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Persistent inflationary pressure calling for stronger policy action amidst weakening shilling and rising global interest rates

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 March 2023, amidst persistent inflationary pressure, weakening Shilling, rising global interest rates, and waning economic recovery. The decision is expected to be underpinned by five macroeconomic developments and considerations:

Amidst persistent inflationary pressure, weakening Shilling, and rising global interest rates, there is scope for a further monetary policy tightening..

- First, inflationary pressure has resurfaced buoyed by rising fuel costs, elevated food prices and stronger demand pressures;
- Second, the strong economic growth outcome registered in 2022 is slowly dissipating with short-term indicators of economic performance pointing to a weak start of 2023;
- Third, interest rates have responded, albeit weakly, to the policy tightening effected in the second half of 2022, calling for an augmented policy signal;
- Fourth, growth in bank lending has remained strong, despite the policy tightening, reflecting an improvement in banking sector asset quality amidst slow transition to risk-based pricing and transmission of policy signals; and
- Fifth, the external economic environment is strongly leaning to reflect higher interest rates as policymakers in advanced economies are gearing to push up efforts to rein in on inflationary pressures.

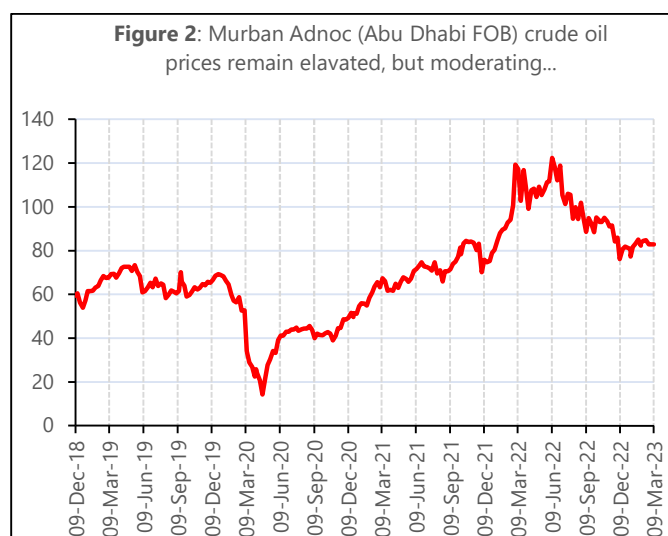
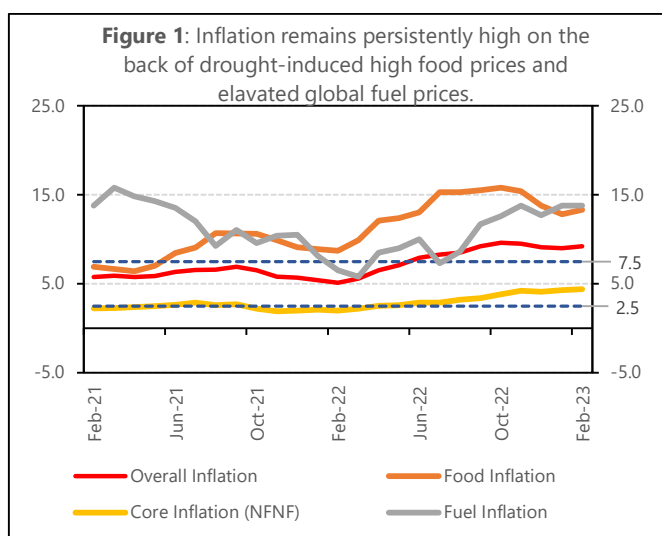
In view of the above developments, we argue that there is scope for a further interest rate hike to provide a stronger signal and tame inflationary pressures in the economy particularly arising from a combination of strong domestic demand and the relatively weaker shilling.

Background

This *Research Note* provides a brief review of five key macroeconomic developments that are expected to underpin the decision of the CBK Monetary Policy Committee on 29th March 2023.

First, inflationary pressure has resurfaced buoyed by rising fuel costs, elevated food prices and stronger demand pressures. Overall inflation rose to 9.2% in February from 9.0% in January 2023, reversing the easing trend that had been noted since October 2022 when it dropped steadily from 9.6% to 9.1% in December 2022 (**Figure 1**). The reversal is attributed to food inflation that rose to 13.3% in February from 12.8% in January reflecting prolonged drought conditions across most parts of the country that impeded food production and supplies. This, coupled with elevated fuel inflation – that stabilized at 13.8% during the period, continued to sustain higher inflationary pressures in the economy. Though at a low level, core inflation depicted steady rise during the period, to the highest since January 2021; at 4.4% in February 2023 from 4.3% in January and 4.1% in December 2022. Analysis at firm level show that both input and output prices rose in February endorsing some evidence of cost-push inflationary pressures.¹

This movement was against a backdrop of tighter monetary policy conditions reflected in the CBR hike effected in the second half of 2022. Going forward, inflationary pressure is expected to remain elevated with fuel inflation projected to rise further on the upward revision in domestic pump prices effected in March 2023²; that more-than-offset the effect of easing crude oil prices (**Figure 2**).



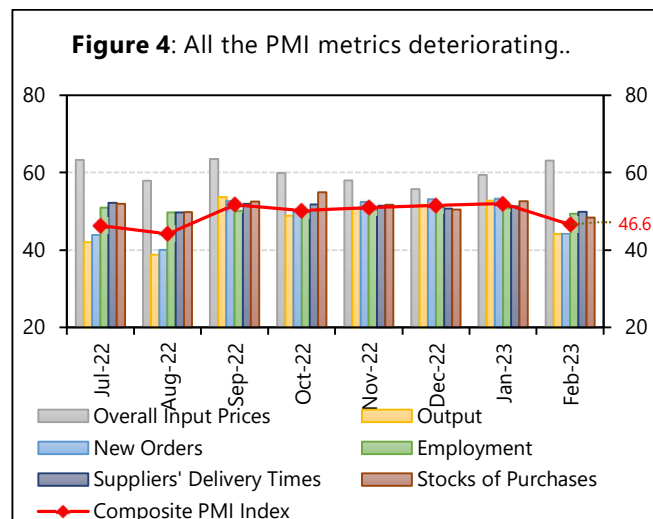
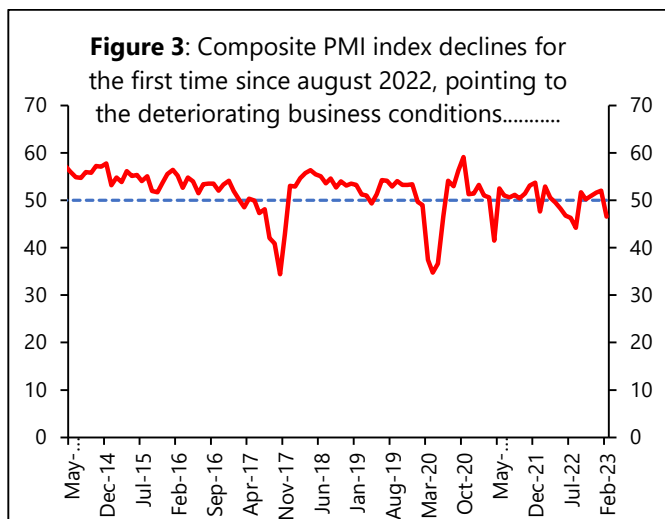
Source: Central Bank of Kenya and Oilprice.com

Second, the strong economic growth outcome registered in 2022 is slowly dissipating with short-term indicators of economic performance pointing to a weak start of 2023. According to Purchasing Managers' Index™ (PMI™) report for Kenya, economic activity is softening with the composite index declining to 46.6 in February 2023; marking the lowest level since August 2022

¹ The latest (February, 2023) PMI report shows that input prices have risen, with the index increasing to 63.1 in February up from 59.4 the previous month. Output prices have also risen, its index rising to 54.7 in February from 54.6 in January 2023.

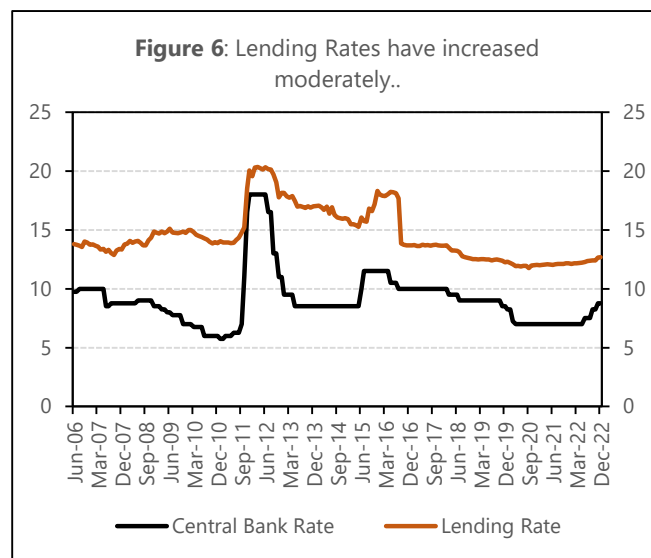
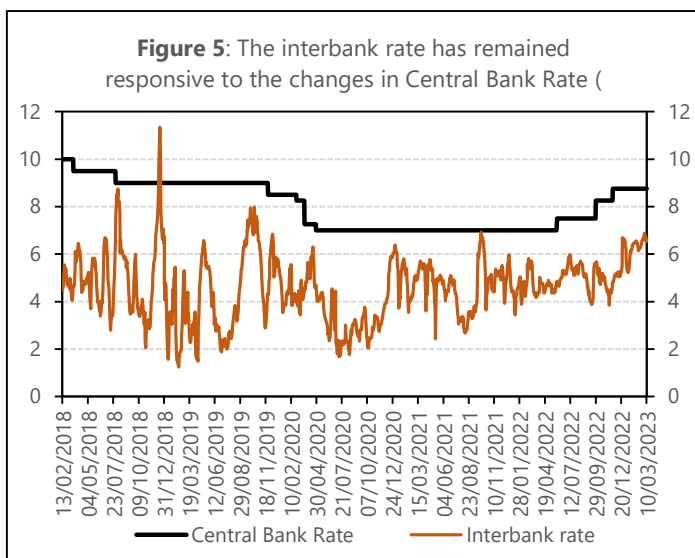
² EPRA revised upwards the domestic fuel pump prices on 14 March 2023.

(Figure 3). Similarly, output index softened to 44.2 in January 2023 from 52.8 in the previous month, effectively driving down employment during the period. Consequently, new orders also declined, reflecting dwindling consumer purchasing power, amidst the escalating cost of living pressures.



Source: IHS Markit®

Third, interest rates have responded, albeit weakly, to the policy tightening effected in the second half of 2022, calling for an augmented policy signal. As shown in Figure 5, the interbank rate rose to 6.6% by mid-March 2023 from 5.4% in December 2022, indicating some response of the short term money market to tighter financial conditions. Longer term interest rates – commercial banks' lending rates, however, only edged up marginally (Figure 6).



Source: Central Bank of Kenya

Fourth, growth in bank lending has remained strong, despite the policy tightening, reflecting an improvement in banking sector asset quality amidst slow transition to risk-based pricing and transmission of policy signals. As Figure 7 shows, growth in credit to the private sector at 12.5% in 2022, was largely broad-based, but evidently stronger in mining and quarrying (having grown by 31.40%), transport and communication (23.48%), agriculture (22.36%), manufacturing (13.78%), business services

(13.68%), consumer durables (12.87%), trade (11.38%), and building and construction (8.2%) (**Table 1**). The policy rate hikes effected in the second half of 2022 was ideally expected to tame demand pressures in the economy by slowing down private sector credit growth, thus minimizing its endorsement of supply-side driven inflationary pressure. The market outcome reflects challenges in the transmission of policy signals to lending rates and a slow transition of the banking industry to risk-based credit pricing environment.³

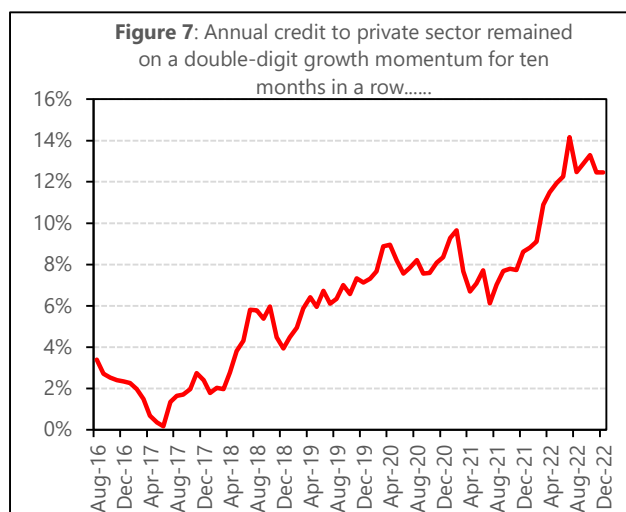
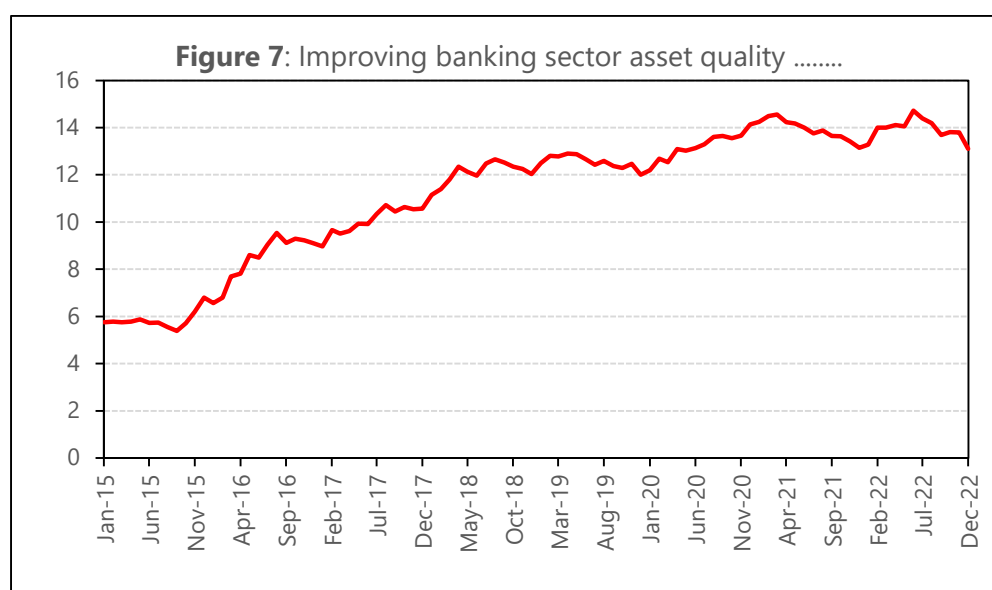


Table 1: Sectoral month-on-month credit growth (%)

| | Sep-21 | Dec-21 | Mar-22 | Jun-22 | Sep-22 | Dec-22 |
|---------------------------------|-------------|-------------|--------------|--------------|--------------|--------------|
| Agriculture | 3.29 | 0.54 | 7.72 | 12.60 | 17.09 | 22.36 |
| Manufacturing | 9.77 | 13.12 | 9.93 | 15.18 | 14.16 | 13.78 |
| Trade | 4.65 | 8.56 | 10.37 | 11.63 | 16.36 | 11.38 |
| Building and construction | 0.50 | 1.84 | 6.39 | 13.99 | 12.52 | 8.20 |
| Transport & communications | 10.95 | 14.24 | 25.06 | 22.15 | 21.54 | 23.48 |
| Finance & insurance | 11.72 | 5.79 | 3.66 | 6.46 | 0.27 | 7.57 |
| Real estate | 2.84 | 0.64 | 0.51 | 0.53 | 0.07 | 3.20 |
| Mining and quarrying | -8.33 | 42.15 | -5.22 | 28.35 | 57.58 | 31.40 |
| Private households | 2.60 | 3.73 | 7.56 | 6.10 | 7.75 | 8.19 |
| Consumer durables | 17.54 | 15.00 | 15.56 | 14.65 | 14.40 | 12.87 |
| Business services | 7.59 | 9.49 | 14.71 | 15.21 | 12.51 | 13.68 |
| Other activities | 59.52 | 39.07 | 60.53 | 57.24 | 53.77 | 41.73 |
| Credit to private sector | 7.68 | 8.60 | 10.89 | 12.26 | 12.86 | 12.46 |

Source: Central Bank of Kenya

Amidst this, the strong growth in private sector credit has been supported by an improvement in the ratio of gross non-performing loans to gross loans (asset quality) of the banking industry, with the ratio declining to 13.1% in December 2022, from 13.7% in September 2022 (**Figure 6**).

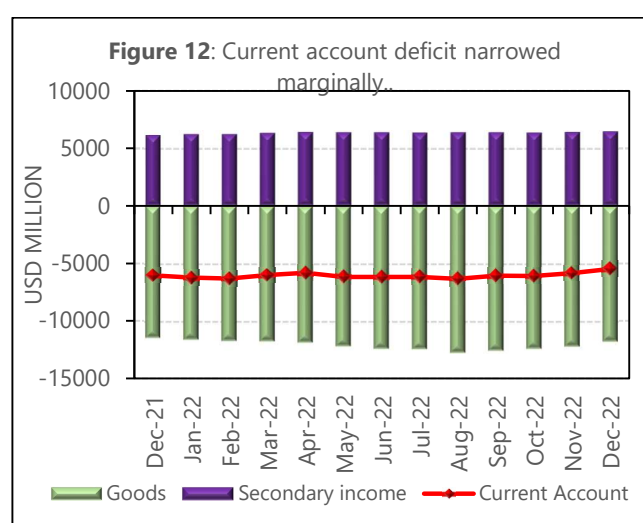
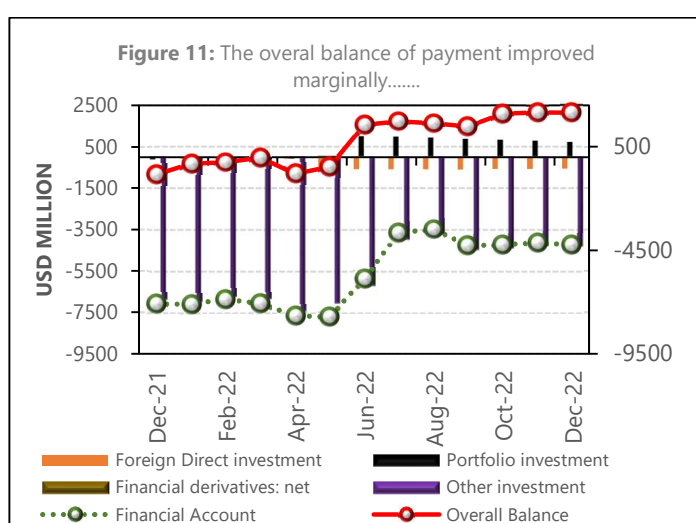
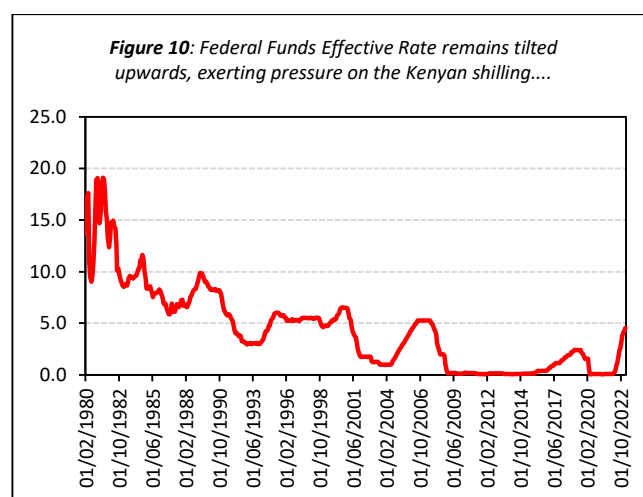
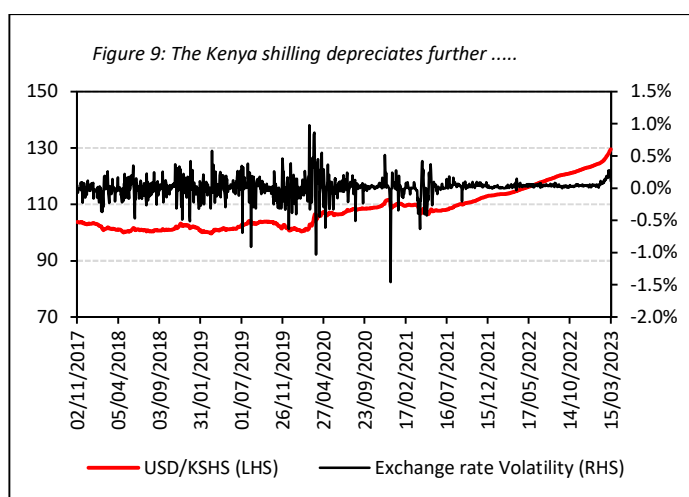


Source: Central Bank of Kenya

³ By mid-March, 27 banks (3 tier I; 7 tier II and 17 tier III) had received approvals of their risk-based credit pricing models, representing only up to 53% of total industry assets.

Fifth, the external economic environment is strongly leaning to reflect higher interest rates as policymakers in advanced economies are gearing to push up efforts to rein in inflationary pressures. Recent developments in the external sector show a sustained steady depreciation of the Shilling vis-à-vis the US dollar (**Figure 9**), at 4.99% by mid-March since the beginning of the year. This depreciation has been driven by a sustained relatively-larger current account deficit (as ratio of GDP particularly with the softening of economic activity) as shown in **Figure 12**, a moderation in the capital and financial account (**Figure 11**) and a reopening of the interest rate differential as advanced countries hiked their interest rates (**Figure 10**).

The sustained current account deficit is expected to continue exerting pressure on the Shilling to depreciate, particularly amidst the steady decline in the official foreign exchange reserves to USD 6,566 million as of 9 March 2023 (covering an equivalent of 3.47 months of imports) that continues to limit the extent to which the country can use official reserves to deal with any emerging short term foreign exchange market pressures.



Source: Central Bank of Kenya and Federal reserve Bank of New York⁴.

⁴ <https://www.newyorkfed.org/markets/reference-rates/effr>

Conclusion

At its meeting scheduled on 29th March 2023, the Monetary Policy Committee (MPC) of the Central Bank of Kenya will be facing a number of key macroeconomic developments; from sustained higher inflationary pressure, a softening economic recovery, robust growth in credit and an external sector characterized by rising interest rates that continue to exert pressure on the shilling to depreciate.

In view of the above developments, we argue that there is scope for a further interest rate hike to provide a stronger signal and tame inflationary pressures in the economy particularly arising from a combination of strong domestic demand and a weaker Shilling.

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