June 5, 2025

RESEARCH NOTE NO.78 – 2025 (RN/78/25)

Keep the monetary policy stance unchanged to anchor price and exchange rate stability

Highlights

The decision of the Monetary Policy Committee (MPC) of the Central Bank of Kenya at its meeting scheduled for **10th June 2025** is expected to be underpinned by the following developments:

- **First,** headline inflation remains low and inflation risks remain somewhat balanced, though global trade tensions and climate-related shocks may pose uncertainty;

- **Second,** Kenya's economy posted resilience in 2024; having recorded a 4.7% growth supported by strong services and agriculture. Available data for first five months of 2025 show improving business sentiment and a signal recovery;

- **Third**, domestic financial conditions are improving, with declining lending rates and a modest recovery in private sector credit, despite concerns of elevated credit risk;

- **Fourth**, the foreign exchange market remains stable, anchored on a steady current account deficit and strong diaspora remittances, despite headwinds from uncertainty arising from global trade tariffs.

In view of these developments, an assessment of the balance of risks particularly on the exchange rate, and to allow time for a stronger pass-through of previous policy measures to filter through the market, we opine that keeping the policy stance unchanged by maintaining the CBR at 10.00% over the near-term would be appropriate.

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> ***Despite global volatility, Kenya's monetary conditions are improving towards a stronger credit growth and economic recovery.***

Background

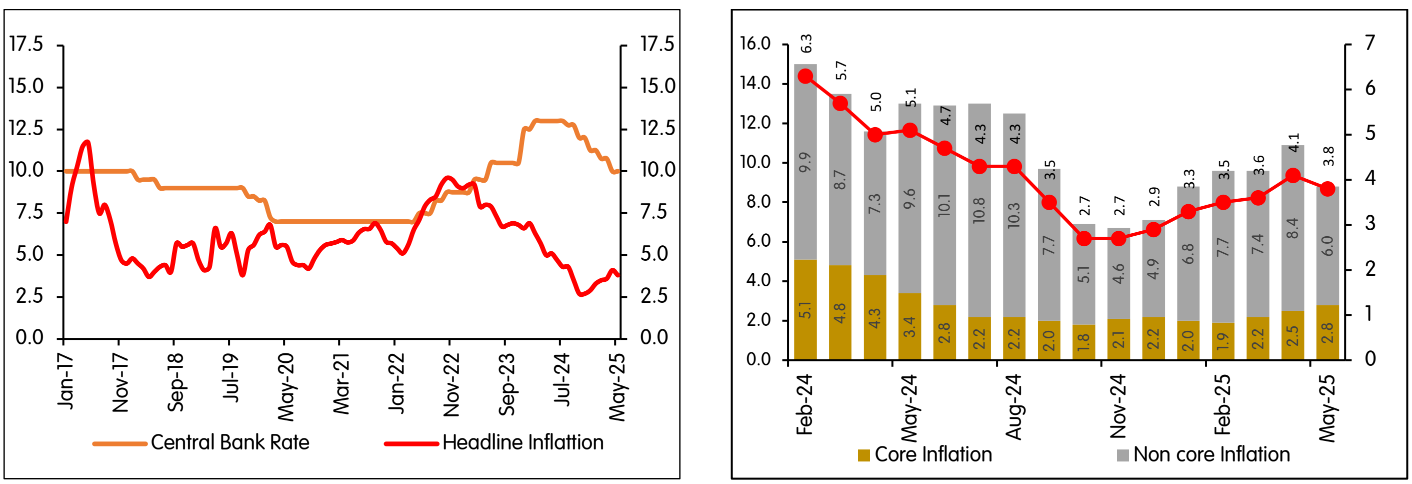
At its meeting on 10th June 2025, the Monetary Policy Committee (MPC) is expected to anchor its policy rate decision on the developments in inflation and its outlook, the economy's growth trajectory, fiscal policy developments, the strength of monetary policy transmission, and the need to balance risks and opportunities of the external sector.

First, headline inflation remains low and inflation risks remain balanced, though global trade tensions and climate-related disruptions pose uncertainty. Headline inflation declined to 3.6% in May 2025 from 4.1% in April 2025 (**Figure 1a)**, while core inflation increased for the third consecutive month to 2.8% (**Figure 1b)**, mainly due to higher prices of cigarettes (25.5%), sifted maize flour (14.0%), and cooking oil salad (1.0%). However, non-core inflation declined to 6.0% from 8.4%, primarily on account of declining energy inflation[1]. While Food and Non-Alcoholic Beverages price index experienced a significant increase of 6.3%, the Transport Index increased by a modest 2.3 % as the Housing, Water, Electricity, Gas, and Other Fuels price category remained largely unchanged.

The risks to domestic inflation in Kenya remain broadly balanced, with annual inflation expected to stay within the target range of **5±2.5%** in 2025. Lower inflation risks are buoyed by declining global commodity and crude oil prices energy prices (**Figure 1c);** a weaker US dollar; and stronger domestic food supplies. Upside risks to inflation include the heightened global trade tensions and disruptions that are contributing to increased uncertainty around Kenya's inflation outlook. In addition, fragmented global supply chains may drive up import costs, while climate-related risks, including extreme weather events, may also lead to higher domestic food prices. Despite recent easing of US-China trade tensions, structural risks remain due to elevated US tariffs and persistent policy uncertainty.

Figure 1: Inflation trends and drivers

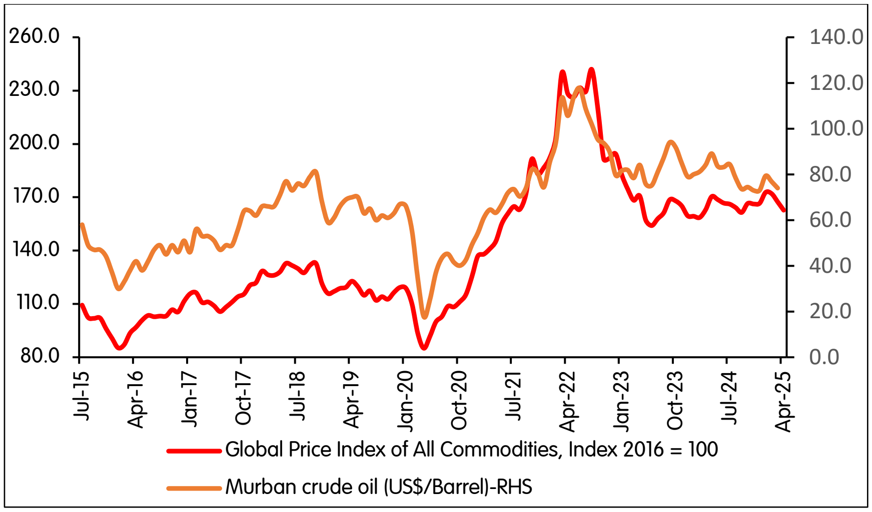
1a: Trends in headline inflation | **1b: Drivers of headline inflation**



Source: *CBK and KNBS*

[1] *Petrol inflation declined by 9.4 %, diesel by 7.9 % while Electricity (200 kilowatts) declined by 4.2 %.*

1c: Trends in Global Price Index of All Commodities and Murban Crude oil

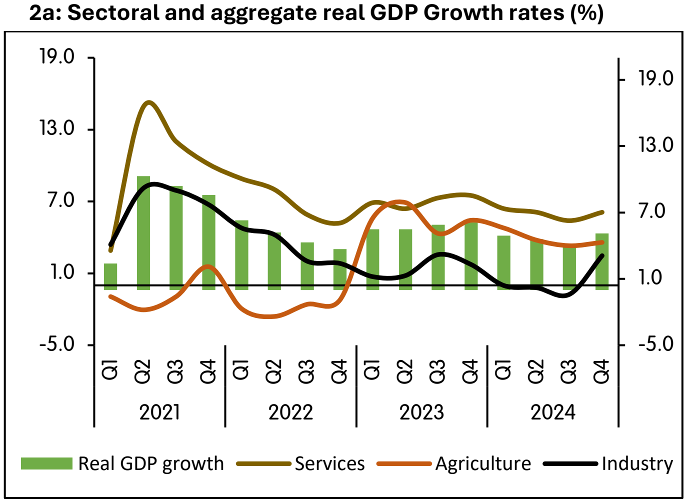


Source: Oil price.com and IMF Commodity prices

Second, Kenya's economy posted resilience in 2024; having recorded a 4.7% growth, supported by strong services and agriculture. Available data for first five months of 2025 show improved business sentiment and a signal recovery. The economy expanded by 5.1 percent in fourth quarter of 2024, yielding 4.7% growth in the full year 2024, supported by resilient performance in the services sector (6.1%) and moderate growth in agriculture (4.3%) (**Figure 2a)**. Higher frequency indicators of economic performance, as shown by the Purchasing Managers Index (PMI) rose for the third consecutive month to 52.0 in April 2025, up from 51.7 in March 2025, marking the highest level since January 2023 (**Figure 2b)**. The improvement was driven by strengthening customer demand, which spurred the fastest rise in new orders in over three years. This, in turn, led to a solid expansion in output, sharp growth in purchasing activity, and accelerated job creation as firms sought to ease workload pressures. Despite rising demand, cost inflation remained moderated relative to the historical trend.

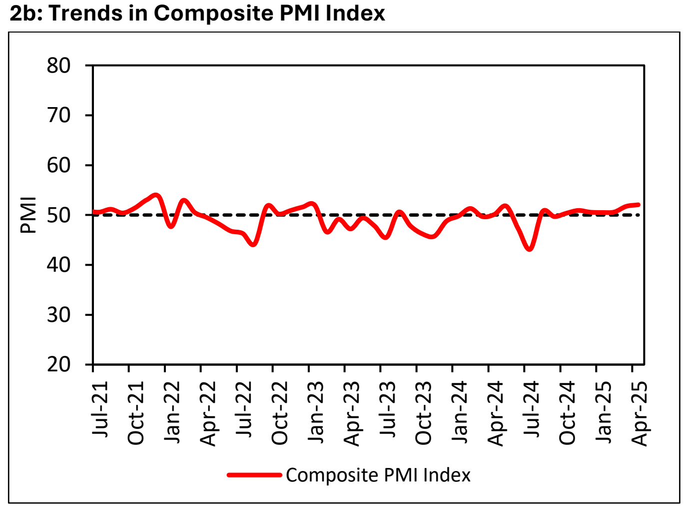
Figure 2: Economic growth outlook

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



Source: KNBS

2b: Trends in Composite PMI Index



Source: IHS Markit

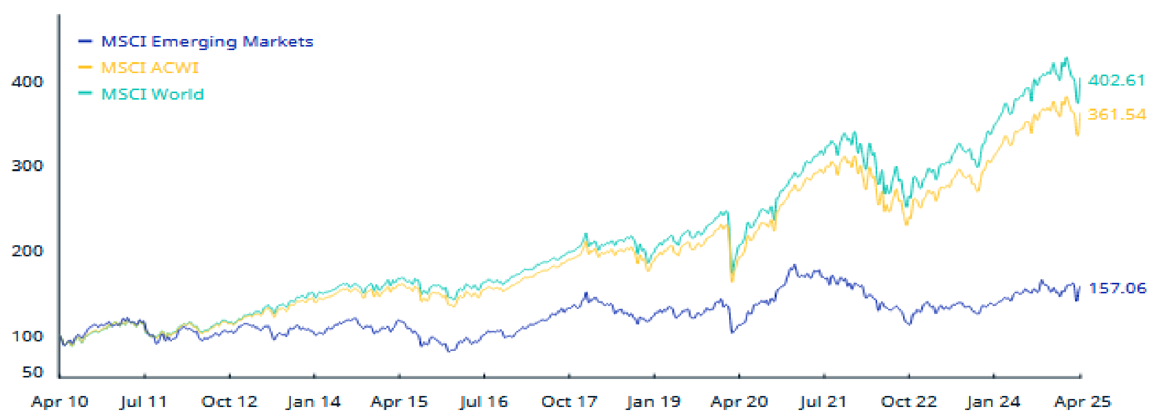
Looking ahead, Kenya's economic growth in 2025 is expected to be driven by continued strength in the services sector and a recovery in agricultural productivity, supported by favourable weather conditions and targeted government interventions. Furthermore, the National Treasury's 2025/26 Budget Statement signals a strategic shift towards a stronger fiscal consolidation. Key priorities include reducing the fiscal deficit to 4.3 % of GDP and stabilizing revenue collection at 17.6% of GDP. To finance the projected deficit, amid persistent expenditure pressures and potential revenue shortfalls, the government plans to consistently reduce and anchor its medium-term debt at 55 % of GDP by 2029.

Nevertheless, downside risks remain. External vulnerabilities, particularly those related to global trade uncertainty, rising protectionism[2], and elevated debt servicing obligations, pose significant challenges to Kenya's growth outlook as a result of their spillover effects. The IMF projects global economic growth to decelerate to 2.8% in 2025, well below the 2000–2019 historical average, as geopolitical tensions, new trade barriers, and policy uncertainty continue to dampen investor sentiment and global trade flows. Aligned to the global growth slowdown is the S&P's Global composite PMI which indicates a slowdown in global economic momentum, with softening output and declining business expectations.

Third, domestic financial conditions are improving, with declining lending rates and a modest recovery in private sector credit, despite concerns of elevated credit risk. Analyses of global financial markets volatility shows mixed performances across regions. In particular, and shown in **Figure 3a,** the Morgan Stanley Capital International (MSCI) World and MSCI - ACWI continue to post resilient gains, while Emerging Markets lag amid volatility, reflecting divergent investor sentiment, fundamentals, and exposure to global trade and debt risks.

Figure 3: Financial Market Dynamics

3a: MSCI Index performance -Net returns (USD)



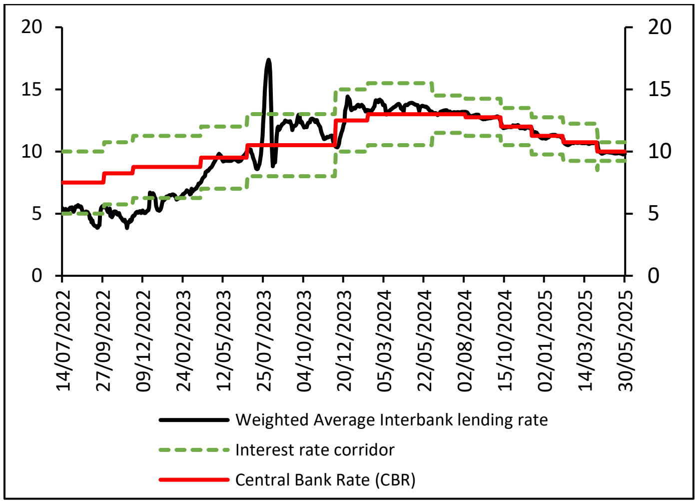
Source: MSCI

Domestically, interest rates have generally declined mirroring the successive cuts in the Central Bank Rate (CBR). The average interbank rate has remained with its official corridor limits and commercial bank lending rates have fallen to average 15.8% in March 2025 2025 (**Figure 3b).** Moreover, the Central Bank of Kenya Credit officer survey[3] shows that during the first quarter of 2025, credit demand has is on the rise particularly in trade. However, banks remain cautious in lending; keeping tight lending standards to avert a further buildup amidst elevated NPLs ratios across most sectors. Banks continue to intensify recovery efforts to minimize the need to increase provisioning for expected credit losses.

[2] *Between January 20 and April 11, 2025, the United States implemented a series of escalating tariff measures. Initial actions included a 20% tariff on Chinese imports, 25% tariffs on steel and aluminum, 25% tariffs on goods from Mexico and Canada, and a 10% tariff on Canadian energy imports. On April 2, 2025, the U.S. introduced additional tariffs targeting the auto sector and specific countries. These were followed by further adjustments on April 9, which raised tariffs on Chinese imports to 145 percent while reducing other country-specific tariffs to 10% . Exemptions for select electronic products were announced on April 11, 2025.*

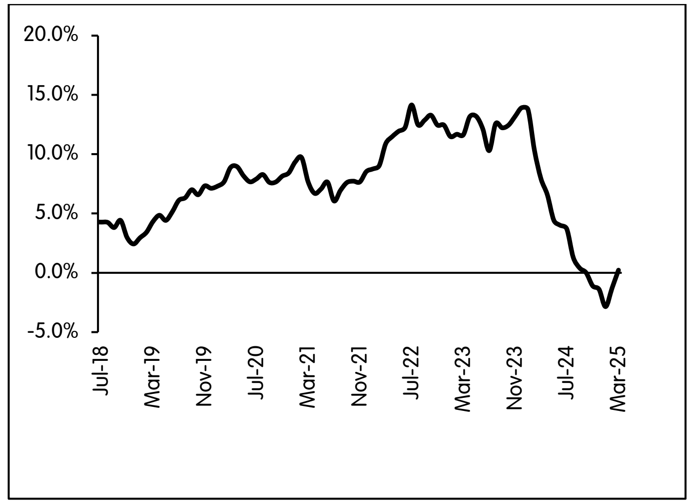
[3] https://www.centralbank.go.ke/uploads/banking_sector_reports/1764041771_Credit%20Survey%20Report%20for%20the%20Quarter%20ended%20March%202025.pdf

3b: Interbank rate remains within the interest rate corridor



Source: CBK

3c: Trends in Credit to the private sector growth (%)



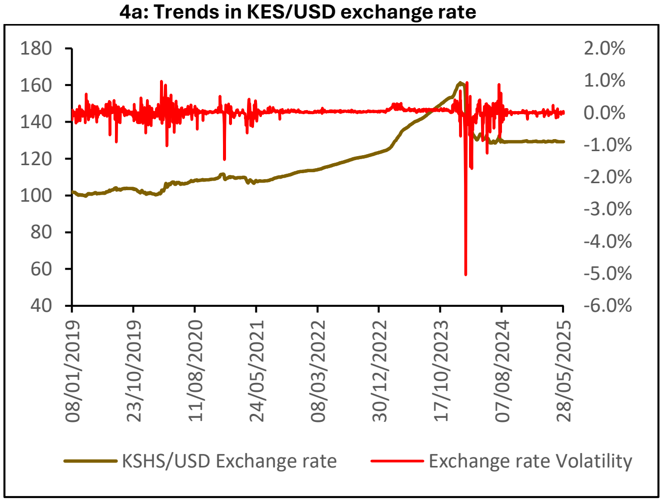
Source: CBK

Bank lending to the private sector increased marginally but remained below historical trends, reflecting subdued demand and tighter lending standards (**Figure 3c)**. In March 2025, overall private sector credit grew by 0.22 % year-on-year, primarily driven by increased lending in the personal and household, trade, and building and construction sectors. Over the same period, gross non-performing loans to gross loans ratio deteriorated from 16.4% in December 2024, to 17.4 % in March 2025; reflecting elevated credit risk.

Fourth, the foreign exchange market remains stable, anchored on a steady current account deficit and strong diaspora remittances, despite headwinds from uncertainty arising from global trade tariffs. As illustrated in **Figure 4a**, the KES/USD exchange rate remains stable, despite escalating headwinds on the U.S. dollar arising from the US tariff measures that are expected to affect global trade and potentially trigger inflationary pressures and further delay interest rate cuts by the Federal Reserve Bank. Despite these emerging market shocks, Kenya's current account deficit remains largely stable albeit widening moderately (**Figure 4b**). This development, alongside a stronger official foreign exchange reserves position (estimated at USD 10,467 million or 4.7 months of import cover as of 29th May 2025) continue to anchor confidence and provide a strong buffer against any emerging short-term shocks in the foreign exchange market.

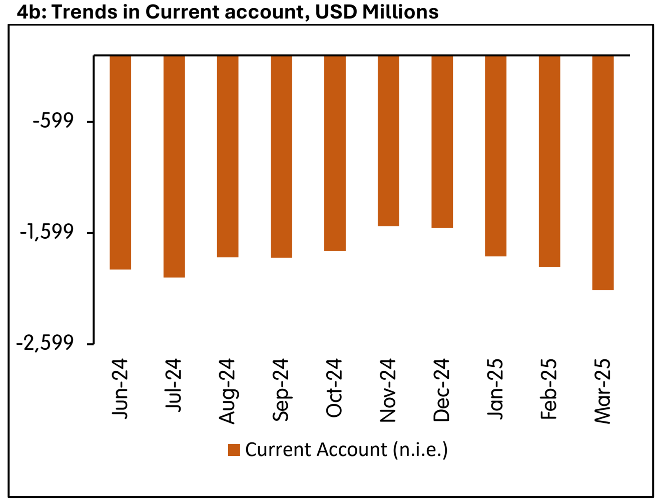
Figure 4: Exchange Rate movement and its drivers

4a: Trends in KES/USD exchange rate



Source: CBK

4b: Trends in Current account, USD Millions



Source: CBK and KNBS

Conclusion

In view of these developments, an assessment of the balance of risks particularly on the exchange rate, and to allow time for a stronger pass-through of previous policy measures to filter through the market, we opine that keeping the policy stance unchanged by maintaining the CBR at 10.00% over the near term would be appropriate.

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