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Research Note

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A call to sustain the current monetary policy stance to support economic recovery with easing inflationary expectations

"With favorable inflationary outlook, and the need to bolster economic recovery, sustaining the current monetary policy stance is warranted...

Highlights

At its meeting scheduled on **29th September 2022**, the Central Bank of Kenya's Monetary Policy Committee (MPC) would be seeking to strike a balance between taming current inflationary pressure on one hand and supporting economic recovery on the other. In this regard, four critical considerations are expected to underpin the policy discussion:

- First, while the current overall inflation remains elevated – above the government's upper target limit of 7.5 percent, inflationary expectations are easing largely driven by a decline in global oil prices;
- Second, economic activity softened in the second and third quarters of 2022 on election jitters and uncertainty, despite a stellar performance recorded in the first quarter;
- Third, private sector credit growth sustained strong double-digit growth rates for the fourth month in a row in June, projecting stronger impetus to economic growth in the coming months; and
- Fourth, is a notable improvement in the economy's external sector performance with a slight narrowing of the current account deficit ratio to GDP, driven largely by improvement in global oil and other commodity prices.

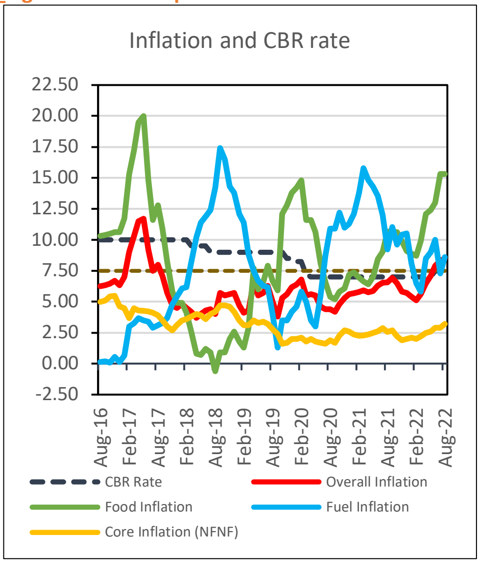
In view of the above developments and a balance of risks, sustaining the current monetary policy stance is warranted, to anchor inflationary expectations and at the same time protect the ongoing economic recovery. This is particularly important with enhanced optimism about the performance of the economy following the peaceful conduct of the general elections in August and the smooth transition in Government.

Background

The MPC meeting of September 29 is expected to provide guidance on the policy direction for the short to medium term; striking a balance between the elevated inflationary pressures and revamping the economic recovery that was underway in the first half of 2022. Four critical factors are expected to underpin the upcoming decision of the MPC:

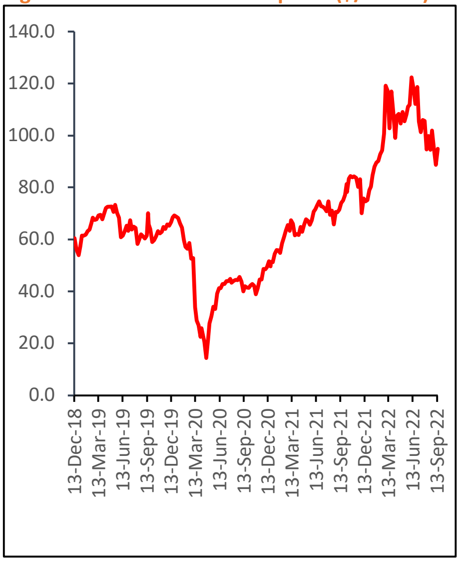
First, while current overall inflation remains elevated – above the government's upper target limit of 7.5 percent - inflationary expectations are easing largely driven by a decline in global oil prices. Overall inflation in August remained elevated, rising further to 8.5 percent from 8.3 percent in July (**Figure 1a**), driven by sustained increases in fuel prices amidst high food prices. In particular, food inflation remained high and largely unchanged at 15.3 percent in August as fuel inflation rose to 8.6 percent on account of a sustained increase in global oil prices. Core inflation – which represents demand pressures in the economy - also edged up to 3.20 percent over the period, reflecting the sustained build-up in demand from the relatively depressed economy over a similar period in 2021. Going forward, easing global oil prices (**Figure 1b**) and other commodity prices (**Figure 1c**) are expected to provide some reprieve on the increases in prices of consumer goods in the domestic market.

Figure 1a: Developments in Inflation



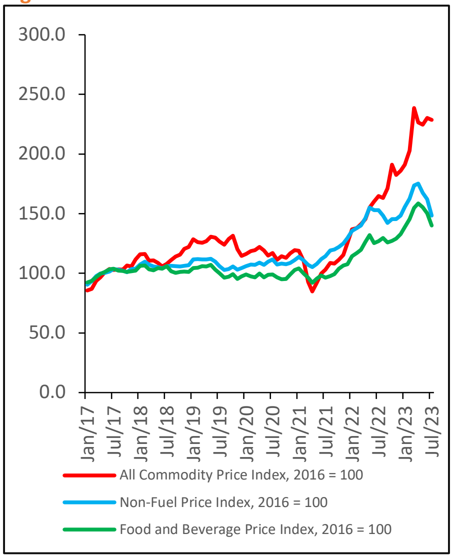
Source: Central Bank of Kenya

Figure 1b: Murban crude oil prices($/barrel)



Source: Oilprices.com

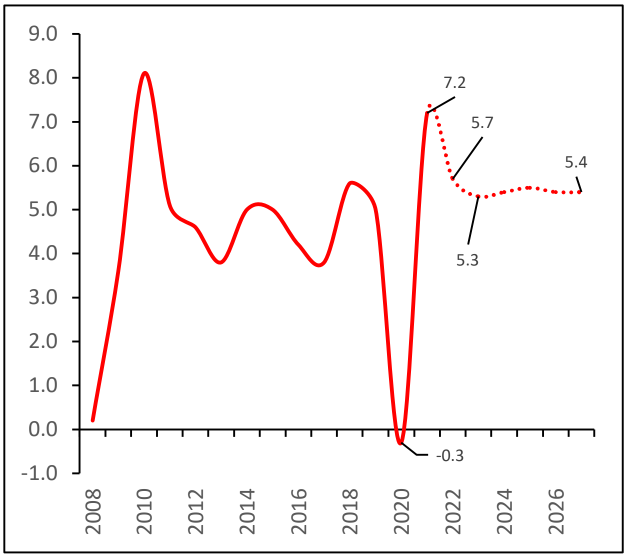
Figure 1c: Evolution of Global Prices



Source: IMF Commodity Prices Database

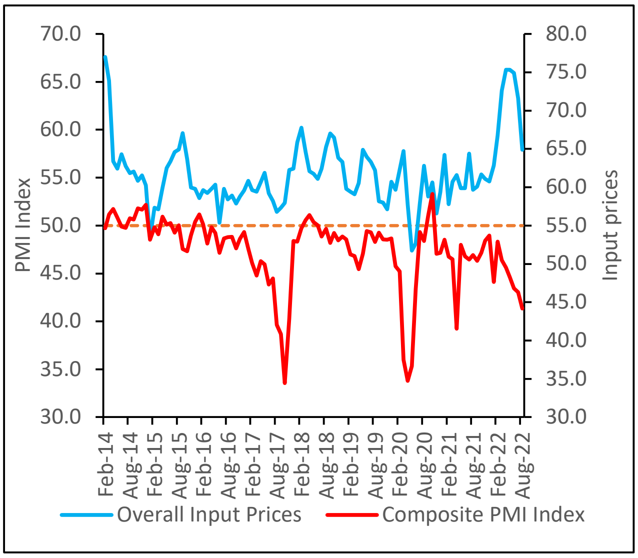
Second, economic activity softened in the second and third quarters of 2022 on election jitters and uncertainty, despite a stellar performance recorded in the first quarter. In the first quarter of 2022, the economy grew by 6.8 percent compared to 2.7 percent in a similar period in 2021 (KNBS, 2022). The observed growth was broad-based, except for agriculture which depicted a contraction largely on depressed rains over the period. Overall, nonetheless, economic growth in 2022 is expected to be supported by a spillover from the strong recovery in 2021. However, risks from the war in Ukraine and drought condition in the country may soften the recovery, to range between 5.5 percent (World Bank, June 2022) and 5.7 percent (IMF WEO, April 2022) as shown in **Figure 2a**. Leading economic indicators, as captured by the Kenya Purchasing Managers' Index™ (PMI™) that declined to 44.2 in August from 46.3 in July (**Figure 2b**), show a month-after-month reduction in economic activity. The decline in economic activity typically characterized periods preceding general elections in Kenya – as investors adopt a wait-and-see approach to scaling up their business. With the peaceful and non-disruptive elections and the smooth transition in government witnessed in the country, business sentiment has been enhanced which would be supportive of stronger economic activities in the fourth quarter and beyond.

Figure 2a: Real GDP growth (Annual % change)



Source: IMF WEO, April 2022

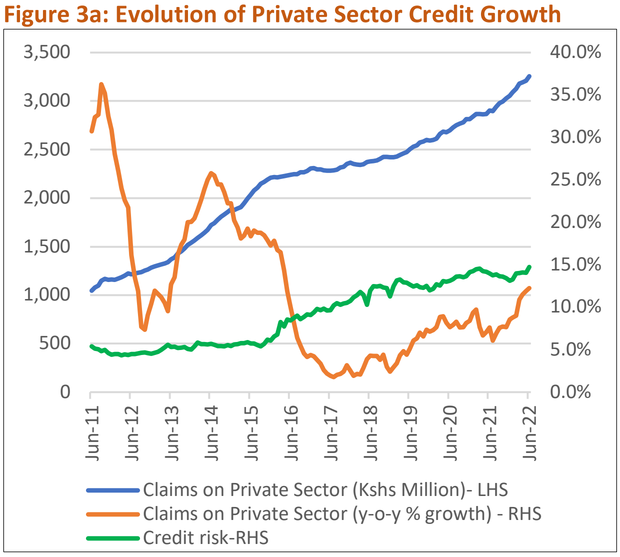
Figure 2b: Evolution of Purchasing Managers' Index



Source: IHS Markit®

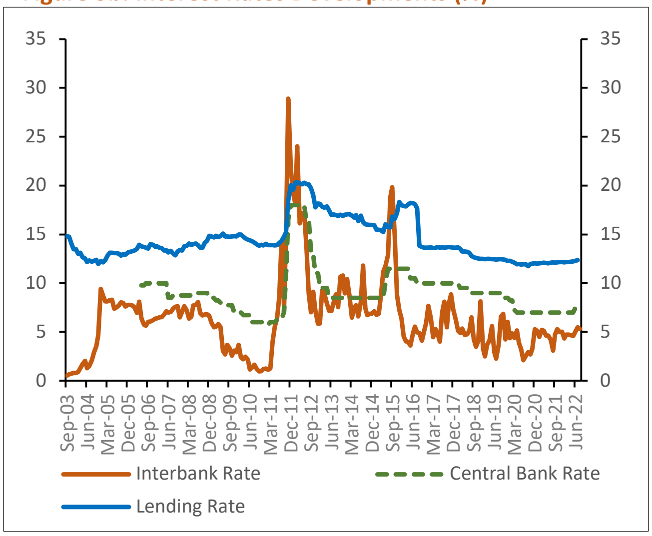
Third, private sector credit growth sustained strong double-digit growth rates, projecting a stronger impetus to economic growth in the coming months. Private sector credit grew by 12.3 percent in June; sustaining double-digit growth for the fourth month in a row (**Figure 3a**). This is indicative of an underlying recovery in economic activity from the depressing effects of COVID-19 in 2020 and 2021(**Figure 3b**). The growth in private sector credit was supported by a flattening out of credit risk as depicted by the NPLs ratio to gross loans (**Figure 3a**) which was partly reflected in the largely unchanged lending rates (**Figure 3b**). An additional contributory factor was the enhanced approvals in risk-based credit pricing models for commercial banks by the Central Bank of Kenya, which supported banks to take up more risk given their ability to alter risk premiums in loan prices.

Figure 3a: Evolution of Private Sector Credit Growth



Source: Central Bank of Kenya

Figure 3b: Interest Rates Developments (%)



Source: Central Bank of Kenya

Fourth, is a notable improvement in the economy's external sector performance with a slight narrowing of the current account deficit ratio to GDP, driven largely by improvement in global oil and other commodity prices. Over the last two months, the exchange rate of the Shilling versus the US dollar sustained its weakening trend (**Figure 4a**), but in a less-volatile manner supported by a narrowing of the current account deficit (**Figure 4b**). The 12-month current-account deficit, estimated at 5.1 percent of GDP in July 2022, reflected a slight improvement in the country's external position when compared to a similar period in 2021, on account of easing global commodity prices -particularly oil- in the international markets, steady growth in immigrant remittances flows and sustained confidence in the economy to meet short-term shocks. Remittance inflows in August 2022 stood at USD 310.5 million comparable to USD 312.9 million in August 2021 (**Figure 4c**). The official usable foreign-exchange reserves that stood at US$ 7,372 million on September 15th, equivalent to 4.2 months of import cover (**Figure 4d**) remained adequate to cover any emerging short-term shocks in the foreign exchange market. The narrowing current account deficit and strong inflows of remittances were the supportive fundamentals that eased the volatility of the exchange rate.

Figure 4a: Nominal exchange rate (KES/USD)

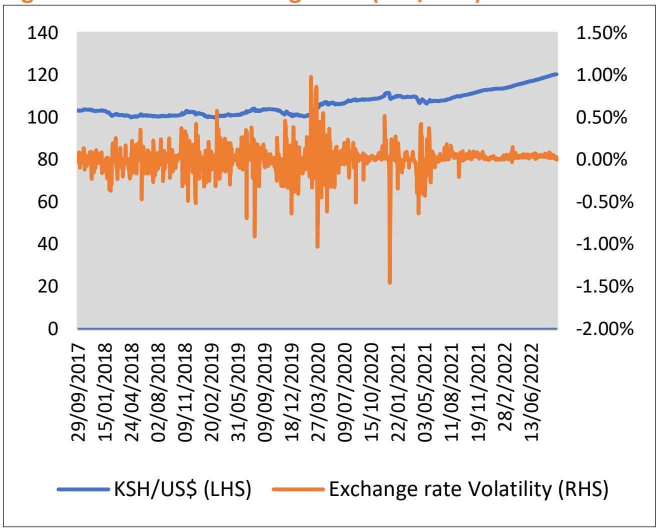


Figure 4b: Current account (%of GDP)

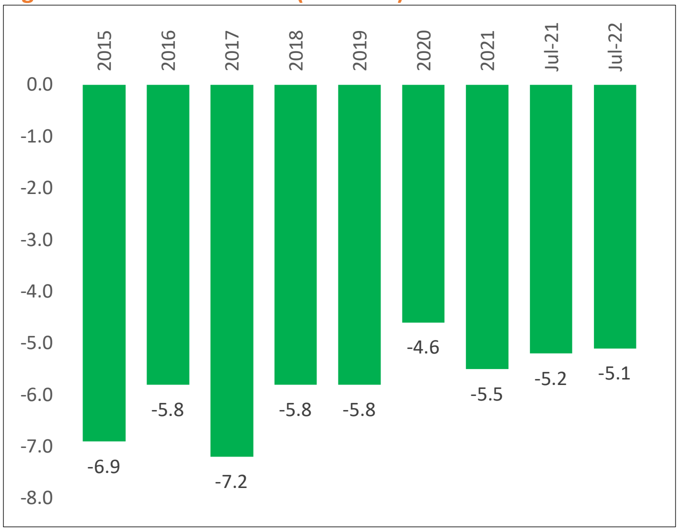


Figure 4c: Remittances Inflows

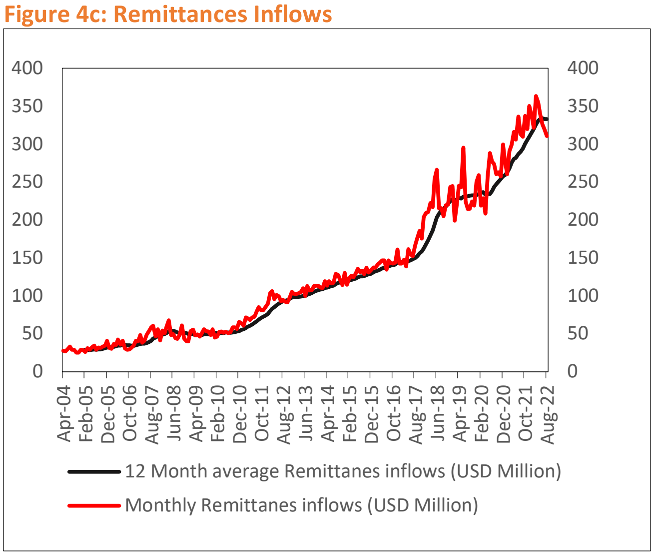
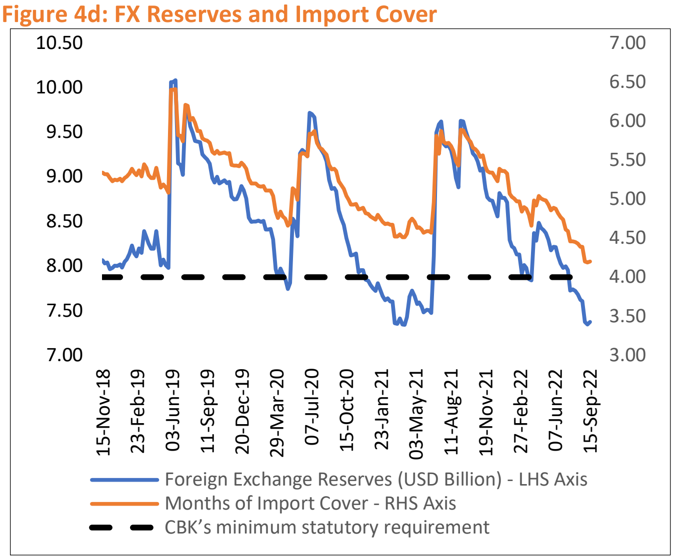


Figure 4d: FX Reserves and Import Cover



Source: Central Bank of Kenya

Conclusion

At its meeting scheduled on **29th September 2022**, the MPC is expected to strike a balance between taming inflationary pressures on one hand and supporting economic recovery on the other. Other considerations include the sustained strong growth in private sector credit and an improvement in the external sector of the economy. In view of these developments and a balance of risks going forward, sustaining the current monetary policy stance is warranted, to anchor inflationary expectations and at the same time protect the ongoing economic recovery. This is particularly important with enhanced optimism about the performance of the economy following the peaceful conduct of the general elections in August and the smooth transition in Government.

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