



CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY®

Research Note

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Maintain the Policy Rate unchanged at 8.25% to allow the previous rate hikes effected in May and September to be fully transmitted

Highlights

In its meeting on Wednesday, November 23, 2022, the Central Bank of Kenya's (CBK) Monetary Policy Committee (MPC) will be expected to announce a policy stance in light of the following four critical considerations:

- First, inflationary pressures have persisted at elevated levels, with sustained increases in food and fuel inflation, but there are expectations of easing food and fuel prices in the near term;
- Second, the economic recovery remains fragile on account of unpredictable weather patterns and depressed global growth performance;
- Third, a tightening of monetary policy effected in a cumulative 100 basis points increase in the CBR between May and September 2022, continues to be transmitted through the market, with the interbank and lending interest rates depicting some marginal increases. This has triggered a softening in credit growth; and
- Fourth, the exchange rate pressure to weaken has been sustained, though at a softer pace on a slight improvement in domestic economic fundamentals.

On assessment of the market developments and the balance of risks going forward, it is worthwhile to consider maintaining CBR unchanged at 8.25% and allow the cumulative 100 basis points hike effected in May and September to be fully transmitted to higher interest rates in the market.

On assessment of the market developments and the balance of risks going forward, we view that a further rate hike to deal with inflationary pressure may exacerbate the fragility of the economic recovery that is currently underway given its implication on credit growth. It is therefore worthwhile to consider maintaining CBR unchanged at 8.25% and allow the cumulative 100 basis points hike effected in May and September to be fully transmitted to higher interest rates in the market.

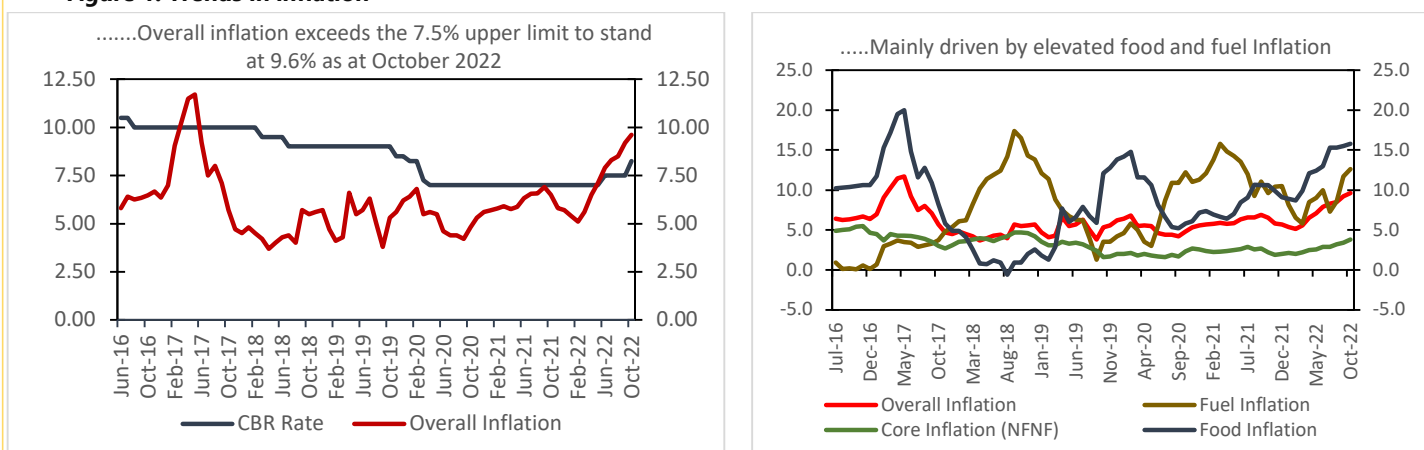
Background

In its meeting on **Wednesday, 23 November 2022**, the Central Bank of Kenya's (CBK) Monetary Policy Committee (MPC) will be faced with two competing and important objectives. First, is taming the protracted inflationary pressure, and second, protecting the ongoing economic recovery that remains fragile. Additionally, keen consideration will be on the evolving global risks and their implications to the domestic economy. Currently, inflationary risks are elevated as evidenced by higher inflation expectations in both developed and emerging economies, escalating Russian-Ukraine war, sustained rise in global commodity prices and stronger monetary policy tightening in advanced economies. On the assessment of the aforementioned, this *Research Note* anchors its arguments on four developments that are likely to be the key considerations as the Monetary Policy Committee (MPC) takes a policy stance on November 23, 2022:

First, inflationary pressures have persisted at elevated levels, with sustained increases in food and fuel inflation.

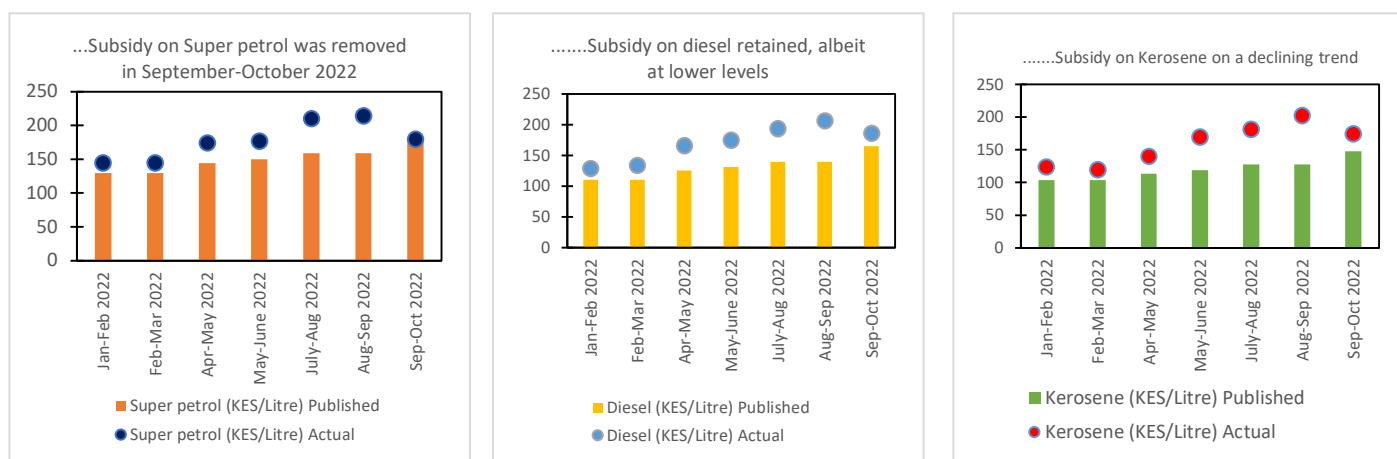
As reflected in **Figure 1A**, the overall inflation increased to 9.6% in October, to build on the momentum that kicked off in February 2022, when it stood at 5.1%. Fuel inflation also edged up from 7.3% in July to 12.6% in October 2022 (**Figure 1B**) on the account of phasing out of the fuel subsidy program (**Figure 2A – 2C**), amid continued high but mildly easing off global petroleum prices. For instance, murban oil prices continued to fall and as of 10 November 2022, it stood at USD 91.00 per barrel (**Figure 3A**). Food price inflation has also been on the rise driven by continued drought conditions in the country and the pass-through effects of the higher global commodities prices (**Figure 3B**). Going forward- in the near term – food prices are expected to ease with the onset of rains in some parts of the country. This coupled with the expected trend declines in global oil prices, is expected to lead to an overall softening of inflationary pressure.

Figure 1: Trends in inflation



Source: CBK

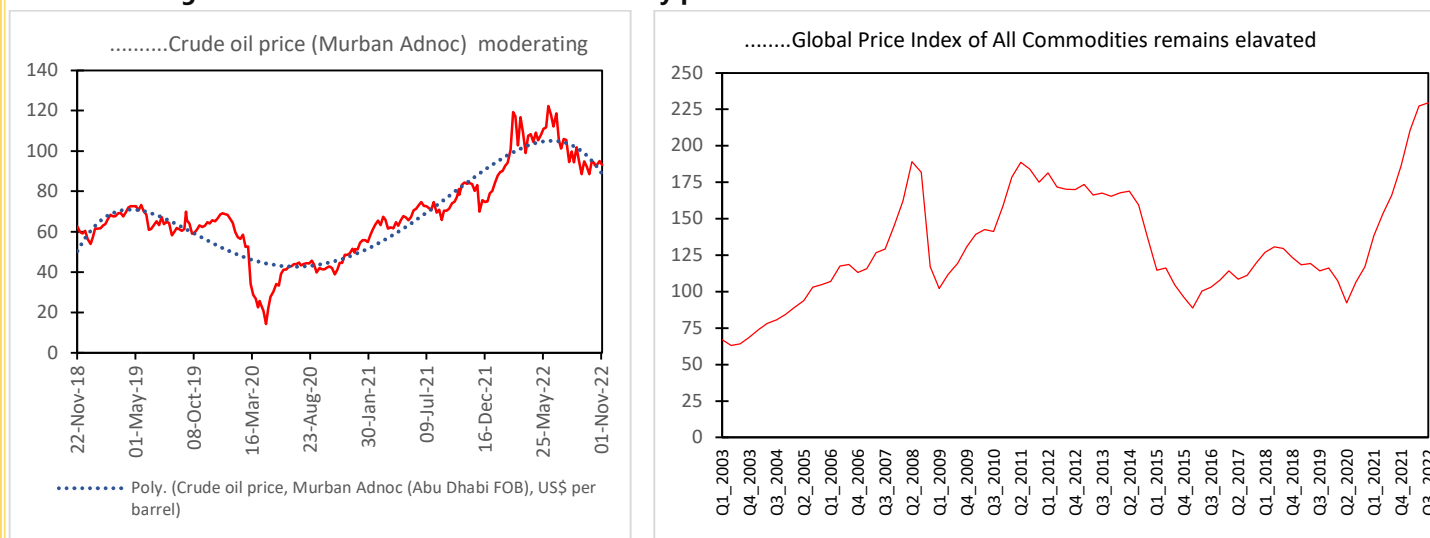
Figure 2: Trends in fuel subsidy program



Source: EPRA

**The gap between the actual and published prices reflects the level of subsidy

Figure 3: Trends in crude oil and commodity prices

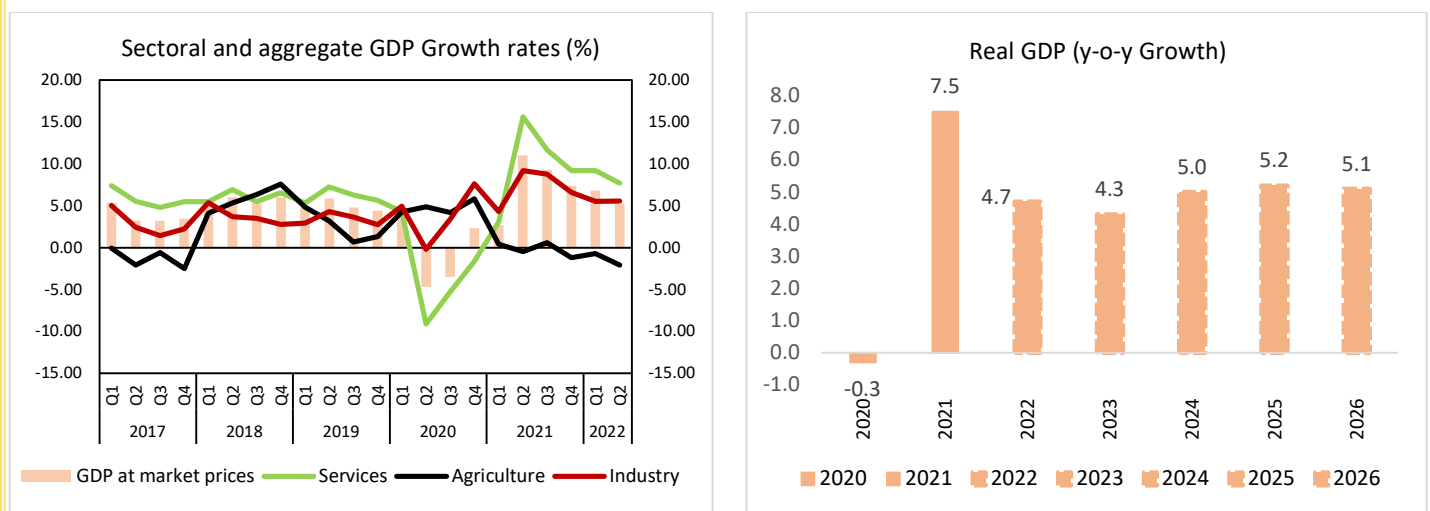


Source: Oilprice.com

Source: IMF Commodity database

Second, the economic recovery remains fragile on account of unpredictable weather patterns and depressed global growth performance. Overall economic growth in the second quarter of 2022 stood at 5.2% on a quarter-on-quarter basis, slower than 11.0% in the second quarter of 2021. Recovery in services, industry and agricultural sectors decelerated during the quarter (**Figure 4A**). IHS Markit® forecasts Kenya’s real GDP growth at 4.7% for 2022 (**Figure 4B**), down from 7.5% in 2021, depressed by the unfavorable weather conditions and spillovers from a slowdown in global economic recovery. Nonetheless, the domestic aggregate supply conditions have been steadily improving and this augurs well for demand ahead of the festive season.

Figure 4: Economic Growth Trends

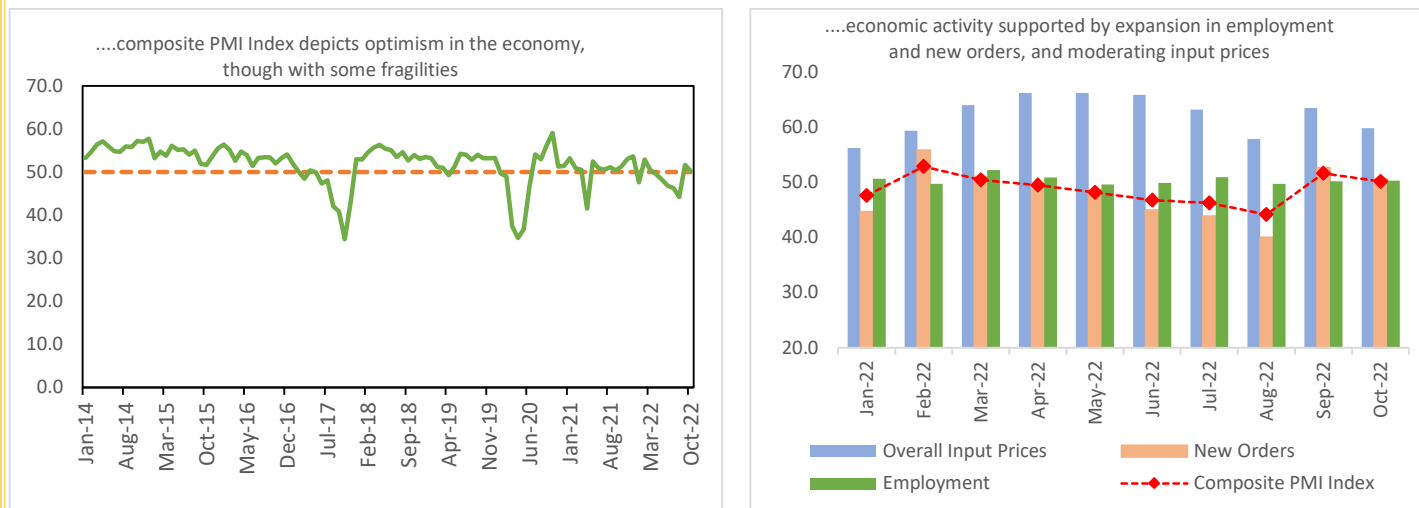


Source: KNBS

Source: IHS Markit

Despite the slipping economic growth momentum, IHS Markit’s Purchasing Managers’ Index (PMI) shows that investor and consumer confidence are firming up in anticipation of stronger economic growth prospects. As depicted in **Figure 4A**, the overall Purchasing Managers’ Index (PMI) stood at 50.2 in October 2022 - above the 50 mark for the second successive month– reflecting a moderate sustained monthly rise in economic activity between August and October, driven by expanding employment opportunities, growing new orders and some notable declines in input prices (**Figure 4B**).

Figure 4: Trends in PMI

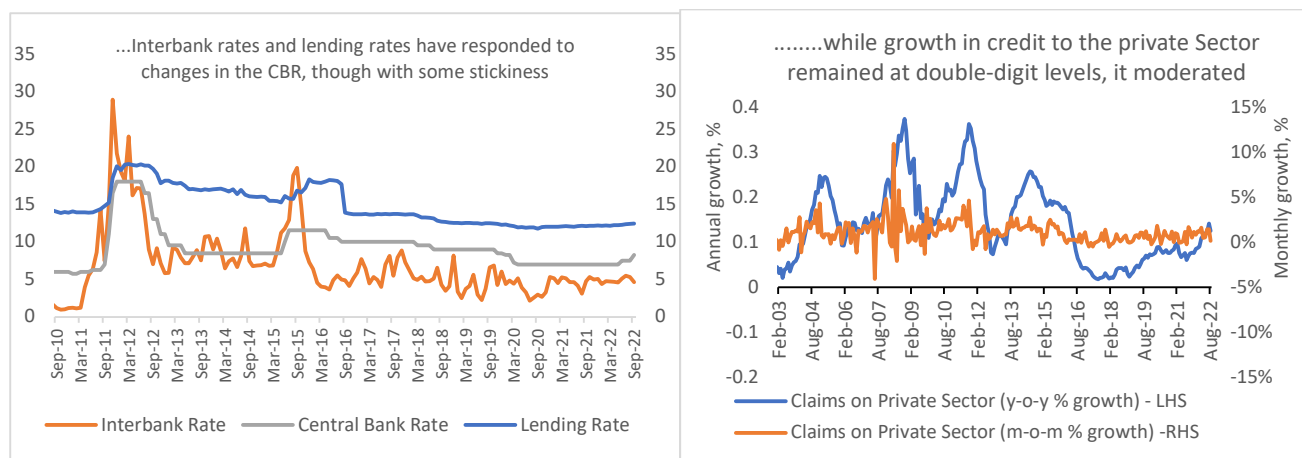


Source: IHS Markit

Third, a tightening of monetary policy effected in a cumulative 100 basis points increase in the CBR between May and September 2022, continues to be transmitted through the market, with the interbank and lending interest rates depicting some marginal increases (Figure 5 A). Following an increase in the Central Bank Rate (CBR) from 7.00% to 7.25% on 30 May 2022, and a further increase to 8.25% on 29 September 2022, the average interbank and commercial banks' lending rates have risen though at less-than proportionate rates. While further adjustments in market interest rates are expected as banks effect the policy changes announced in September, an outcome of the significant hike in the policy rate has been seen through the moderating credit growth to the private sector.

In particular, available data shows the private sector credit growing on year-on-year basis by 12.5% in August 2022, slower than 14.2% in July (Figure 5C). The double-digit credit growth, driven by strong uptake of credit by key sectors such as agriculture, manufacturing and consumer durables, continue to support the economic recovery. Going forward, any further policy rate hikes, in our view, may trigger stronger interest rates rises, depress credit growth and exacerbate the fragilities in economic recovery.

Figure 5: Trends in the Interest rates and Credit growth

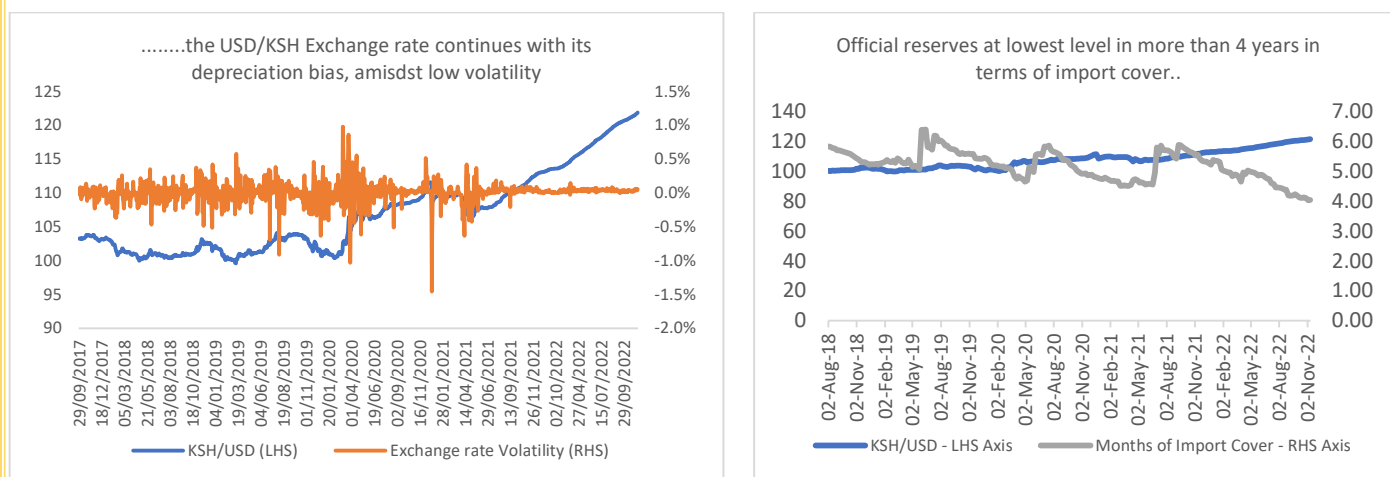


Source: CBK

Fourth, exchange rate pressure to weaken was sustained, though at a softer pace on a slight improvement in economic fundamentals. The 12-month current account deficit in September narrowed slightly to USD 6,021 million, from USD 6,113 million in July, on a faster improvement in exports than the growth in imports over the period. Despite the slowdown in global growth and increased tightening of the global financial conditions - as the US Federal reserve maintained a hawkish stance on rising inflationary pressures - the financial account deficit of the balance of payments improved, though marginally, from USD 6,151 million in July to USD 6,839 million in September. This eased the financing of the current account and thus pressure on the exchange rate to depreciate (**Figure 6A**).

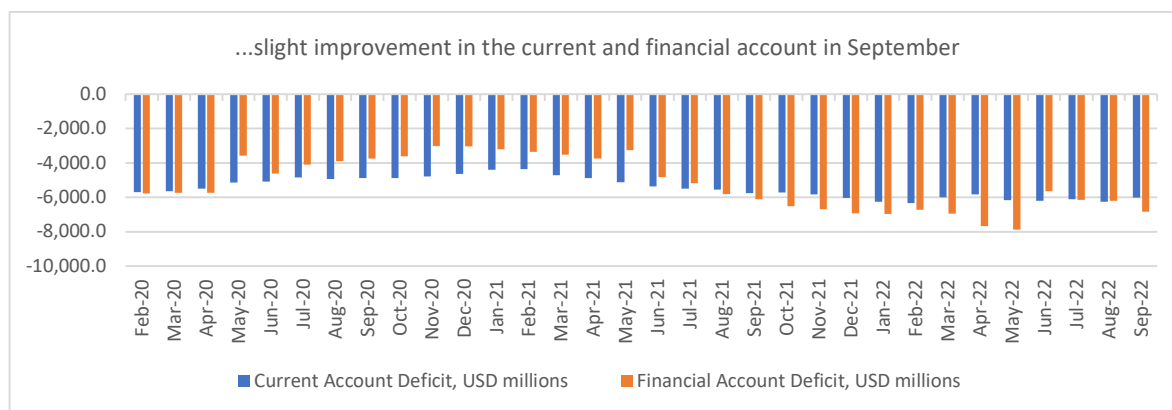
On the downside, the CBK official foreign exchange reserves sustained a declining trend from USD 7.42 billion (or 4.24 months of import cover) on 29 September to USD 7.19 billion (or 4.03 months of imports) on 17 November. The decline in official foreign exchange reserves amidst the statutory endeavour to maintain a minimum of 4 months of import cover, reflects a narrowing headroom on CBK to deal with any emerging short-term shocks in the foreign exchange market. However, the sustained improvements in the inward flows of diaspora remittances, which rose to USD 317.9 million in September 2022 compared to USD 309.8 million in September 2021, provided support in boosting foreign exchange supply.

Figure 6: Trends in the Exchange Rate



Source: CBK

Figure 7: Developments in the Balance of Payments



Source: CBK

Conclusion

In its meeting on Wednesday November 23, 2022, the CBK Monetary Policy Committee (MPC) will be expected to announce a policy stance in light of the following four critical considerations:

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- Fourth, the exchange rate pressure to weaken has been sustained, though at a softer pace on a slight improvement in domestic economic fundamentals.

On assessment of the market developments and the balance of risks going forward, we view that a further rate hike to deal with inflationary pressure may exacerbate the fragility of the economic recovery that is currently underway given its adverse implication on credit growth. *It is therefore worthwhile to consider maintaining CBR unchanged at 8.25% and allow the cumulative 100 basis points hike effected in May and September to be fully transmitted to higher interest rates in the market.*

This *Research Note* is a publication of the Kenya Bankers Association Centre for Research on Financial Markets and Policy®. The Centre was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and initiate dialogue on critical policy matters that impact the financial sector. Through these activities, the Centre acts as a platform for intellectual engagement between experts on financial markets, banking industry players and policy makers.

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