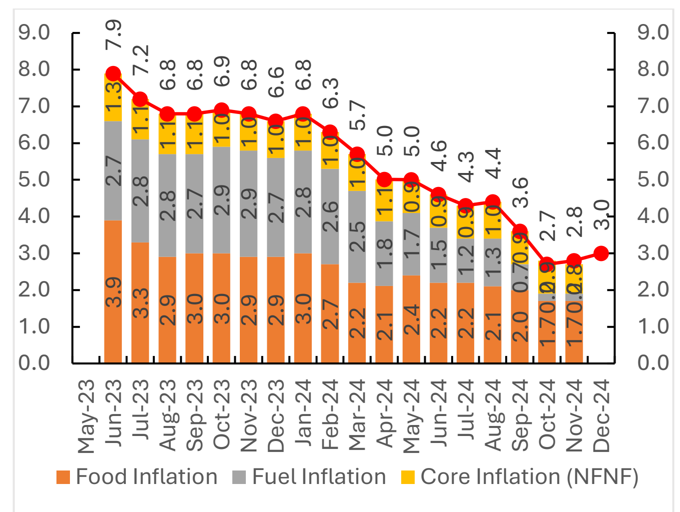
First, inflation remains stable within its target band, and inflation expectations are well anchored, supported by easing food and fuel prices and muted demand pressures in the economy. In response to the Central Bank Rate hikes effected by CBK from June 2023 to March 2024, overall inflation has declined and remained within its target range (**Figure 1a**). However, there were moderate increases in food inflation to 4.8% in December 2024 from 4.5% in November 2024, as the decline in fuel inflation slowed down to -1.0 % in December 2024. Core (non-food non-fuel) inflation remained steady at 3.2% between November and December 2024, reflecting muted demand pressures in the economy. Overall, the notable decline in fuel inflation has been the main contributor to the overall low inflation in the economy (**Figure 1b**).

Figure 1: Inflation trends and drivers

1a: Overall Inflation rate versus Central Bank Rate (%)



1b: Contribution to overall inflation (%)



Source: *CBK and KNBS*

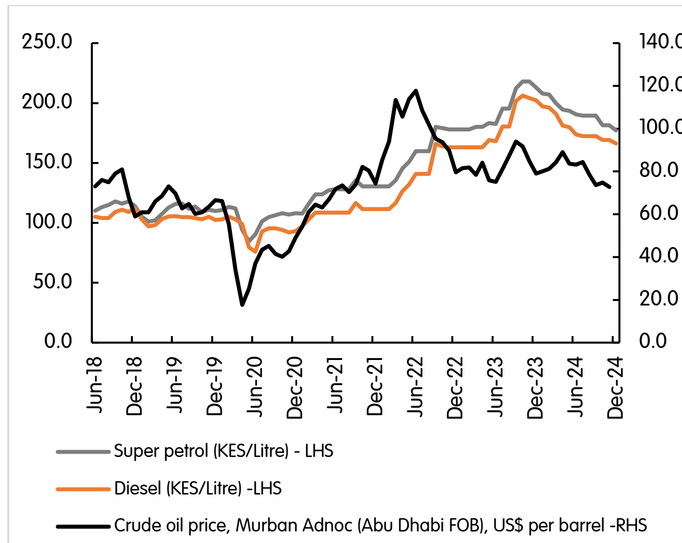
Moreover, the passthrough effects of external factors are expected to weigh on inflation outcome. Currently, global oil demand is forecasted[1] to grow by 1.4 mb/d[2] in 2025 and 2026, driven primarily by non-OECD countries (1.3 mb/d) with minimal growth in OECD regions (0.1 mb/d). Oil supply by the US, Brazil and Canada (not participating in cooperation with other oil producing countries) is expected to increase by 1.1 mb/d each year. This is expected to largely offset any emerging supply-driven price pressures in the global economy.

Murban crude oil prices have been on a declining trend, averaging less than $80 per barrel as from August 2024 to December 2024; a trend that has been mimicked by the domestic fuel prices (**Figure 1c**). Food inflation is also expected to ease, supported by improved food supply despite a slight uptick in global prices, as indicated by the FAO Food Inflation Index (**Figure 1d**). Going forward, inflation is expected to rise moderately in the near term but stay

[1] *https://momr.opec.org/pdf-download/*
[2] *million barrels per day*

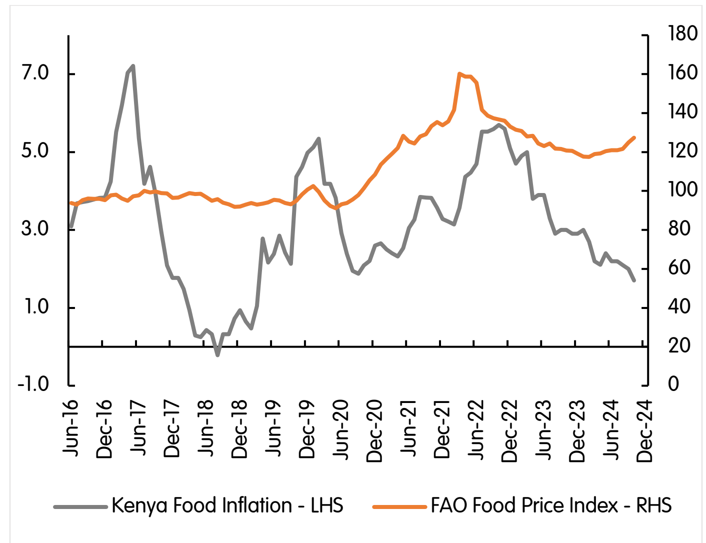
within target band of 5±2.5% mainly due to stable global commodity prices, anchored inflation expectations and forecasts (**Figure 1e**)[3].

1c: Murban Crude oil price and domestic retail fuel prices



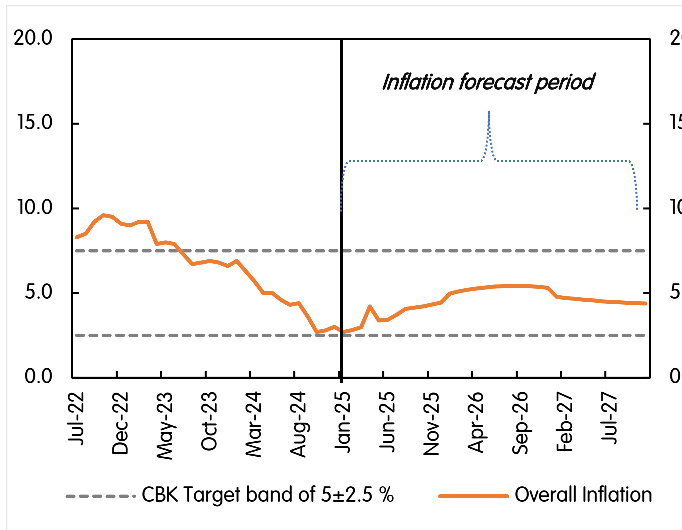
Source: Oilprice.com and EPRA

1d: Trends in food inflation

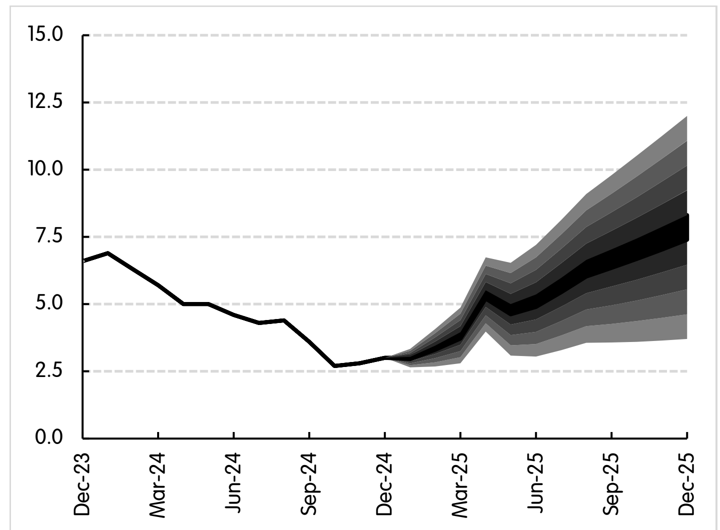


Source: FAO and KNBS

1e: Inflation forecasts



Source: S&P Global market intelligence



Source: KBA Staff computations

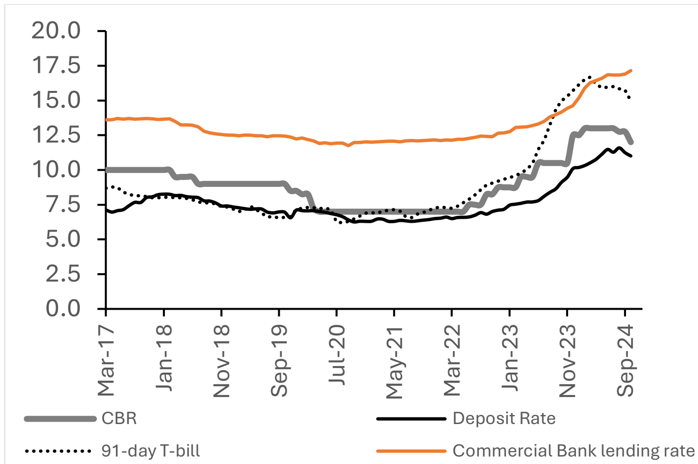
Second, the elevated non-performing loan (NPL) ratios continue to delay adjustments in lending rates consistent with risk-based credit pricing by banks; thereby constraining credit growth. Following the CBR cut in October 2024 by 75 basis points, the average interbank market rate declined by 61 basis points and the average deposit rate (measure of the average cost of funds) declined by a marginal 23 basis points as banks faced stiff competition from Government securities for wholesale deposits in the market. However, the 91-day Treasury bill rate declined by 78 basis points reflecting a stronger pass-through of monetary policy signals via the Treasury bill market than the money market (**Figure 3a**). With the industry NPL ratio remaining elevated at 16.5% (**Figure 3c**), the ongoing lending rate adjustments for the less risky segments would be moderated by minimal adjustments on the sectors perceived to be riskier (**Figure 3a**).

3 See forecast by S&P Global market intelligence and Kenya Bankers Association

Moreover, with external financing options for the Government remaining tight (as reflected by the 10-year Eurobond yields averaging about 9.0% from October 2024 through January 2025) (**Figure 3b**), this continues to depict higher financing costs by the Government as evaluated by investors, going forward. As lending rates remain elevated, credit growth remains muted (**Figure 3c** & **Figure 3d**). As such, there is need to stimulate credit growth through a further cut in the CBR alongside other measures to support the ongoing risk-based credit pricing framework, and resolve credit market challenges such as the long-standing pending bills to forestall a further escalation of NPLs.

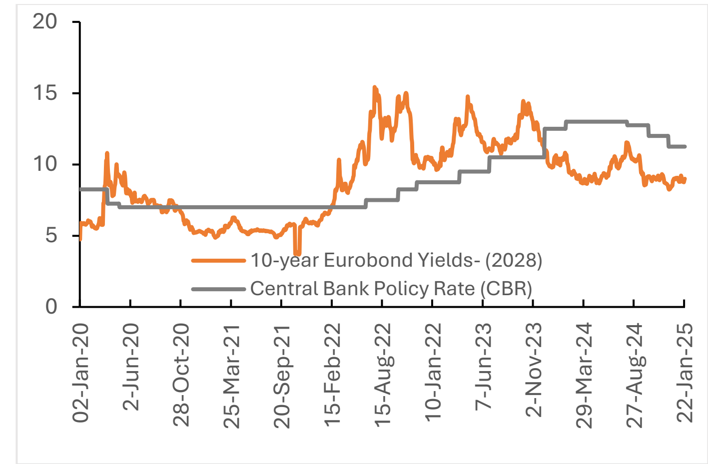
Figure 3: Credit market dynamics

3a: Trends in the market interest rates



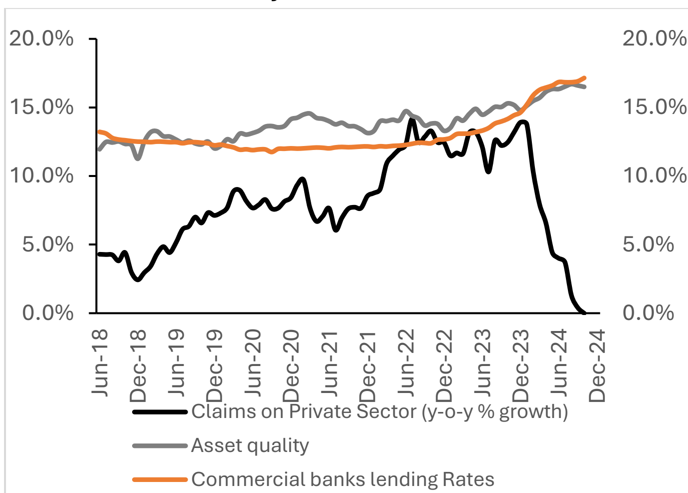
Source: CBK

3b: Movement in CBR rates and 10-year Eurobond yield curve



Source: NSE and CBK

3c: Credit market dynamics



Source: CBK

3d: Sectoral credit growth

	Dec 2023	March 2024	June 2024	Oct 2024
Credit to private sector	**13.9**	**7.9**	**4.0**	**0.0**
Agriculture	23.4	17.5	10.1	8.9
Manufacturing	20.9	9.4	-0.6	-11.6
Trade	13.1	6.2	3.1	4.7
Building and construction	8.6	0.1	-8.3	-16.7
Transport and communication	20.8	6.9	4.4	8.0
Finance and Insurance	60.2	13.0	3.2	-5.2
Real estate	7.1	5.2	3.6	2.8
Mining and quarrying	15.1	34.4	111.7	26.3
Private households	2.5	8.6	7.5	5.9
Consumer durables	9.9	6.4	3.9	3.3
Business services	7.7	6.8	1.9	-3.8

Source: CBK

Third, economic growth slowed to 4.0% in the third quarter of 2024, weighed down by weaker growth in credit, dimmed positive sentiment and global uncertainties during the period. However, prospects for a stronger recovery have emerged. The Kenya National Bureau of Statistics (KNBS) estimates that the real GDP growth stood at 4.00% in the third quarter compared to 4.6% in the second quarter of 2024[4]. The slowdown in the third quarter was driven by deceleration in growth across most sectors and contraction in the industry by 0.2%. The services sector grew by 5.3% as agriculture expanded by 4.2% (**Figure 2a**). Higher frequency data for the fourth quarter, as reflected by the Purchasing Managers Index (PMI) that stood at above the neutral 50 mark for the third consecutive month in

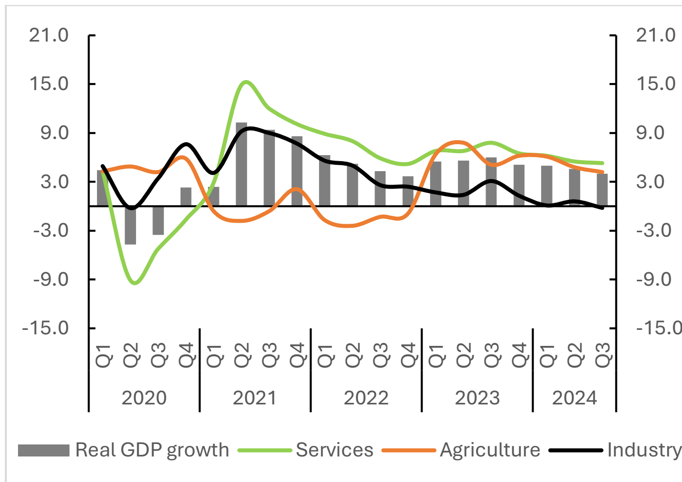
[4] https://www.knbs.or.ke/quarterly-gdp/

December 2024, indicated consistently better prospects for economic activity in the last quarter of the year[5] (**Figure 2b**).

However, the domestic growth path remains uncertain on account of two developments. First, are the spillover effects of the subdued global growth, with the world output projected at 3.2% in 2024, driven by emerging economies like India (6.5%) and China (4.8%) (**Figure 2c**)[6]. Second, is the rise in global uncertainty with global economic policy uncertainty index edging up to 339 in November 2024 (**Figure 2d**) with projected significant policy shifts[7] by the United States of America's new administration potentially altering the recovery prospects. These developments call for a cautious domestic policy alignment to avert any perverse effects.

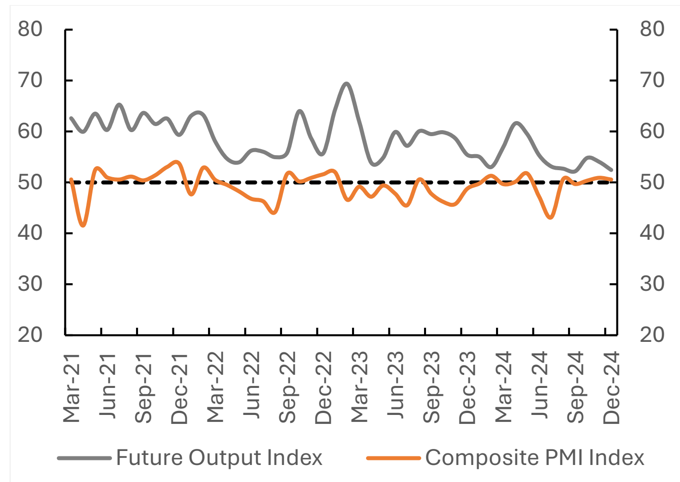
Figure 2: Economic growth outlook

2a: Sectoral and aggregate GDP Growth rates (%)



Source: KNBS

2b: PMI Trends



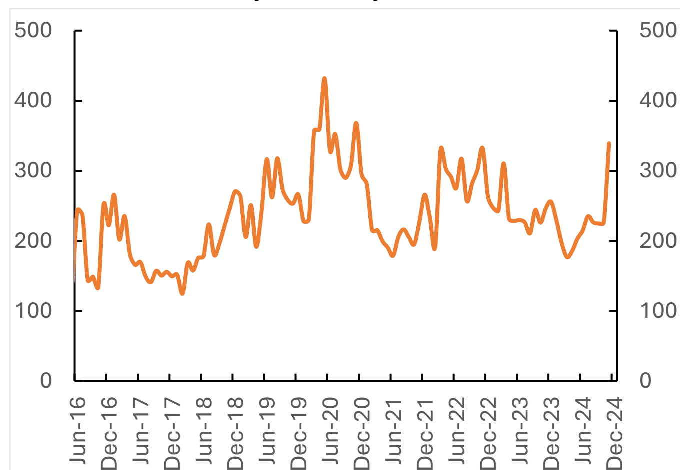
Source: IHS Markit

2c: World Economic Outlook Projections

		January 2025 Projections	
	2024	2025	2026
World Output	**3.2**	**3.3**	**3.3**
Advanced Economies	**1.7**	**1.9**	**1.8**
United States	2.8	2.7	2.1
Euro Area	0.8	1.0	1.4
Japan	-0.2	1.1	0.8
United Kingdom	0.9	1.6	1.5
Emerging and Developing Economies	**4.2**	**4.2**	**4.3**
China	4.8	4.6	4.5
India	6.5	6.5	6.5
Brazil	3.7	2.2	2.2
Sub-Saharan Africa			
Nigeria	3.1	3.2	3.0
South Africa	0.8	1.5	1.6

Source: IMF World Economic Outlook (January 2025)

2d: Global Economic Policy Uncertainty Index



Source: Federal Reserve Bank

Fourth, the exchange rate remains stable supported by a steady current account deficit anchored on robust remittances and inflows from tourism, and strong official foreign exchange reserves. The KES/USD exchange

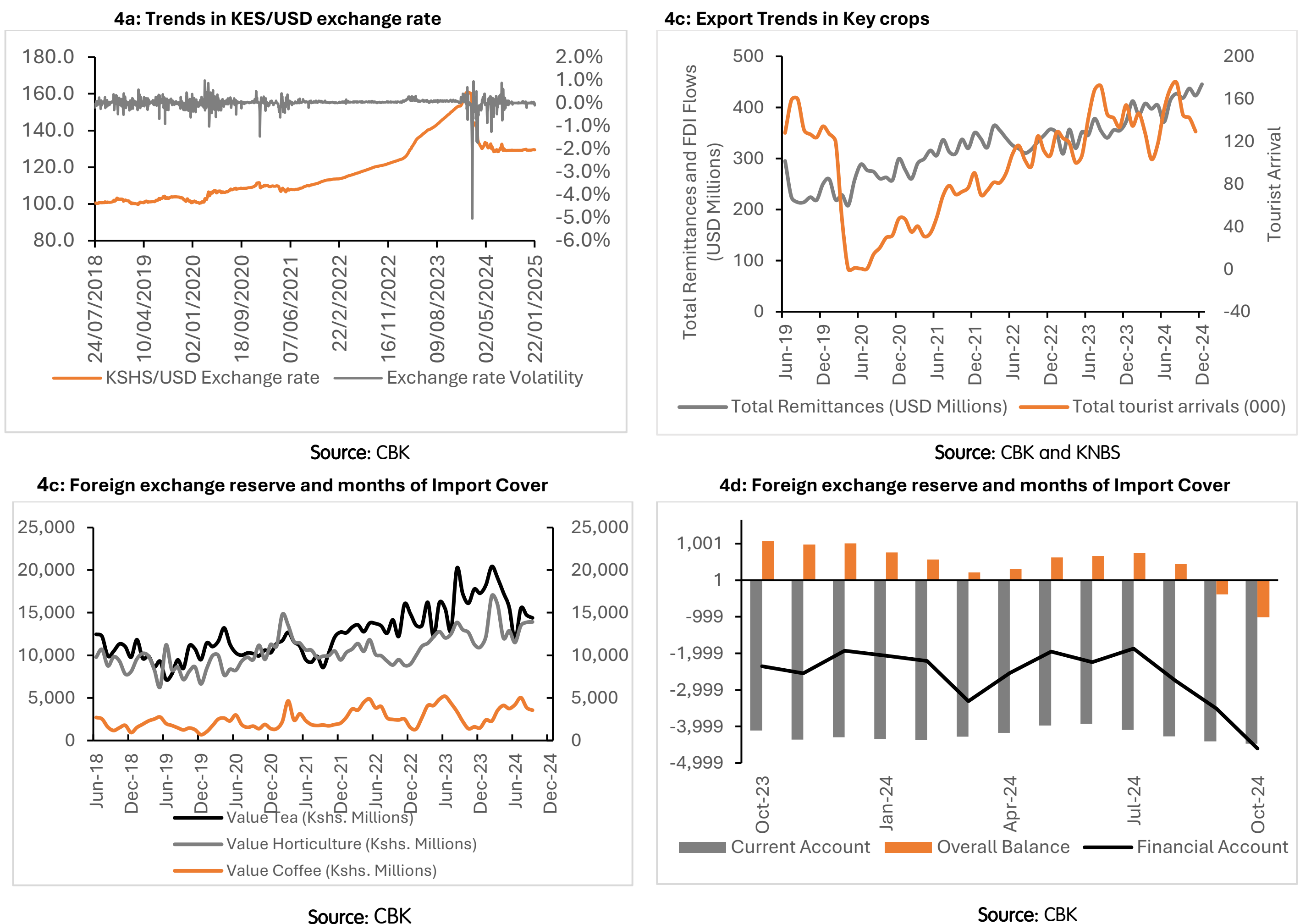
[5] S&P Global & IHS Markit Merger

[6] https://www.imf.org/en/Publications/WEO

[7] *Donald Trump issued dozens of executive orders and memoranda involving immigration, trade and energy policy during his first 24 hours as president.*

rate remained relatively stable with an appreciation bias; averaging Ksh 129.87 against the US dollar in the first 22 days of January 2025, with minimal daily volatility particularly from October 2024 (**Figure 4a**). This stability was supported by robust remittance inflows, peaking at USD 445 million in December 2024, steady tourist arrivals (**Figure 4b**) and resilient performance of tea and horticultural produce exports (**Figure 4c**). Additionally, the CBK usable foreign exchange reserves remained strong, standing at $8,652 million (equivalent to cover 4.4 months of imports against a statutory minimum of 4.0 months) as of 23 January 2025. Strong reserves enhance market confidence that the economy would be able to effectively deal with any emerging short term foreign exchange market shocks. The current account deficit despite widening marginally to USD -4,471 million in October 2024 (**Figure 4d**), remained largely within sustainable limits of about 5.0% of GDP. Proactive fiscal policy interventions are crucial in the very short term amidst growing external imbalances and global uncertainties. With room for monetary policy maneuver narrowing, the Central Bank of Kenya while seeking to boost credit growth would have to balance this objective with sustaining the current exchange rate stability.

Figure 4: Exchange Rate movement and its drivers



Conclusion

In view of these developments, and the growing need to reverse the deceleration in private sector credit, we call for a further cut in the Central Bank Rate (CBR) to provide additional impetus to the ongoing downward adjustments in the commercial banks' lending rates.

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