Research Note

29 May 2024

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Macroeconomic Indicators Reflect Stability; Calling for a Hold on Monetary Policy Stance

Highlights

The decision of the Central Bank of Kenya's Monetary Policy Committee (MPC), during its meeting on **5th June 2024**, is expected to be anchored on the ongoing transmission of its previous monetary actions, and four critical developments:

- First, overall inflation is within the target range, and inflation expectations appear anchored in the short- to medium term. It declined to 5.0% in April 2024, driven by lower fuel and food inflation;

- Second, there is an evident underlying robust economic growth momentum extended from 2023 when the economy grew by 5.6%, and enhanced optimism by key economic agents;

- Third, credit growth remains strong, despite concerns of deteriorating asset quality, possibility of interest rates remaining elevated for longer, and the projected impact of the Finance Bill 2024 provisions on the cost of financial services; and

- Fourth, is a notable favourable improvement and stability in the external sector, as the Kenya Shilling continues to strengthen against the US dollar, supported primarily by favourable macroeconomic fundamentals.

"The underlying price pressures have cooled off, economic growth remains strong, while the external sector has stabilized; necessary conditions for maintenance of stance"

In view of these developments, and a balance of risks, we argue that maintaining the current monetary policy stance – *in keeping the CBR unchanged at 13.0% - would be appropriate.*

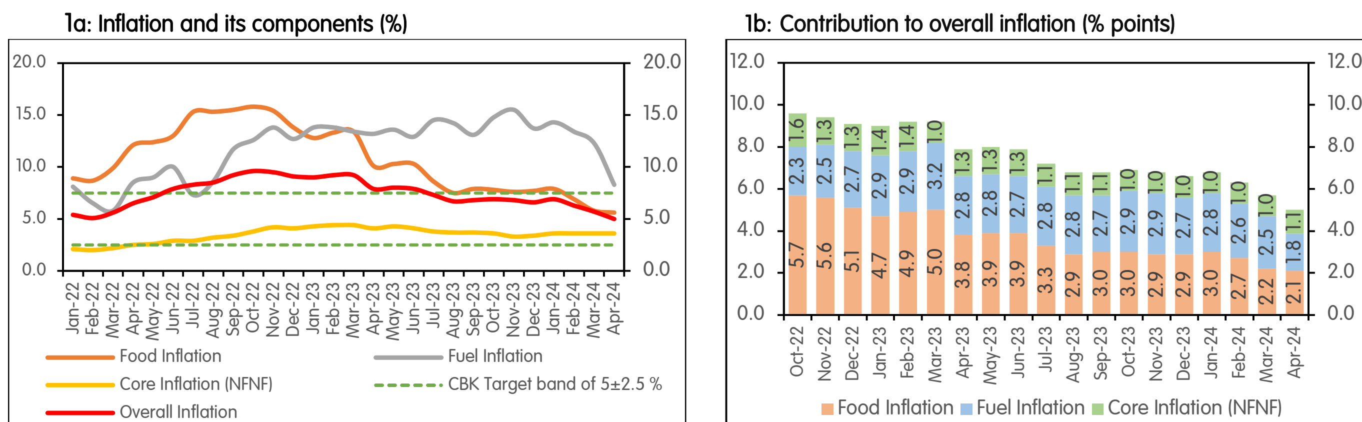
Background

The monetary policy decision during the MPC meeting scheduled for **Wednesday 5th June 2024** is expected to be anchored on four key factors; ranging from well anchored inflation expectations, robust economic growth prospects; strong growth in credit, and the continued stability evident in the external sector.

First, overall inflation is within the target range, and inflation expectations appear anchored in the short- to medium term. In the recent months, the overall inflation has consistently continued declining from a high of 6.9% in January 2024 to hit the midpoint of the CBK target range, 5.0 % in April 2024 **(Figure 1a)**. This trend is mainly driven by declining food and fuel inflation, that respectively eased to 5.6% and 8.3% in April 2024 from 5.8% and 12.3% in March 2024. Demand pressures during the period remained muted, reflected in relatively minimal changes in core inflation.

The contribution of fuel inflation to overall inflation declined from 2.5 percentage points in March 2024 to 1.8 percentage points in April 2024 **(Figure 1b)** on account of declining fuel prices, following two successive downward revisions of domestic fuel prices by EPRA. Similarly, the contribution of food inflation declined, albeit marginally, from 2.2 percentage points in March 2024 to 2.1 percentage points in April 2024 on account of improved rainfall that resulted in price drops on some key food items such as loose maize grain, cabbages, tomatoes, white wheat flour, sugar and Irish potatoes.

Figure 1: Inflation trends and drivers

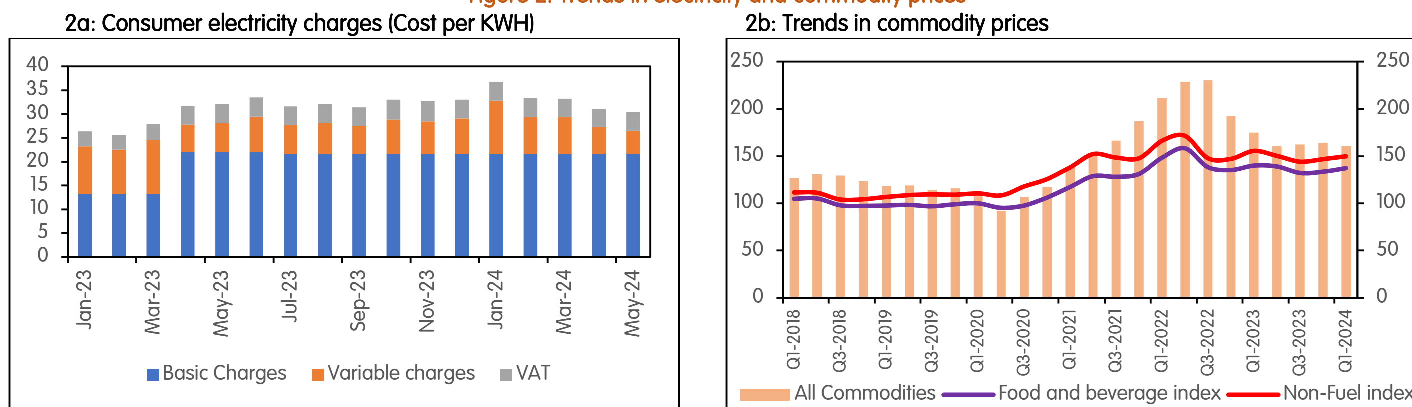


Source: CBK and KNBS

Source: CBK and KNBS

Furthermore, the reduction in variable electricity costs from 11.12 KWH in January 2024 to 4.82 KWH in May 2024 **(Figure 2a)** (mainly due to the recent appreciation of the Kenya shilling and inflation adjustments), coupled with declining global commodity prices **(Figure 2b)** would potentially catalyze further easing of the inflationary pressure. Notwithstanding these developments, upside risks to inflation in the short to medium term include the effects of the recent floods across the country on short term food supplies and potential adverse impact of the proposed increases in taxes on the consumer cost of key commodities (such as oil imports due to increased foreign exchange transaction costs and critical manufactured goods) and services.

Figure 2: Trends in electricity and commodity prices



Source: https://www.stimatracker.com/

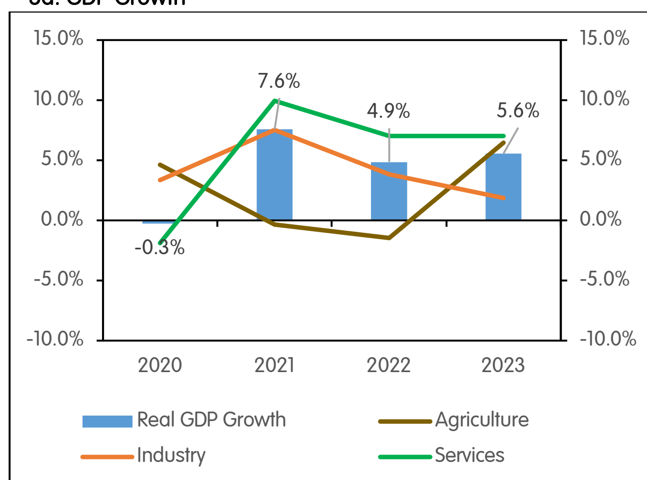
Source: IMF Commodity Prices Database

Second, there is an evident underlying robust economic growth momentum extended from 2023 when the economy grew by 5.6%, and enhanced optimism by key economic agents. The economy remained strong in 2023 expanding by 5.6% compared to a growth of 4.9% in 2022 **(Figure 3a)**. The growth was broad-based but was more pronounced in the service-oriented and agricultural sectors, which grew by 7.0% and 6.5%, respectively. In particular, accommodation and food service activities grew by 33.6% on account of a recovery in tourism activities.

The Composite Purchasing Managers Index (PMI) index – that reflects higher frequency leading economic performance indicators - further points to optimism and stability in the economy **(Figure 3b)**. The Index rose to 50.1 in April 2024 from 49.7 in March 2024; reflecting improved economic performance in the second quarter relative to the first quarter. The improved economic performance was driven partly by a general decline in input prices. The input price index decreased for the sixth consecutive month in April 2024, falling below 50.0 neutral mark for the first time since June 2020, particularly reflecting lower input costs in manufacturing, services, and retail, that more-than-offset the input price increases in agriculture and construction sectors.

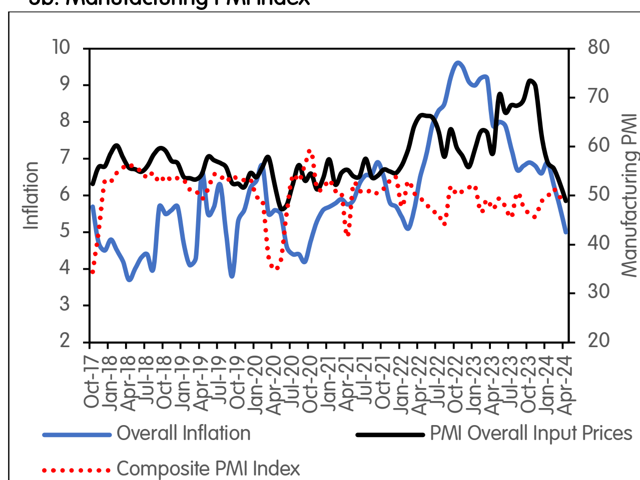
Figure 3: Trends in GDP growth and Manufacturing PMI index

3a: GDP Growth



Source: KNBS

3b: Manufacturing PMI Index

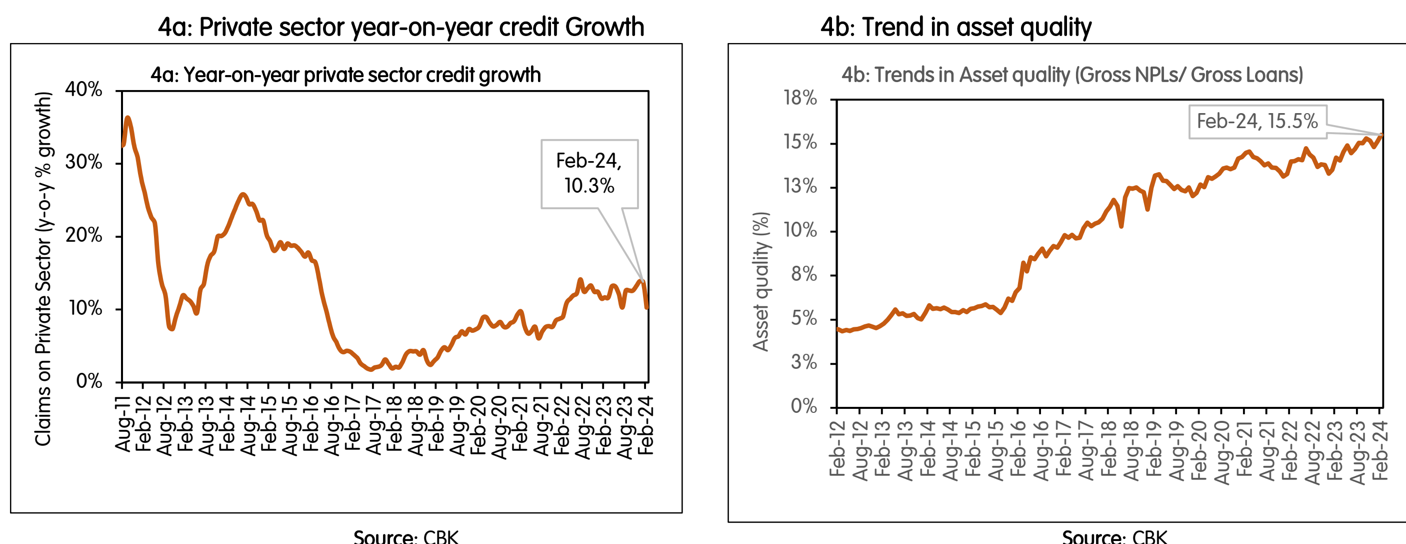


Source: IHS Markit®

Third, credit growth remains strong, despite concerns of deteriorating asset quality, possibility of interest rates remaining elevated for longer, and the projected impact of the Finance Bill 2024 provisions on the cost of financial services. Latest published data shows that private sector credit growth remained on a double-digit growth streak, albeit at a decelerated pace. In February 2024 , credit grew by 10.3% down from 13.8% in January 2024, all assessed on a year-on-year basis **(Figure 4a)**, mainly supported by robust growth in the agricultural sector (32.5%), manufacturing (23.1%); transport and communication (16.6%) and trade (12.9%).

However, the deteriorating asset quality remains a concern in the credit market; with the ratio of non-performing loans (NPL) to gross loans rising to 15.5% in February from 15.1% percent in January 2024 and 14.8% as at end 2023 (**Figure 4b**). The increase in NPLs was mainly driven by loan impairments in real estate, trade, personal & household, energy and water, and building and construction sectors. As a consequence, banks continue to make adequate provisions for expected credit losses and tighten credit standards to avert a build-up in non-performing loans going forward.

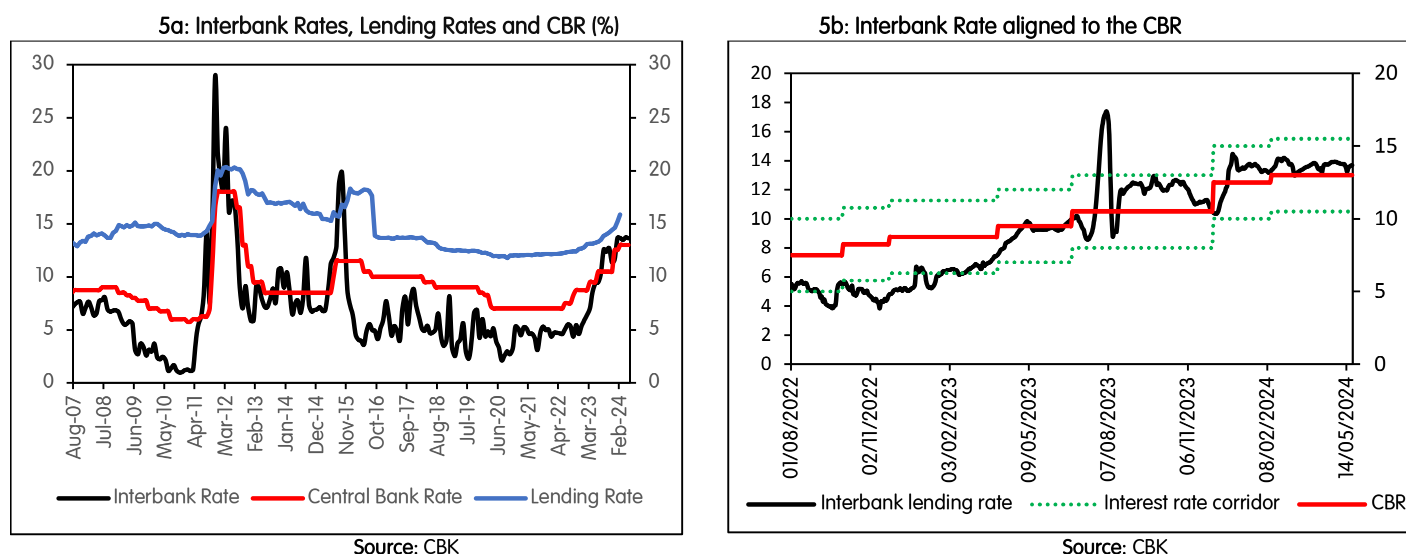
Figure 4: Credit growth and asset quality Evolution



Source: CBK Source: CBK

Moreover, credit lending interest rates have risen in tandem to the tightened monetary policy conditions as reflected in the elevated Central Bank Rate; effectively indicating an alignment of market outcomes with the policy stance (**Figure 5a**). In particular, short-term interest rates continue to closely track the Central Bank Rate (CBR) within the set interbank interest rate corridor set at CBR ± 2.50 percent (**Figure 5b**). Going forward, there are upside risks to the cost of financial services with the proposal to increase excise duty from 15% to 20% and the introduction of 16% VAT on financial services from 1st July 2024. This, in an environment of high interest rates, may exert extra strain on customers and potentially exacerbate their difficulties in servicing existing facilities.

Figure 5: Trends in market rates



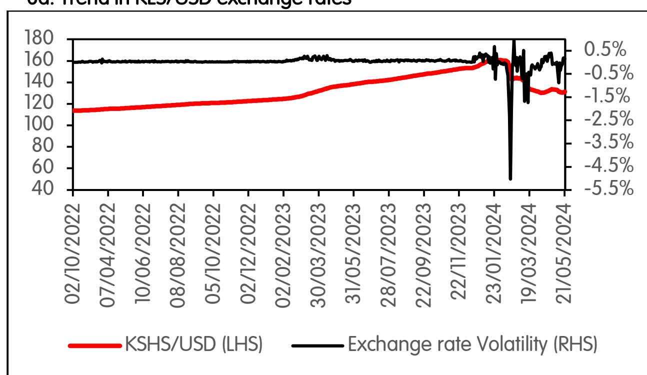
Source: CBK Source: CBK

Fourth, is a notable favourable improvement and stability in the external sector, as the Kenya Shilling continues to strengthen against the US dollar, supported primarily by favourable macroeconomic fundamentals. As of 21 May 2024, the shilling averaged Ksh. 131.20 per US dollar, marking an 18.7% appreciation from its peak of Ksh 161.36 per US dollar on 23 January 2024 (**Figure 6a**). The appreciation has been supported by improved macroeconomic fundamentals particularly a narrowing in the current account deficit and resilient remittances (that rose by 24.0% in April 2024 on year-on-year basis) (**Figure 6b**). The current account deficit narrowed to USD 4,307.4 million in January 2024 from USD 5,575.7 million in January 2023 (**Figure 6c**); easing pressure on the exchange rate. Going forward, risks to exchange rate movements would include the outcomes of proposals contained in Finance Bill 2024 (should it be passed into law) particularly the evolution of the Government's fiscal deficit (**Figure 6d**) with the

projected new taxes and possible disruptions in the foreign exchange market with the proposed taxation on transactions. Concerns also remain on the adequacy of the official foreign exchange reserves to cushion the economy against any emerging short-term shocks on the foreign exchange market; given that the reserves – that stood at USD 6,989 million as of May 23 – could only cover 3.7 months of imports against a statutory minimum of at least 4 months.

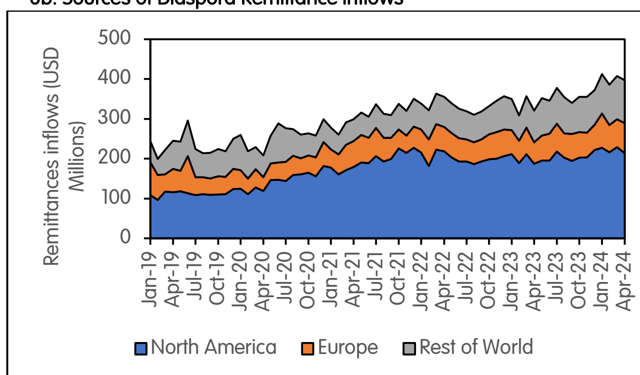
Figure 6: The external sector dynamics

6a: Trend in KES/USD exchange rates



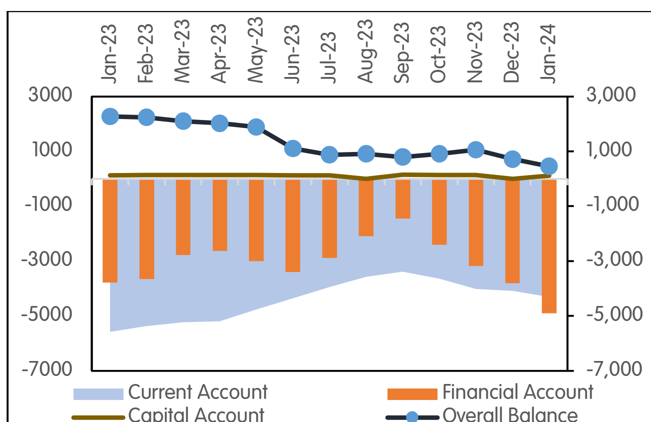
Source: CBK

6b: Sources of Diaspora Remittance Inflows



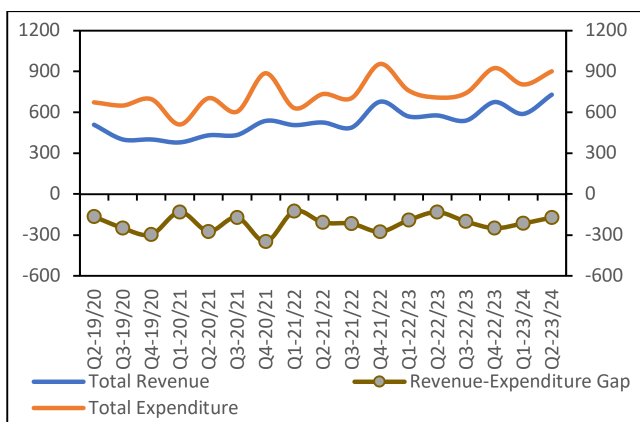
Source: CBK

6c: The Balance of Payment (USD millions)



Source: KNBS

6d: Trend in government revenues and expenditures (Ksh billions)



Source: KNBS and IHS Markit®

Conclusion

In view of these developments, and a balance of risks, we argue that maintaining the current monetary policy stance – *in keeping the CBR unchanged at 13.0% - would be appropriate.* This would facilitate a complete pass-through of previous monetary policy actions and avert any disruptions that any rate cut may have on the foreign exchange market given projected delays in interest rate adjustments in advanced economies.

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