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Research Note

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Amidst High Inflationary Pressures and Expectations, and Waning Economic Recovery, a Hold on Interest Rates would be Appropriate

Highlights

The CBK Monetary Policy Committee (MPC) is expected to take a decision on the policy stance for the near- to medium term during its meeting on **29th May 2023**, amidst softening inflationary pressures, elevated global and domestic interest rates and waning economic recovery. The decision is expected to be underpinned by four key macroeconomic developments and considerations:

- First, inflationary pressures have softened driven by easing food price increases, but overall inflation remains above the target range with strong probabilities of a reversal;
- Second, despite the economy depicting some resilience in 2022 and expanding by a modest 4.8 percent, leading indicators for 2023 show some fragility;
- Third, private sector credit continued to post a double-digit growth in 2023 despite at a decelerating pace, reflecting the impact of the transmission of the strong monetary policy tightening effected since May 2022 and the deteriorated industry asset quality;
- Fourth, the external sector developments depict some fragility largely driven by the sustained wide current account deficit that continues to fundamentally exert pressure on the exchange rate to weaken.

“Trade-off between high inflation and the need to preserve economic recovery calls for a hold on CBR...”

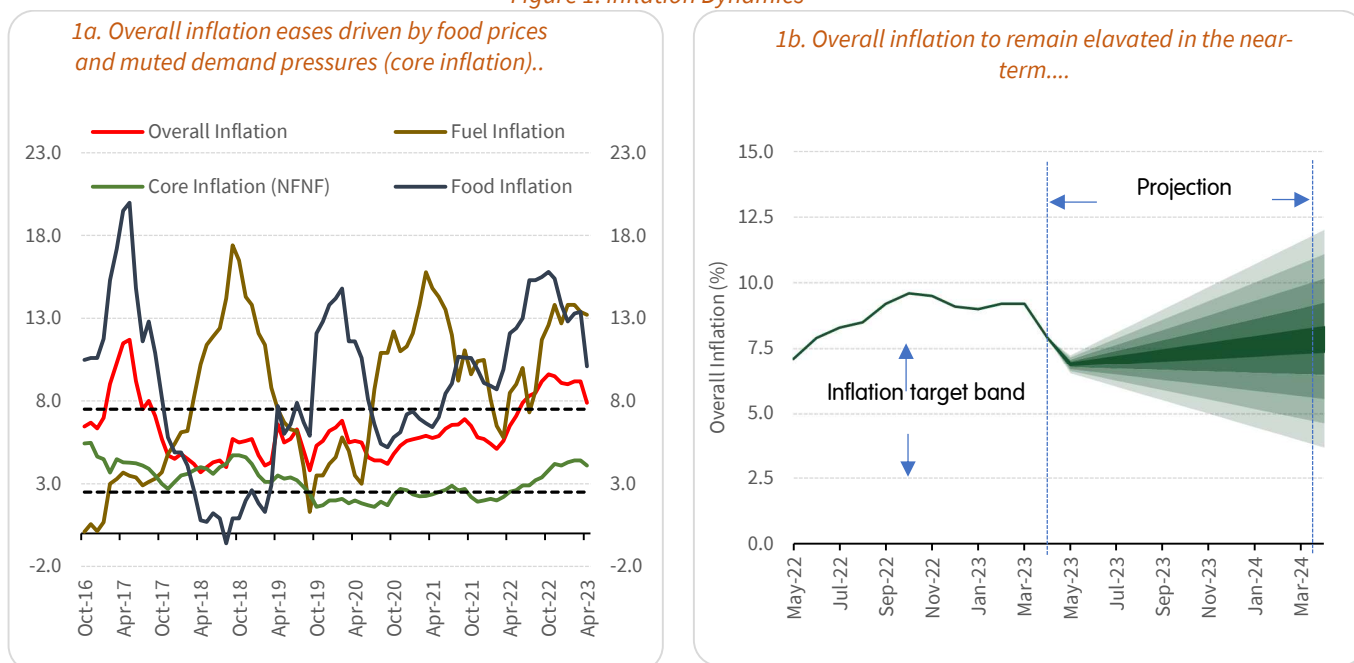
In view of the above developments, and the balance of risks on inflationary pressures and economic growth preservation, we argue that the sustenance of the current monetary policy stance – in keeping the CBR unchanged at 9.50 percent - would be appropriate.

Background

This Research Note provides a brief review of four key macroeconomic developments and considerations that are expected to underpin the decision of the CBK's Monetary Policy Committee on **29th May 2023**:

First, inflationary pressures have softened driven by easing food price increases, but overall inflation remains above the target range with strong probabilities of a reversal. Overall inflation in April 2023 eased to 7.9% - edging closer to the upper bound (7.5%) of the inflation target - from 9.2% in March on account of a decline in food inflation to 10.1% from 13.4% in March and a slight moderation in core inflation to 4.1% from 4.4% over the period. However, fuel inflation remained elevated during the period at 13.2%. Being an intermediate good, this reflects some inherent pressures for most consumer goods to remain high (Figure 1a). Going forward, the balance of risks for the trajectory of inflation in the short term remains biased to the upside (Figure 1b), owing to the expected coming into effect of the new fuel tax proposals contained in the Finance Bill 2023; the continuing geopolitical tensions and their impact on food and fuel prices, and the softening global growth.

Figure 1: Inflation Dynamics



Source: Central Bank of Kenya

Source: KBA Staff computations¹

Second, despite the economy depicting some resilience in 2022 and expanding by a modest 4.8 percent, leading indicators for 2023 show some fragility. Recently published economic data shows that the economy in 2022 - amidst multiple global and domestic shocks - expanded by 4.8% compared to 7.6% growth in 2021 (Figure 2a). The modest growth was supported by the services sector whose growth was the highest at 7.0% (down from 9.8% in 2021), and industrial sector at 3.9%, down from 7.5% in 2021, as manufacturing activity remained depressed (Figure 2c). Agriculture, despite being the 'backbone' of the economy, continued on a contraction trajectory, narrowing by 1.6% during the period compared with a contraction by 0.4% in 2021 (as shown in Figure 2b) on adverse weather conditions experienced across the country.

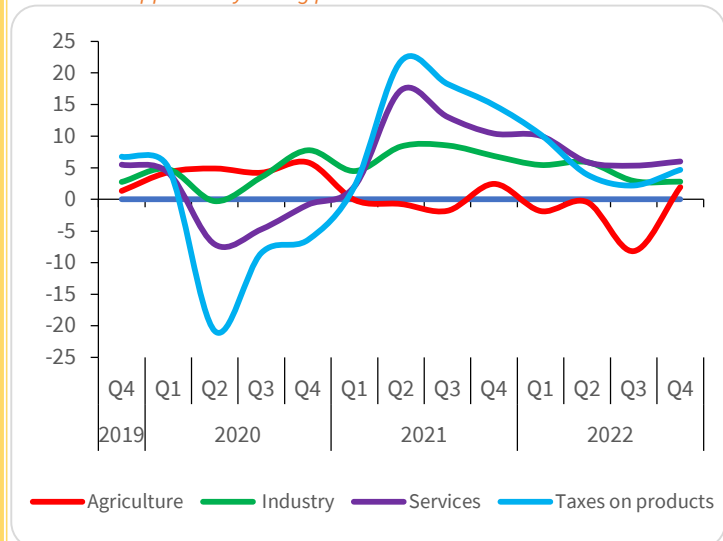
Leading economic indicators – such as the Kenya Purchasing Managers' Index™ (PMI) fell to 47.2 in April from 49.2 in March 2023 (Figure 2d) for the third month in a row indicating a sustained deterioration in private sector business activity. In fact, most sub-indicators show decreased input purchases and rising output prices, and significant drops in outputs in manufacturing and services. With the waning economic activity, the economy going forward is likely to post slower-than-

¹ The fan chart captures the most probable inflation outcomes. The deeper the colour the more probable the outcome going forward.

projected growth rates (of 6.2% by CBK and 5.0% by the World Bank posted in early 2023), unless stronger policies to support some economic activities are deployed.

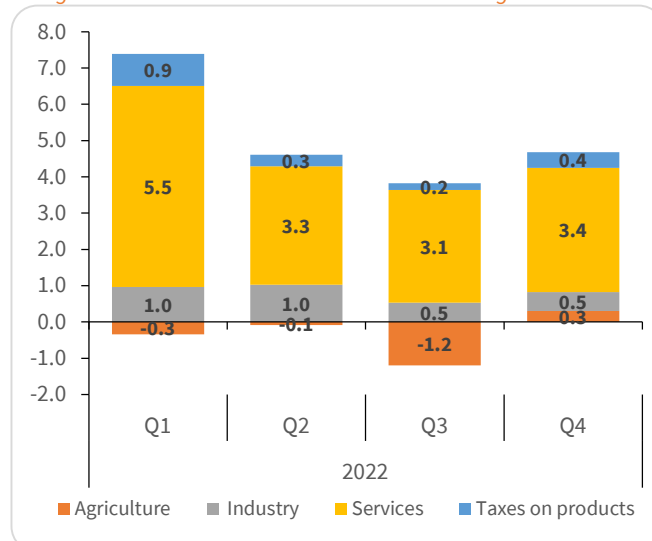
Figure 2: Indicators of Economic Activity

2a. Growth supported by strong performance of the services sector..



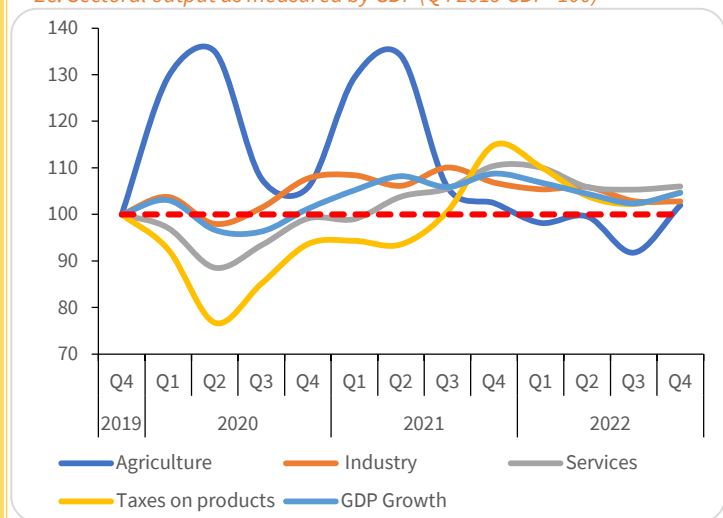
Source: CBK & KNBS

2b. Agriculture sector's contraction sustained through 2022...



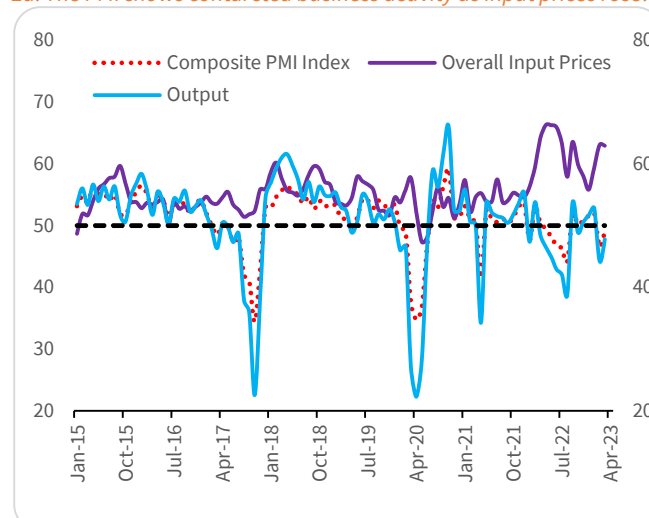
Source: KBA based on KNBS Data

2c. Sectoral output as measured by GDP (Q4 2019 GDP=100)



Source: CBK & KNBS

2d. The PMI shows contracted business activity as input prices rose...



Source: IHS Markit

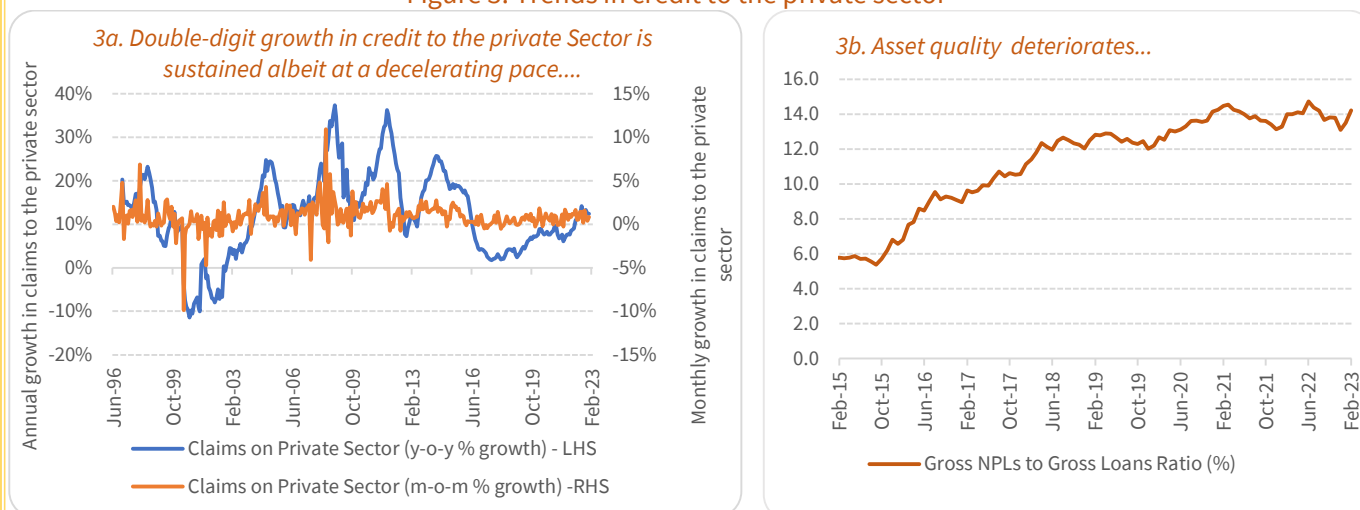
Third, private sector credit continued to post a double-digit growth in 2023 despite at a decelerating pace, reflecting the impact of the transmission of the strong monetary policy tightening effected since May 2022 and the deteriorated industry asset quality. Latest published data shows that private sector credit growth decelerated in February to 11.7% from 12.7% in December 2022 (Figure 3a). Despite this, strong double-digit growth was observed in manufacturing (whose credit grew by 15.2%), transport and communication (16.5%), trade (11.8%), and consumer durables (12.4%).

The deceleration in private sector credit mirrored the deterioration in the industry asset quality with the non-performing loan (NPL) ratio rising to 14.0% in February 2023 from 13.3% in December 2022 (Figure 3b) owing mainly to a deterioration in the industry's portfolios in trade, personal and household, manufacturing and, building and construction sectors. In addition, the rise in interbank rates and banks' lending rates (Figures 4a& 4b) - in line with expectations following the

successive hikes in the Central Bank Rate in the second half of 2022 - saw the interbank (overnight) rates rise steadily to 9.3% as of 11 May 2023, from an average of 5.4% in December 2022, and the average banking sector lending rate increased to 13.1% in February 2023 from 12.7% in December. The upward adjustments in lending rates constrained demand for loans during the period.

Going forward, expectations of a slowdown in economic growth and elevated inflationary pressures in 2023 are likely to further exacerbate credit risks and thus asset-quality deterioration, thereby further slowing down private-sector credit loan growth.

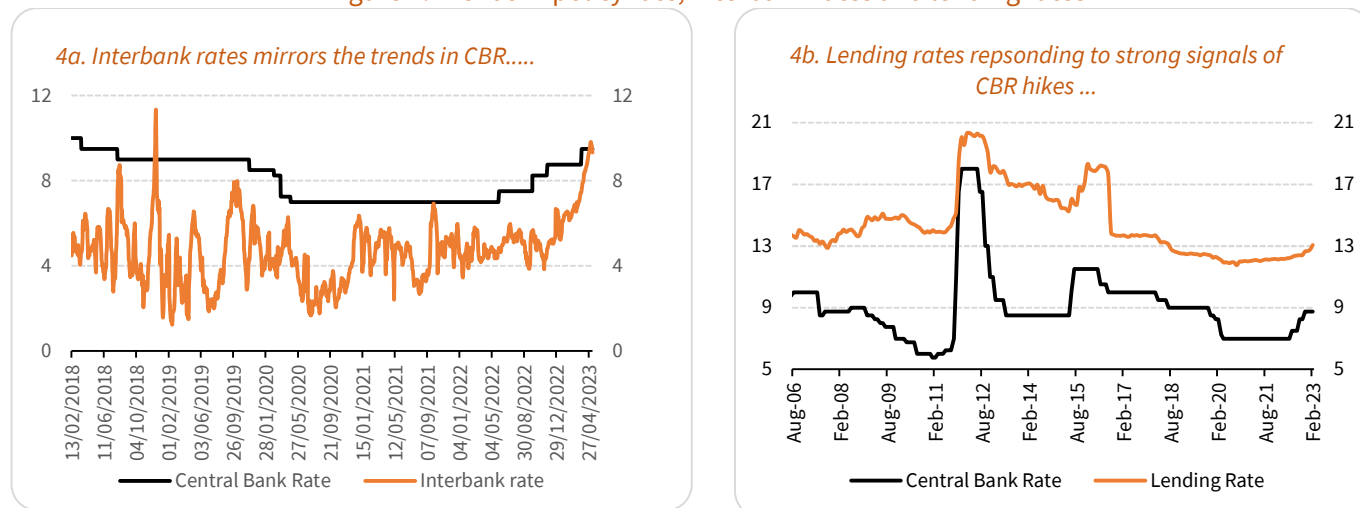
Figure 3: Trends in credit to the private sector



Source: KBA based on CBK data

Source: CBK

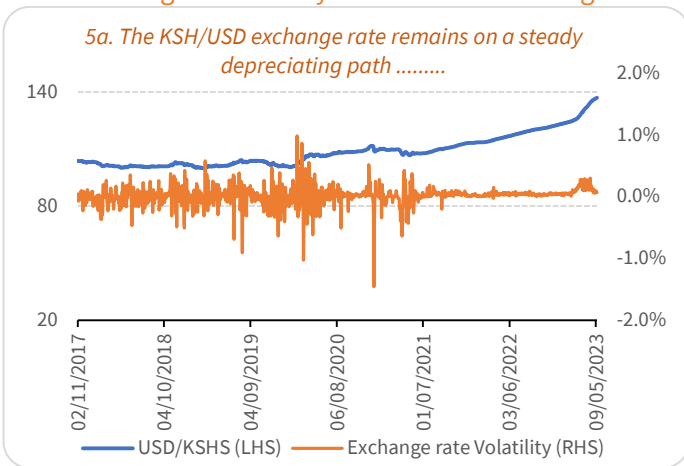
Figure 4: Trends in policy rate, interbank rates and lending rates



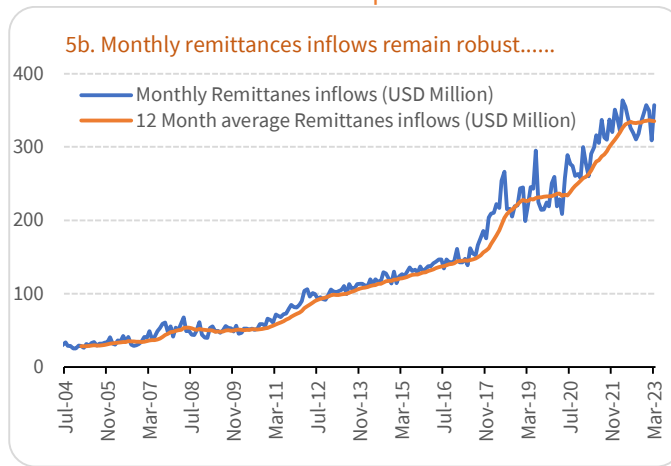
Source: CBK

Fourth, the external sector developments depict some fragility largely driven by the sustained wide current account deficit that continues to fundamentally exert pressure on the exchange rate to weaken. The Kenya shilling exchange rate has sustained its depreciating trend against the US dollar (Figure 5a), despite the strong and resilient inflows of diaspora remittances (Figure 5b) and easing oil prices (Figure 5c). The depreciation is on account of dwindling official foreign exchange reserves (Figure 5d) – that stood at USD 6,297 million (or 3.50 months of import cover) as of 18 May 2023, below the CBK’s statutory minimum requirement of 4 months of import cover – and continues to adversely affect market confidence on the country’s ability to effectively deal with any emergent foreign exchange market shocks; a wide current account deficit (Figure 5e); and the trend narrowing of Foreign Direct Investment (FDI), portfolio and financial net inflows (Figure 5f) as US dollar investments become more attractive in global markets.

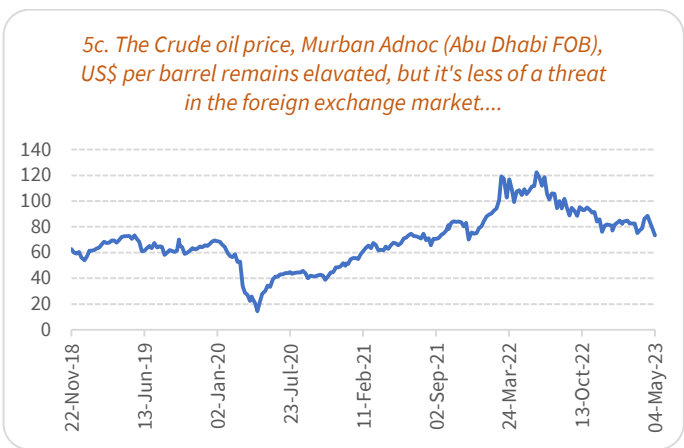
Figure 5: The Dynamics of the exchange rate market and external sector developments



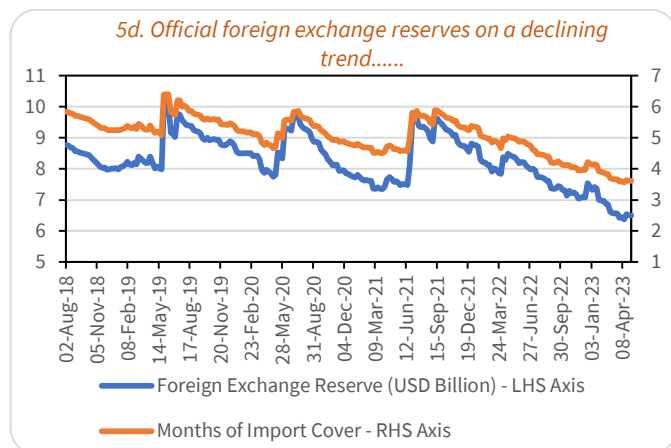
Source: CBK



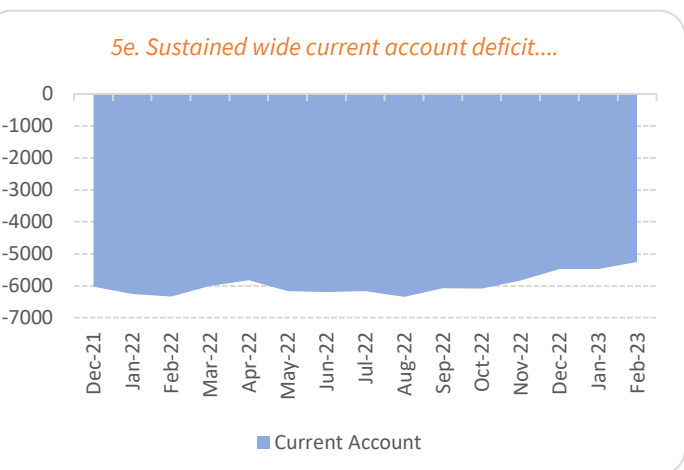
Source: CBK



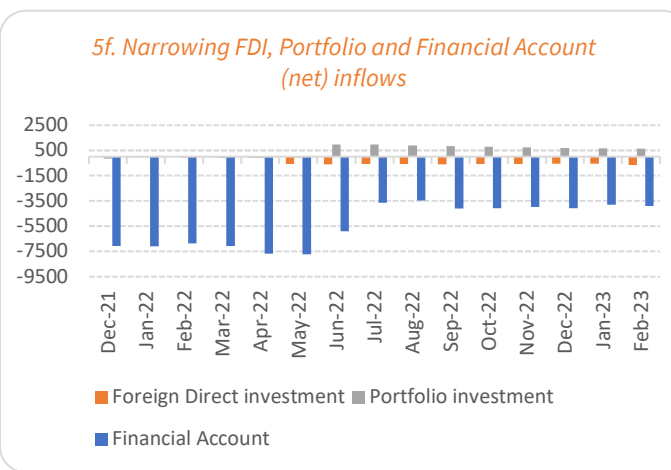
Source: Oilprice.com



Source: CBK



Source: CBK



Source: CBK

Conclusion

The Central Bank of Kenya's MPC meeting of 29 May 2023 is expected to announce the monetary policy stance to be adopted in the near to medium term. Underpinning this decision will be the trade-off between providing a stronger signal to tame inflation that, though eased, remains elevated, rising inflationary expectations in the outlook, and the need to support economic activity amidst waning prospects. Other critical developments of interest would be the decelerating private sector credit growth and deteriorated asset quality and fragilities of the external sector that continue to pose risks on the stability of the exchange rate. *Against these developments and the balance of risks, we argue that the sustenance of the current monetary policy stance – in keeping the CBR unchanged at 9.50 percent - would be appropriate.*

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