April 2, 2025

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There is headroom for a further cut in the Central Policy Rate to support credit growth amidst anchored Inflation

Highlights

The Monetary Policy Committee (MPC) of the Central Bank of Kenya at its meeting scheduled for **8th April 2025** faces a critical decision to support private sector credit growth while sustaining price and exchange rate stability. A number of developments are expected to anchor the Committee's decision:

- **First,** inflation remains low and stable, and inflation expectations are well anchored within the target range in the near term;

- **Second,** economic activity though resilient, appears fragile on weak credit growth as well as emerging global trade and inflation risks;

- **Third,** there is weak transmission of monetary policy rate cuts effected in the previous months that, together with elevated credit risk, continue to constrain bank lending to the private sector;

- **Fourth,** the foreign exchange market remains stable and facing limited adverse risks, anchored on a sustainable current account deficit, a positive sentiment and strong inflows of remittances and export earnings.

In view of these developments and an analysis of the balance of risks, we view that there is headroom to accommodate a further Central Bank Rate cut to provide a stronger impetus and sustain the momentum for lending rate reductions in the market and unlock private sector credit growth.

> "
> ***Amidst stable inflation and well-anchored inflation expectations, stimulating credit growth would be necessary to spur economic activity.***

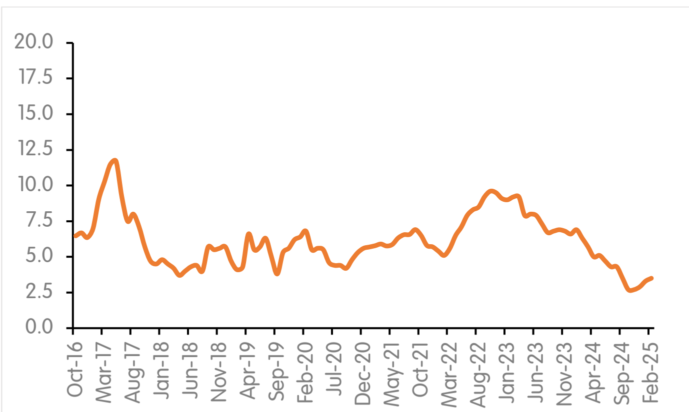
Background

At its meeting on 8th April 2025, the decision of the MPC is expected to be underpinned by four macroeconomic developments.

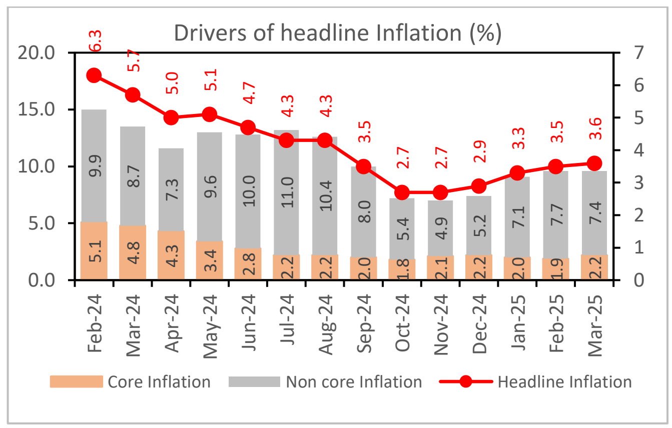
First, inflation remains low and stable, and inflation expectations are well anchored within the target range in the near term. Headline inflation edged up slightly to 3.6% in March 2025 from 3.5% in February (**Figure 1a**), driven by an increase in core inflation to 2.2% from 1.9% over the period. Non-core inflation, however, eased to 7.4% from 7.7% in February (**Figure 1b**). In terms of their contributions to overall inflation, core inflation pushed up overall inflation by 2.3 percentage points as non-core inflation contributed 1.3 percentage points. On the global front, headline inflation is projected to moderate to 3.8 % in 2025 and 3.2 % in 2026, with G20 economies' inflation projected to ease to 2.6% in 2025 and 2.4% by 2026[1] (**Figure 1d**), towards their respective policy targets. However, upward risks to inflation in global markets mainly include potential upward reviews on trade tariffs, especially by the USA, that may attract consequential retaliation by other key global markets and push up global inflation.

Figure 1: Inflation trends and drivers

1a: Trends in headline inflation

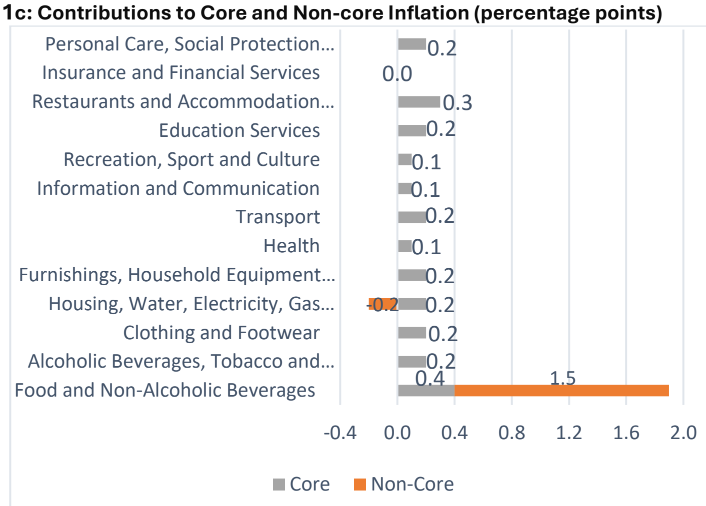


1b: Drivers of headline inflation



Source: *CBK and KNBS*

1c: Contributions to Core and Non-core Inflation (percentage points)



Source: KNBS

1d: Core Inflation for selected countries

		March 2025 Projections	
	2024	2025	2026
G20 Advanced Economies	**2.7**	**2.6**	**2.4**
Euro Area	**2.8**	**2.2**	**2.0**
Germany	3.2	2.7	2.2
France	2.3	1.7	1.8
Italy	2.2	1.8	1.9
Spain	2.8	2.2	1.9
Japan	**2.0**	**1.8**	**2.0**
Korea	2.2	2.0	2.1
Mexico	4.1	4.2	3.5
United Kingdom	3.7	2.9	2.3
United States	2.8	3.0	2.6
South Africa	4.2	4.1	4.5

Source: OECD (March 2025)

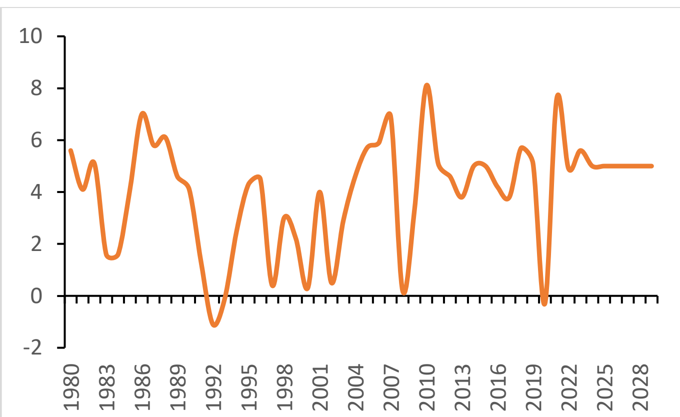
[1] OECD Economic Outlook (March 2025)

Second, economic activity though resilient, appears fragile on weak credit growth as well as emerging global trade- and inflation risks. The IMF projects Kenya's real GDP growth at 5.0 % in both 2025 and 2026, driven by a robust agricultural sector and rising exports[2] (**Figure 2a**). However, emerging protectionist trade policies in the US that may filter through other advanced markets, could push global inflation higher and slowdown the pace of monetary policy easing. This would keep the US dollar stronger against other major currencies, and lead to higher import costs and potential inflationary pressures in frontier economies such as Kenya.

Despite these risks, high frequency data on economic activity in the country – as carried by the Purchasing Managers Index (PMI) data - shows that businesses recorded a mild improvement in operating conditions in February 2025, with the PMI rising marginally to 50.6 from 50.5 in January 2025 (**Figure 2b**). This growth was driven by resilient activity in agriculture, manufacturing, and construction, while retail and services eased. Despite the softer inflation outturn, there were marginal gains in employment and inventories (**Figures 2b and 2c**) as sales remained muted and business sentiment weakened. From the fiscal side, the Government progressed the implementation of fiscal consolidation as a priority; ensuring the overall fiscal deficit (even with supplementary budget approval) target was pursued aiming to reduce the debt-to-GDP ratio to 55 % by 2029 to enhance debt sustainability (**Figure 2d**).

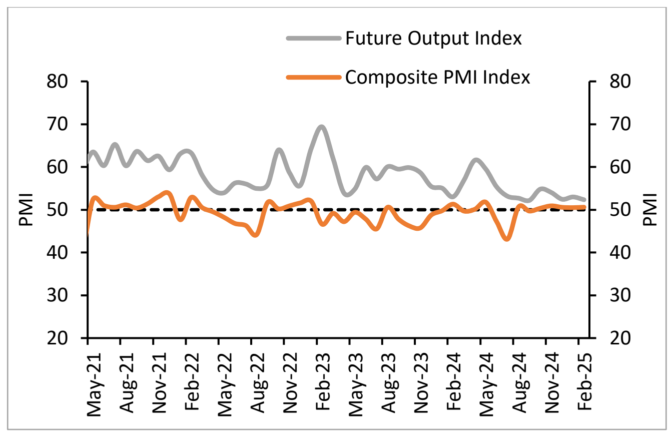
Figure 2: Economic growth outlook

2a: Kenya's GDP Growth rates (%)



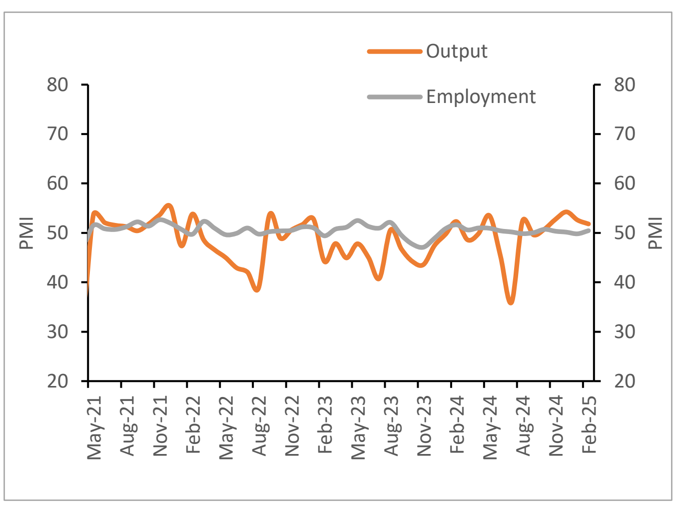
Source: IMF

2b: PMI Trends



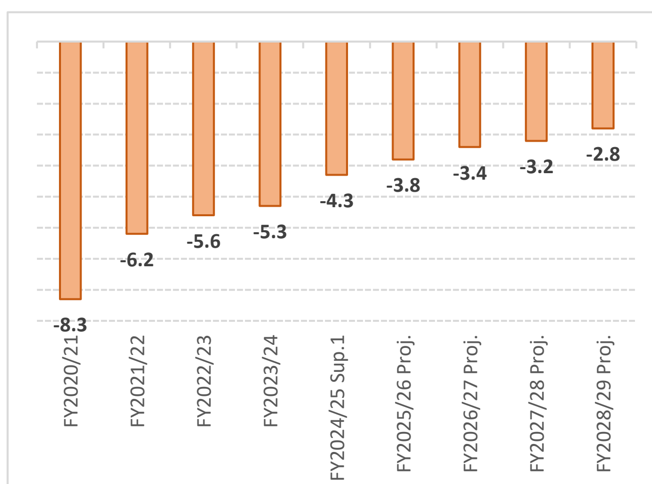
Source: IHS Markit

2c: PMI Trends



Source: IHS Markit

2d: Fiscal Deficit (% of GDP)



Source: The National Treasury

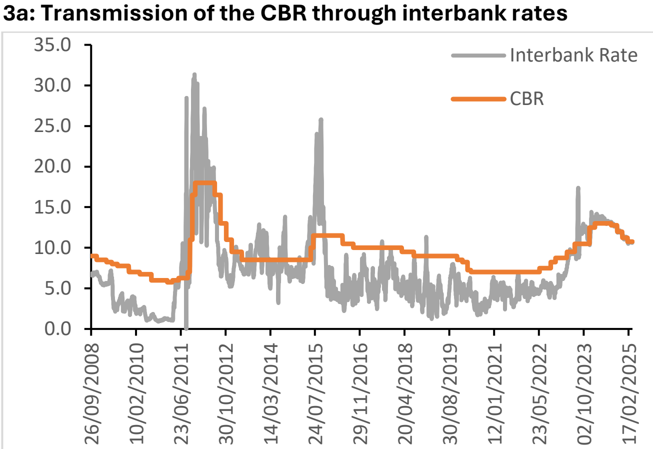
[2] Kenya's Real GDP projection (IMF)

Third, there is weak transmission of monetary policy rate cuts effected in the previous months that, together with elevated credit risk, continue to constrain bank lending to the private sector. The MPC on 6th February 2025 lowered the Central Bank Rate (CBR) by 50 basis points to 10.75% and the Cash Reserve Ratio (CRR) by 100 basis points to 3.25%. The implementation of the CBR cut through CBK monetary operations led to a decline in the interbank rate (as shown in **Figure 3a)** to 10.68% by 28 March 2025; aligning the latter to interbank market corridor of CBR +/- 150 basis points. Since August 2024 when the MPC started reducing the CBR (cumulatively by 225 basis points by end March 2025), the interbank rate has declined by about 252 basis points reflecting effective CBR transmission to the short end of the market yield curve.

However, acknowledging the presence of transmission lags in the market particularly to the longer-dated credit facilities, the average lending rate in the market continued to increase (in response to the CBR hike that had been effected and sustained at 13.00% for 6 months to August 2024) to 17.22% by November 2024, before declining steadily to 16.44% in February 2025. Since November 2024, the average lending rate has declined by 78 basis points compared to a decline in average deposit rates by 65 basis points to 9.76% in February 2025 **(Figure 3b)**.

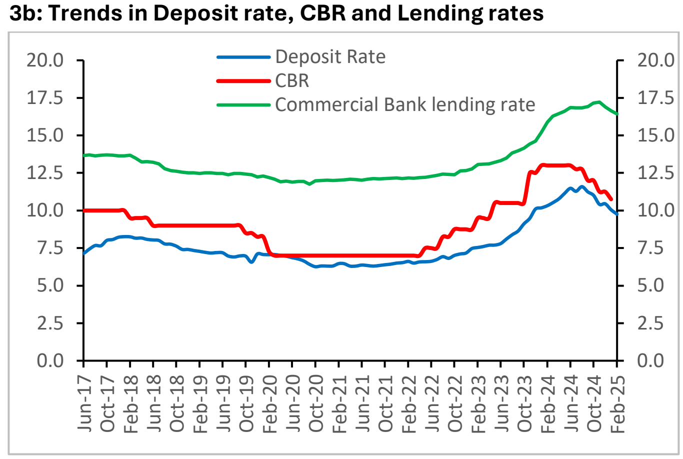
Figure 3: Credit market dynamics

3a: Transmission of the CBR through interbank rates



Source: CBK

3b: Trends in Deposit rate, CBR and Lending rates

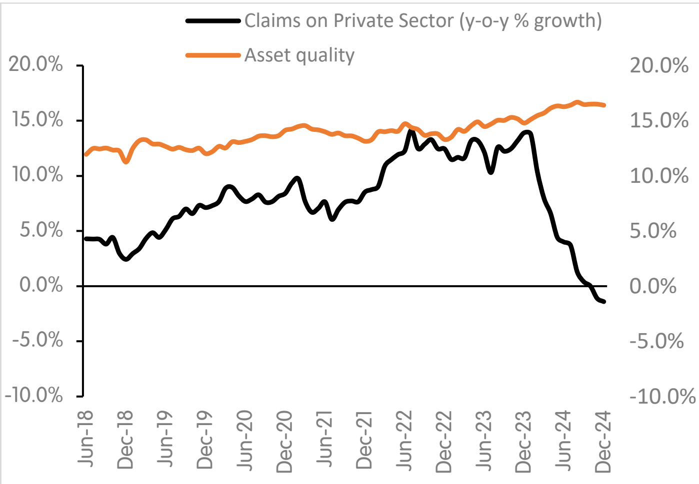


Source: CBK

Overall commercial bank private sector credit contracted by 1.4 % in December 2024 on a year-on-year basis, mainly reflecting exchange rate valuation effects on foreign currency denominated loans following the appreciation of the Shilling, and reduced demand attributed to high lending interest rates. While foreign currency denominated loans, (which account for about 26 % of total loans) contracted by 11.4 %, local currency denominated loans grew by 2.1 % in December – though posting varied growth rates across sectors (**Figure 3b**).

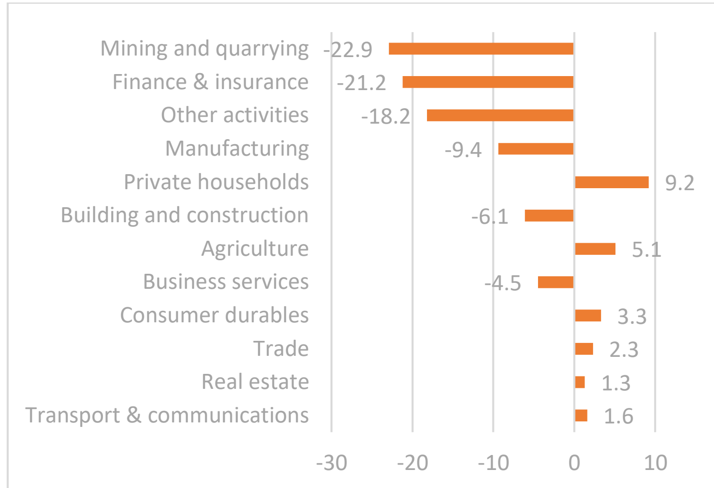
An additional constraint to private sector credit supply was the elevated credit risk; with the ratio of gross non-performing loans (NPLs) to gross loans estimated at 16.4 % in December 2024 largely unchanged from 16.5% in October, though marginally lower than 16.7 % in September (**Figure 3a**).

3a: Growth in Credit to the private sector



Source: CBK

3d: Sectoral credit growth(in Percentage), December 2024

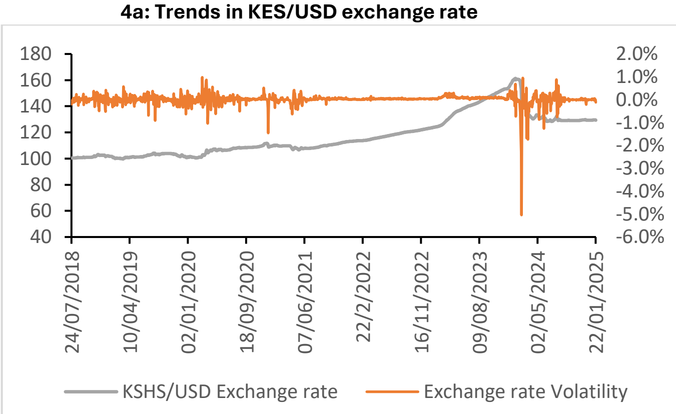


Source: CBK

Fourth, the foreign exchange market remains stable and facing limited adverse risks, anchored on a sustainable current account deficit, a positive sentiment and strong inflows of remittances and export earnings. As depicted in **Figure 4a,** the KES/USD exchange rate remained relatively stable at around Ksh.129 per US dollar, supported by strong positive sentiment, resilient inflows of diaspora remittances and a strong growth in key export earnings, particularly from increased flows of tourists (**Figure 4b**), tea, coffee and horticultural exports (**Figure 4c**). In addition, the country's official foreign exchange reserves have grown and stood at USD 9,956 million (5.1 months of import cover) as of 27th March 2025; providing an adequate buffer against any short-term shocks in the foreign exchange market and sustaining a positive sentiment. Going forward, there are minimal adverse risks on the exchange rate, with the country's upgrade in credit rating. In addition, the current account deficit despite widening marginally to USD 4,515.2 million in December 2024, appears sustainable in the short to medium term (**Figure 4d**).

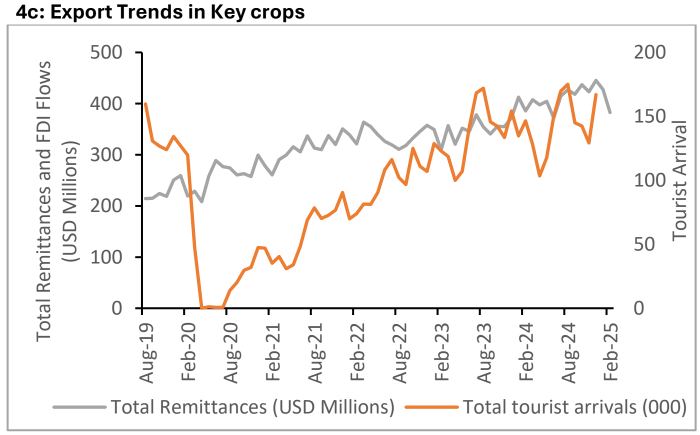
Figure 4: Exchange Rate movement and its drivers

4a: Trends in KES/USD exchange rate



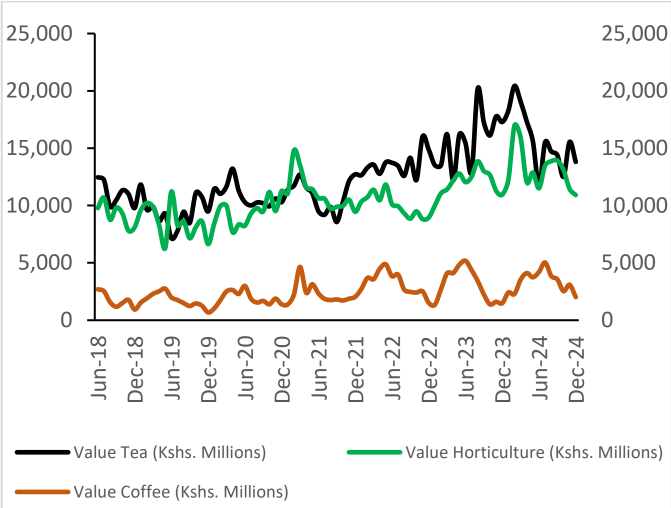
Source: CBK

4c: Export Trends in Key crops



Source: CBK and KNBS

4c: Foreign exchange reserve and months of Import Cover



Source: CBK

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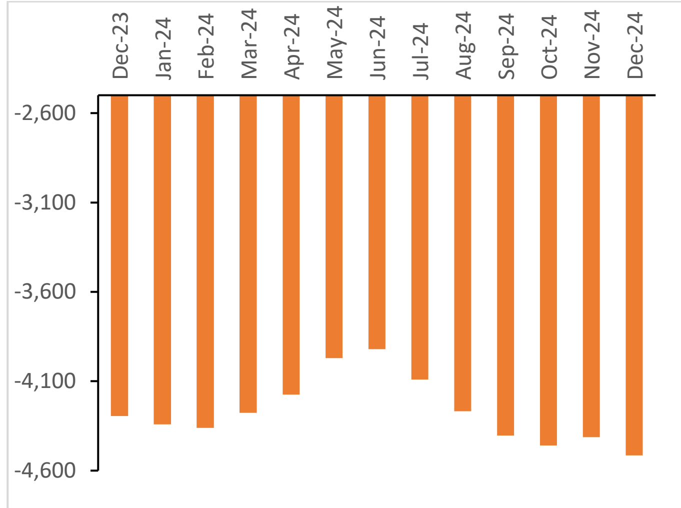

Source: CBK

Conclusion

In view of these developments and an analysis of the balance of risks, we view that there is headroom to accommodate a further Central Bank Rate cut to provide a stronger impetus and sustain the momentum for lending rate reductions in the market and unlock private sector credit growth.

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