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FINANCIAL MARKETS AND POLICY®

Research Note

28 MARCH 2024

Research Note No.71 – 2024 (Rn/71/24)

Foreign Exchange Market Pressures have eased off and inflation has cooled off; calling for a hold on Monetary Policy

Highlights

The discussions of the Monetary Policy Committee, during its meeting on **3rd April 2024**, are expected to be anchored on the evolution of inflation, developments in the foreign exchange market and the ongoing transmission of its previous monetary actions:

“Maintaining the current monetary policy stance, in keeping the CBR unchanged, would anchor inflation expectations and support exchange rate stability.”

- Overall inflation has declined, to 6.3% in February 2024; towards the mid-point of the target range;
- Amidst increased prospects for stronger global growth, domestic economic activity is recovering in tandem, as leading indicators signal strong economic performance in early 2024;
- Credit growth remains strong despite an elevated credit risk; reflecting strong uptake of credit for working capital in key sectors;
- The foreign exchange market functioning has improved; anchoring a stable exchange rate, that reflects developments in the fundamentals and improved market sentiment;
- In view of the above developments, we argue that the sustenance of the current monetary policy stance – *in keeping the CBR unchanged at 13.0% - would be appropriate*, to affirm commitment to a path towards low and stable inflation and anchor exchange rate stability, while protecting economic activity;

Background

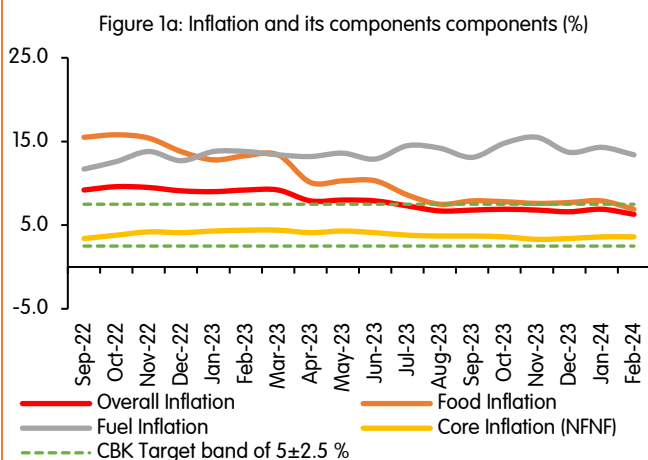
The policy decision during the MPC meeting scheduled for 3rd April 2024 is expected to be anchored on four key factors; ranging from strong economic growth prospects; strong growth in credit, and continuing resolution of inflation and exchange rate pressures.

First, overall inflation has declined, to 6.3% in February 2024; towards the mid-point of the target range. Latest data shows that overall inflation declined to 6.3% in February 2024 from 6.9% in January 2024, towards the midpoint of the target range of 5.0% (Figure 1a). As depicted in Figure 1b, the main drivers of lower inflation included food inflation and fuel inflation. Food inflation eased to 6.9% in February 2024 from 7.9% in January 2024, largely reflecting declining prices of sifted maize flour [by 12.2%] and loose maize grain [9.7%]. These price declines more-than-compensated the increases in the prices of sugar [30.2%] and potatoes (Irish) [11.2%].

Similarly, fuel inflation declined to 13.4% in February 2024 from 14.3% in January 2024, largely due to a drop in prices of electricity [Electricity (50 KWT), Electricity (200 KWT)] and kerosene prices over the period. However, core (Non-food non-fuel, NFNF) inflation remained low, only edging up slightly to 3.6% in February 2024 from 3.4% in December 2023. The risk to inflation is moderate in the near term, with expectations anchored on the recent downward revisions in the domestic pump prices and the declining food prices. Moreover, the benchmark international oil prices have remained low and stable, at USD 85.88 per barrel on 28 March 2024.

Figure 1: Inflation trends and drivers

1a: Inflation and its components



Source: Central Bank of Kenya

1b: Inflation by broad categories and items (%)

Food inflation	6.9	Fuel inflation	13.4
Sugar	30.2%	Electricity (50 KWT)	42.7
Maize flour sifted	(12.2)	Electricity (200 KWT)	31.8
Potatoes (Irish)	11.2	Kerosene	32.1
Maize grain loose	(9.7)	Diesel	20.4
Tomatoes	(0.7)	Petrol	16.2
Fresh packeted cow milk	(0.5)	Gas/LPG	2.7
Core inflation	3.6	Overall Inflation	6.3

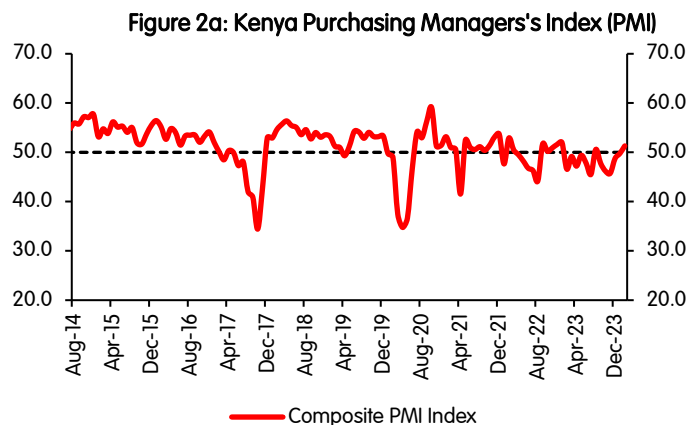
Note: The sub-components represent the percentage Change over last year, that is February 2024/February 2023

Source: Kenya National Bureau of Statistics

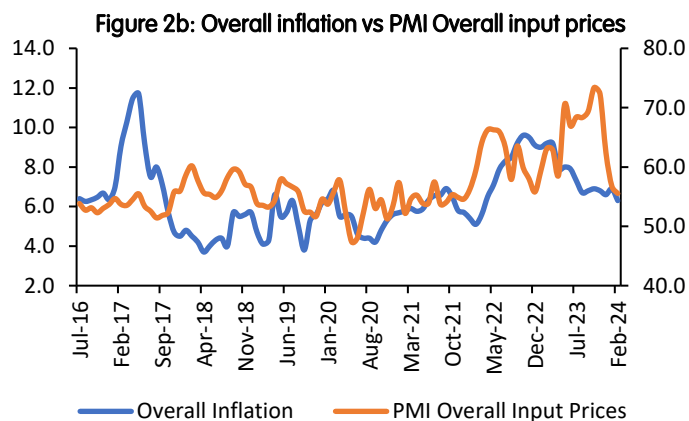
Second, amidst increased prospects for stronger global growth, domestic economic activity is recovering in tandem, as leading indicators signal strong economic performance in early 2024. Global economic growth has been revised upwards to 3.1% for 2024 and 3.2% for 2025 as economies consider unwinding the high interest rate regimes that were put in place to address inflationary pressures. The projections recognize that a major risk is persistence of high inflation that may weigh on economic activity in 2024 (IMF WEO Update, January 2024).

On the domestic economic scene, leading indicators point to strong performance. Composite Purchasing Managers Index (PMI) rose to 51.3 in February 2024 from 49.8 in January 2024; reflecting improved economic performance over the period (Figure 2a), supported by enhanced manufacturing output, new orders, and strong future output expectations (Figure 2c).

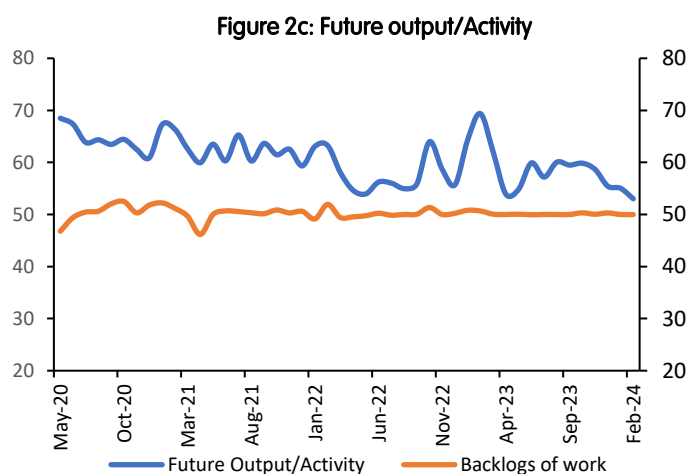
Figure 2: Global and domestic growth prospects



Source: IHS Markit®



Source: IHS Markit®

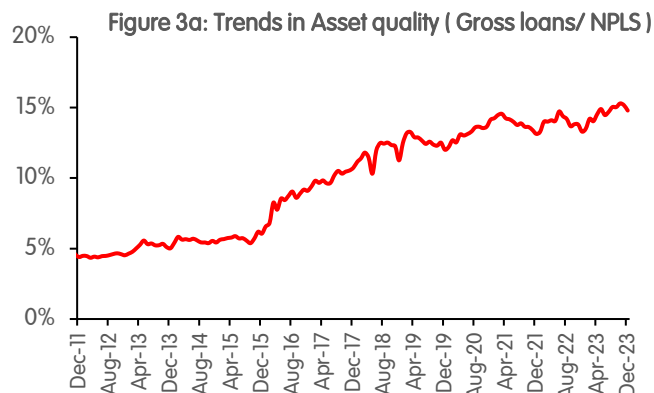


Source: IHS Markit®

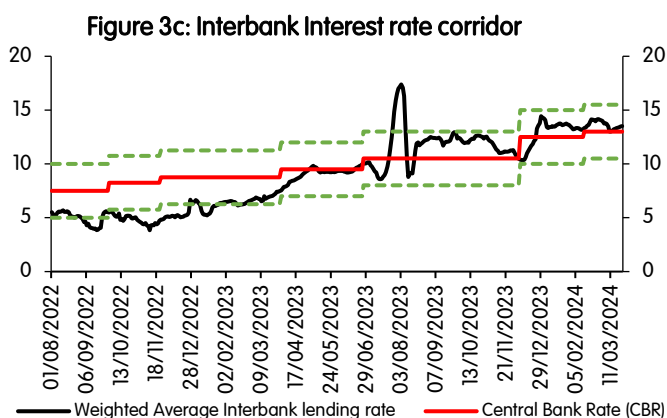
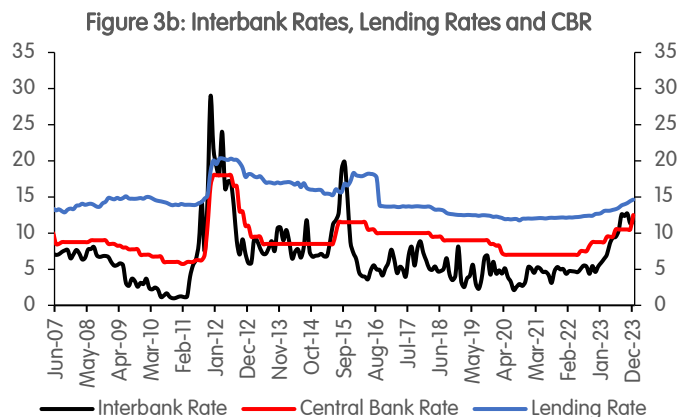
Third, credit growth remains strong despite concerns of elevated credit risk; reflecting strong uptake of credit for working capital in key sectors. Latest published data shows that commercial banks' total lending to the private sector credit grew by 13.9% in December 2023 up from 13.2% in November 2023 (**Figure 3d**), with strong growth in December evident in manufacturing (20.9%), transport and communication (20.8%), trade (13.1%) and consumer durables (9.9%). This was partly driven by a notable decline in the ratio of gross non-performing loans (NPLs) to gross loans, which eased to 14.8% in December from 15.3% in October 2023 (**Figure 3a**).

However, the market outcome on credit was against expectations, given the increase in commercial banks' lending rates, to 14.6% in December 2023 from 12.7% in December 2022 (**Figure 3b**). The rise in lending rates was in response to the consistent incremental tightening of monetary policy that saw the Central Bank Rate increased from 9.50% in May 2023 to 13.00% by February 2024. With the tightening monetary policy stance, its transmission was expected to cause a rise in interbank market rates, but the rates would be fine-tuned to remain within the interbank market interest rate corridor set at $CBR \pm 2.50\%$ (as shown in **Figure 3c**); thereby effectively anchoring market outcomes on the policy stance.

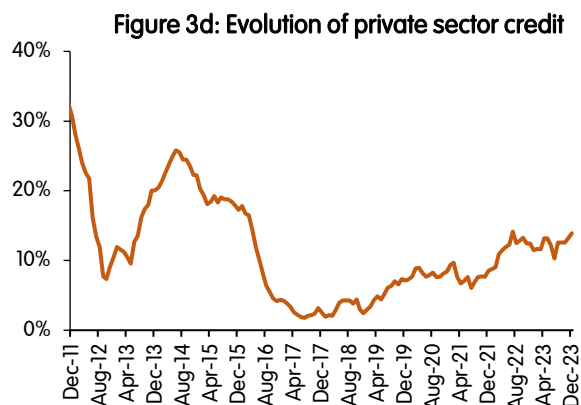
Figure 3: Trends in the Money Market Rates and Private sector credit Growth



Source: Central Bank of Kenya



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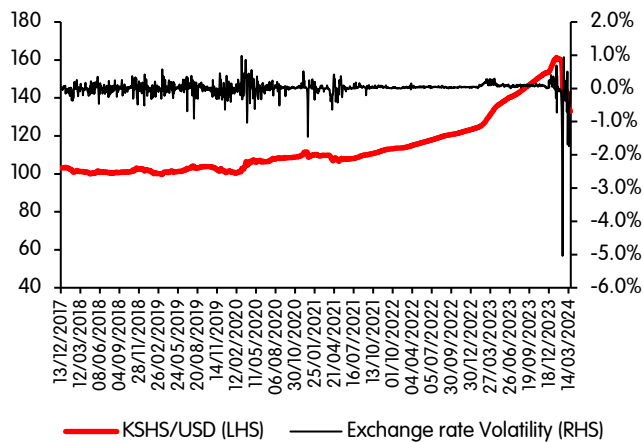
Fourth, the foreign exchange market functioning has improved; anchoring a stable exchange rate, that reflects developments in the fundamentals and improved market sentiment. The Kenya Shilling has been on a strengthening trajectory against the dollar since January 2024. As of 27 March 2024, it averaged Ksh. 131.80 per US dollar, having strengthened by 18.3% since 23rd January 2024 when it peaked at Ksh 161.36 per US dollar (Figure 4a). The Central Bank of Kenya, during its strengthening path, moderated the exchange rate volatility with market interventions.

The Kenya shilling is expected to continue on its strengthening path with improving market fundamentals evident in the narrowing current account deficit (Figure 4b) and capital and financial accounts of the balance of payments (Figure 4c). The current account deficit narrowed to stand at USD 4,259.4 million in December 2023, compared to USD 5,774.2 million in December 2022 (Figure 4b).

Moreover, market sentiment in the foreign exchange market has improved on the government move to effect a successful Eurobond buy-back plan that was heavily over-subscribed and boost its reserves with additional funding from the IMF. Consequently, the CBK foreign exchange reserves recovered to US\$7.2 billion as of 21 March 2024 (equivalent to 3.7 months of imports cover) providing enhanced buffer against any emerging short-term shocks in the foreign exchange market.

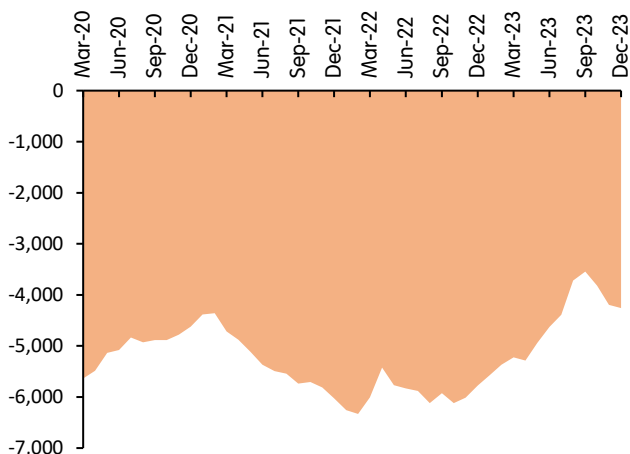
Figure 4: The external sector dynamics

Figure 4a: Trends in KES/USD exchange rate



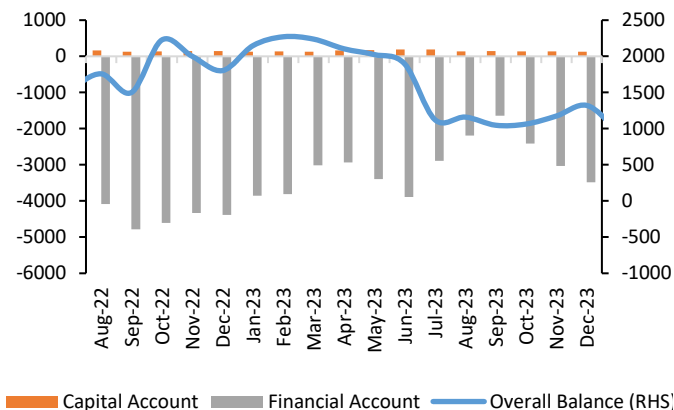
Source: Central Bank of Kenya

Figure 4b: Evolution of the Current Account Deficit



Source: KNBS

Figure 4c: Evolution of the Capital and Financial Accounts (Net Balances in USD Millions)



Source: Kenya National Bureau of Statistics

Conclusion

The Central Bank of Kenya's MPC in its meeting on 3rd April 2024 is expected to announce the monetary policy stance to be adopted in the near to medium term. Four developments are expected to underpin the decision of the MPC. First, there has been a notable decline in the overall inflation towards the mid-point of the target range. Second, amidst increased prospects for stronger global growth, domestic economic activity is recovering in tandem, as leading indicators signal strong economic performance in early 2024. Third, credit growth remains strong despite concerns of elevated credit risk; reflecting strong uptake of credit for working capital in key sectors. Finally, the foreign exchange market functioning has improved; anchoring a stable exchange rate, that reflects developments in the fundamentals and improved market sentiment.

In view of the above developments, we argue that the sustenance of the current monetary policy stance – *in keeping the CBR unchanged at 13.0%* - would be appropriate, to affirm commitment to a path towards low and stable inflation and anchor exchange rate stability while protecting economic activity.

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