

Research Note



August 6, 2025

RESEARCH NOTE NO.79 – 2025 (RN/79/25)

Amidst subdued private sector activity and anchored inflation, there is adequate headroom for a rate cut

Highlights

The decision of the Monetary Policy Committee (MPC) of the Central Bank of Kenya at its meeting scheduled for **12th August 2025** is expected to be underpinned by the following developments:

- **First**, inflation and inflation expectations remain well anchored within the target range;
- **Second**, economic growth, despite depicting resilience with stronger agriculture performance, is fragile; calling for a stronger anchor;
- **Third**, credit growth recovery is yet to pick up despite notable reductions in lending rates, largely reflecting protracted delay in asset quality improvement and credit consumers taking a wait-and-see attitude on investments in anticipation of lower interest rates in the near to medium term;
- **Fourth**, the yield curve on government securities has flattened for the medium to long term, reflecting increased uncertainty on economic conditions going forward;
- **Fifth**, there are minimal threats to exchange rate stability with the external sector performance depicting resilience buoyed by the current account deficit remaining within sustainable bounds;

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Given weak credit growth and fragility in economic activity, amidst anchored pressure, there is scope for a rate cut.

In view of these developments, and given favourable external interest rate differential, we view that there is scope to cut the Central Bank Rate (CBR) to support credit growth and anchor economic growth. This will complement the structured efforts to resolve the long-standing Government pending bills that are expected to improve NPL ratios in the market.

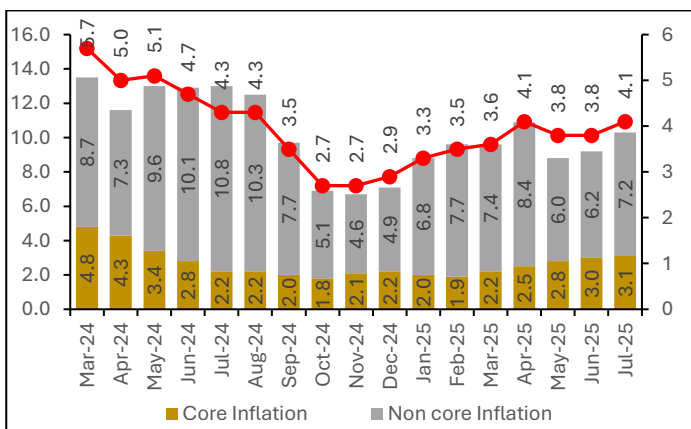
Background

At its meeting on 12th August 2025, the Monetary Policy Committee (MPC) is expected to anchor its policy rate decision on the following five key developments:

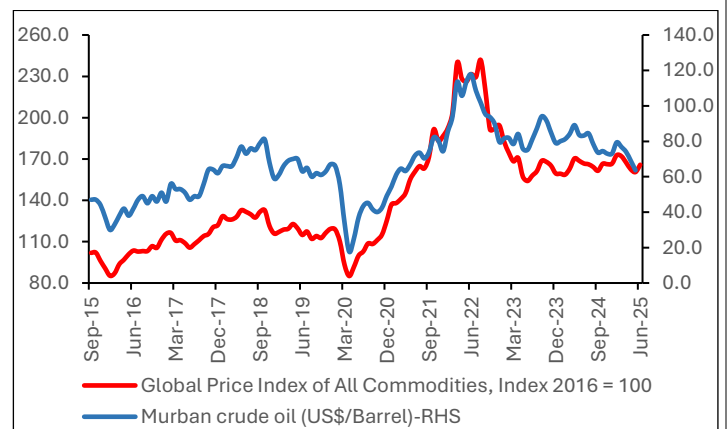
First, inflation and inflation expectations remain well anchored within the target range. Headline inflation remained well within the target range of between 2.5% and 7.5% in July 2025, rising marginally to 4.1 from 3.8% in June 2025 (**Figure 1a**). The marginal rise reflected an increase in non-core inflation to 7.2% from 6.2% that was moderated by subdued demand in the economy with core inflation remaining largely unchanged at 3.1% from 3.0% in June. Furthermore, the downside risk of passthrough effects from changes in global fuel and other commodity prices remains low (**Figure 1b**).

Figure 1: Inflation trends and drivers

1a: Headline inflation and its drivers



1b: Global Price Index (All Commodities) and Murban Crude oil prices



Source: KNBS, IMF commodities prices and Oilprices.com

Second, economic growth, despite depicting resilience supported by stronger agriculture performance, is fragile; calling for a stronger anchor. In the first quarter of 2025, Kenya’s real GDP growth stood at 4.9% similar to levels recorded in the first quarter of 2024 but slower than 5.1% in the fourth quarter of 2024. This growth was largely supported by the strong performance of the agricultural sector, which expanded by 6.0% compared to 5.6% in a similar quarter in 2024 and 4.3% in the previous quarter, largely on account of more favorable weather patterns across most parts of the country. Non-agricultural sector recorded strong performance, though slowing down to 4.6% from 4.8% in the first quarter of 2024. This was on account of a slowdown in the services sector that more-than-offset the strong growth in industry during the period (**Table 1**).

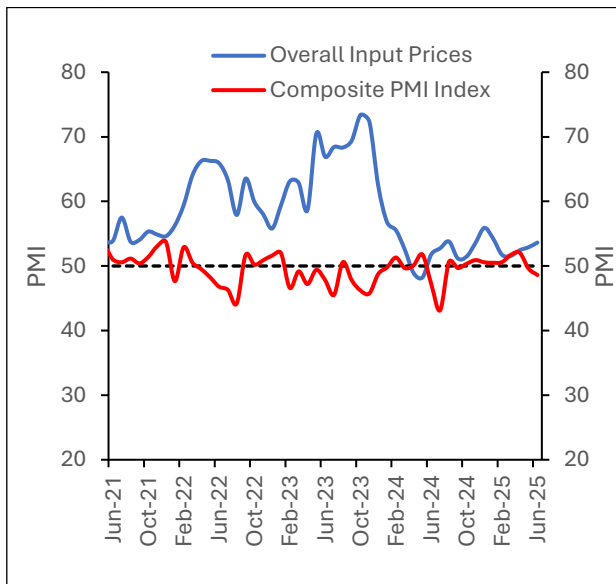
Table 1: Sectoral and aggregate real GDP Growth rates (%)

	2024				2025
	Q1	Q2	Q3	Q4	Q1
1.0 Agriculture	5.6	4.5	4.0	4.3	6.0
2.0 Non-Agriculture (o/w)	4.8	4.6	4.3	5.3	4.6
2.1 Industry	0.4	0.2	-0.4	3.1	3.0
2.2 Services	6.4	6.1	5.4	6.1	5.0
2.3 Taxes on products	2.9	3.8	6.3	4.5	5.7
Real GDP Growth	4.9	4.6	4.2	5.1	4.9

Source: KNBS (June, 2025)

Analyses of higher frequency data for the first and second quarters of 2025 also show a deceleration in economic activity month after month. In particular, the Kenya Purchasing Managers' Index (PMI) (**Figure 2**) declined further for the second consecutive month in June 2025, stood at 48.6, down from 49.6 in May 2025. This reflected the sharpest deterioration in business conditions in 11 months, driven by a notable contraction in business activity, reduced customer spending with elevated input prices, challenging macroeconomic environment and operational disruptions linked to protests. The downturn was further exacerbated by a steeper drop in new orders.

Figure 2: Trends in Composite PMI Index



Source: IHS Markit

From a global perspective, however, the IMF's July 2025 outlook projects global growth at a modest 3.0% for 2025 and 3.1% for 2026, down from 3.3% in 2024 (**Table 2**), marking a slight upward revision from its April forecast.

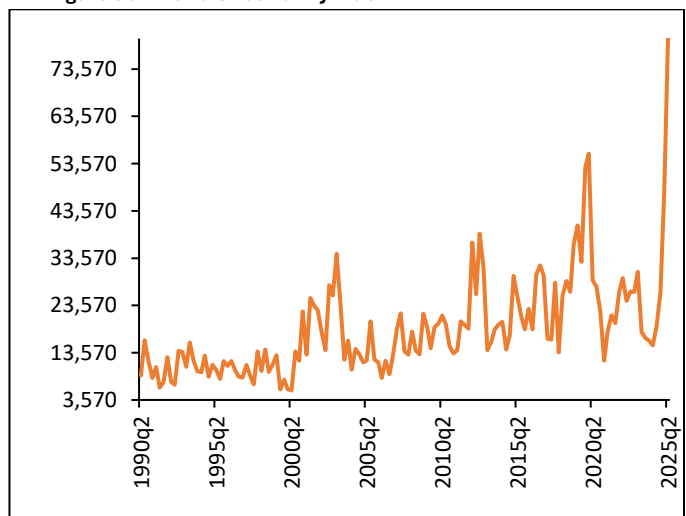
This modest improvement still reflects fragile resilience, largely influenced by trade-related distortions in form of tariffs that have triggered heightened uncertainty. In fact, the World Uncertainty Index has increased (**Figure 3b**), albeit with some decline in effective tariff rates. Economic policy uncertainty is expected to persist throughout 2025 and into 2026, posing a continued risk to global economic activity.

Figure 3: Global economic growth and outlook

Table 2: Overview of the World Economic Outlook Projections

	2024	July 2025 Projections	
		2025	2026
World Output	3.3	3.0	3.1
Advanced Economies	1.8	1.5	1.6
United States	2.8	1.9	2.0
Euro Area	0.9	1.0	1.2
Japan	0.2	0.7	0.5
United Kingdom	1.1	1.2	1.4
Emerging and Developing Economies	4.3	4.1	4.0
China	5.0	4.8	4.2
India	6.5	6.4	6.4
Brazil	3.4	2.3	2.1
Sub-Saharan Africa			
Nigeria	3.4	3.4	3.2
South Africa	0.5	1.0	1.3

Figure 3b : World Uncertainty Index



Source: IMF (WEO) and Federal Reserve Bank

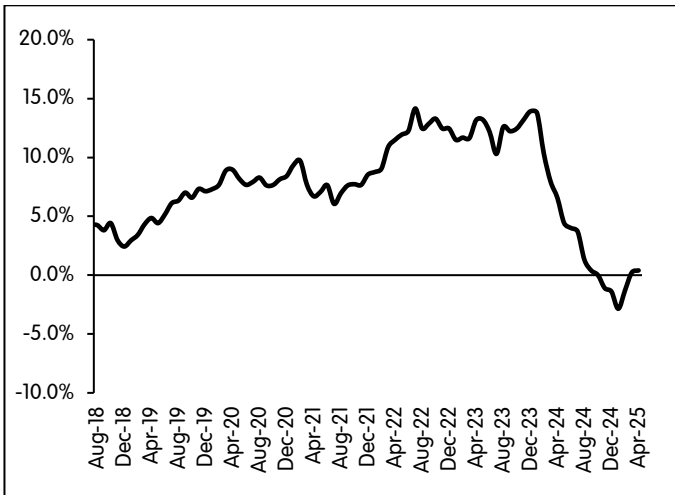
Third, private sector credit growth recovery is yet to pick up despite notable reductions in lending rates, largely reflecting protracted delay in asset quality improvement and credit consumers taking a wait-and-see attitude on investments in anticipation of lower interest rates in the near to medium term. Private sector credit growth is recovering, but slowly. In May 2025, credit to the private sector growth increased to 2.0%, up from 0.4%

in April 2025 and -2.9% in January 2025 (**Figure 4a**). The slow recovery reflects largely the impact of declining lending rates, with the average commercial bank lending rates easing to 15.4% in May 2025, from 15.7% in April 2025 and 17.2% in November 2024. From the policy front, the average interbank rate continued to oscillate its defined policy corridor (shaded area in Figure 4b), but generally mirroring a decline from 11.06% on January 2, 2025 to 9.6% by August 1, 2025 (**Figure 4b**).

However, the sector’s asset quality deteriorated further, with the NPL ratio edging up to 17.6% in April 2025 (**Figure 4c**), driven mainly by the real estate, trade, manufacturing, and personal lending segments. While banks remain adequately capitalized and liquid, lending activity remains subdued due to weak borrower creditworthiness and tepid demand, pointing to structural frictions impeding the transmission of lower interest rates to increased credit uptake. A resolution of the NPL problem, through such initiatives as the planned securitization of bills in the construction sector, will support a faster recovery in private sector credit leading to stronger rebound of broad money supply in the economy towards its long term mean growth (**Figure 4d**).

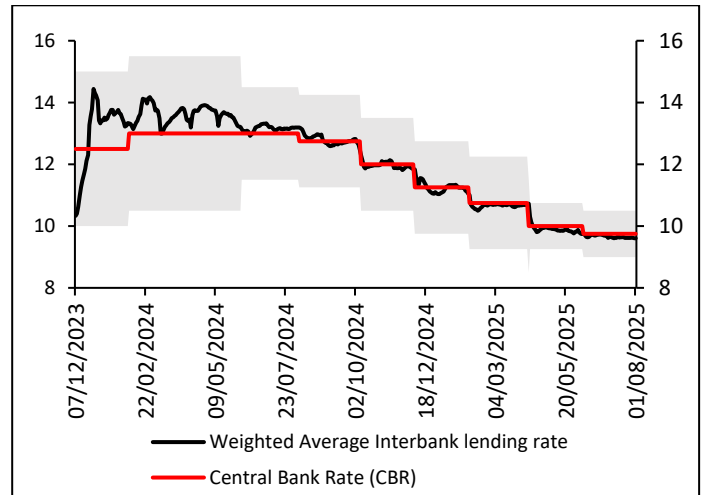
Figure 4: Credit Market Developments

4a: Growth in credit to the private sector (%)



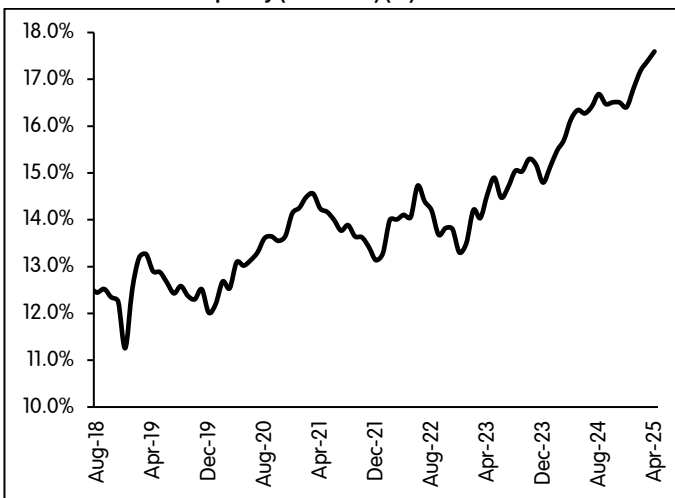
Source: CBK

4b: Policy rate transmission through Interbank rate



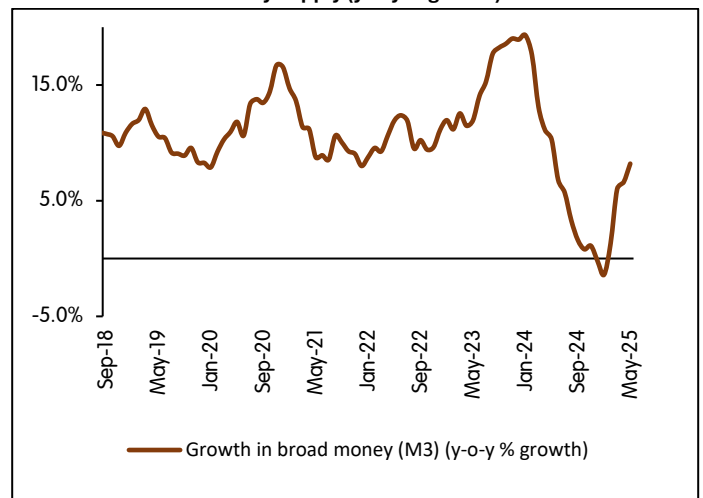
Source: CBK

4c: Trends in asset quality (NPL ratio) (%)



Source: CBK

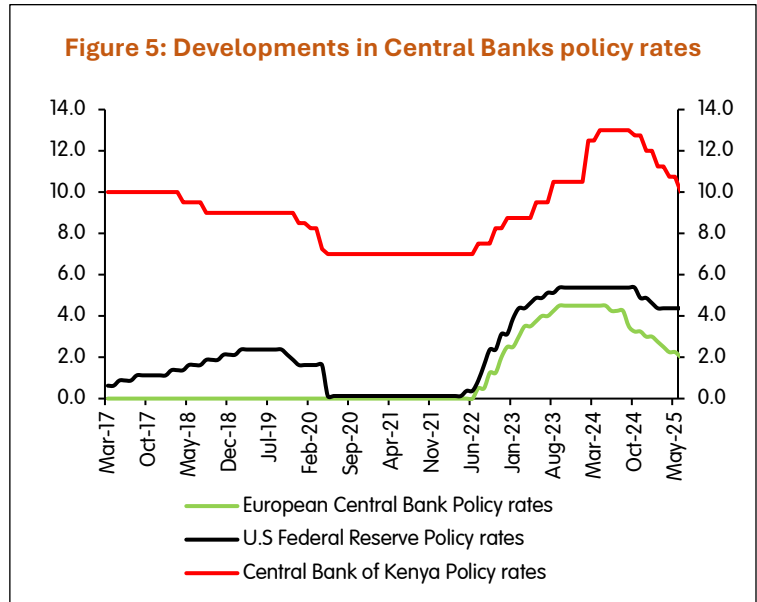
4d: Growth in broad money supply (y-o-y % growth)



Source: CBK

A comparative analysis of the policy rates shows that the recent domestic CBR cuts have been partly driven by the need to maintain healthy interest rate differentials between domestic and other leading global policy rates such as the European Central Bank rate and the US Federal Reserve rate. Globally, monetary conditions have also become more supportive.

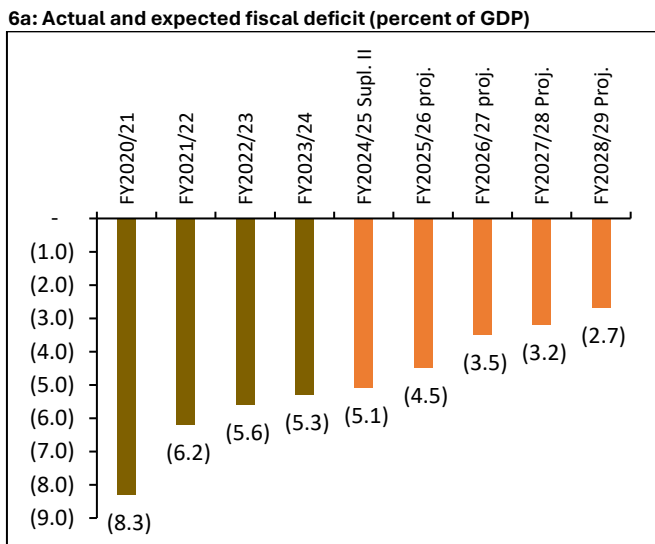
The U.S. Federal Reserve and the European Central Bank (ECB) have progressively reduced their policy rates (**Figure 5**) with projections of further cuts before end of 2025. These developments provide adequate headroom for further cuts to be effected in the domestic market, with minimal risk on capital flows and exchange rate stability.



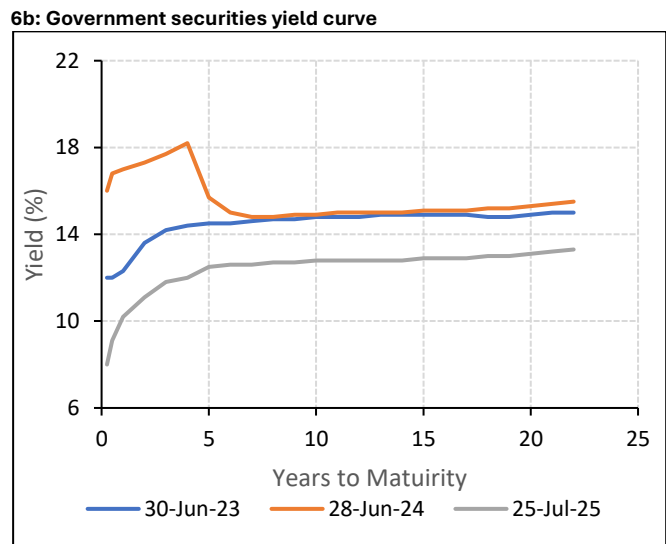
Source: CBK, U.S Federal Reserve bank and European Central Bank

Fourth, the yield curve on government securities has flattened for the medium to long term, reflecting increased uncertainty on economic conditions going forward. The Kenyan government’s expected fiscal consolidation over the medium term is projected to steadily reduce the fiscal deficit from 5.1% of GDP in FY2024/25 to 2.7% in FY2028/29, thereby lowering debt vulnerabilities and supporting a more sustainable debt-to-GDP trajectory (**Figure 6a**). However, fiscal risks remain elevated due to high debt servicing costs and subdued revenue performance. Commitment to the consolidation efforts would help speed up the declines in interest rates thereby support the transmission of monetary policy signals, reduce uncertainty and entrench a well-behaved yield curve of Government securities. As of July 25th 2025, the yield curve had shifted downward, was well-behaved on the short end (reflecting some well-anchored inflationary expectations) but flat on the medium to long-end (**Figure 6b**) reflecting some uncertainty in the market for longer-dated securities.

Figure 6: Fiscal policy and yield curve dynamics



Source: The National Treasury



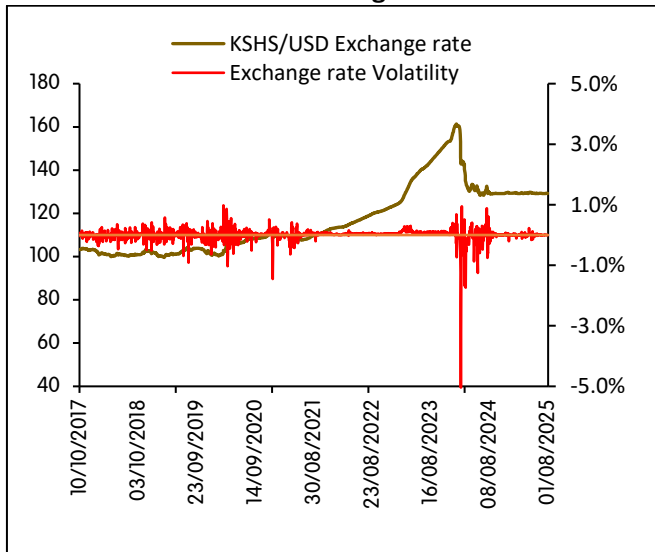
Source: NSE

Fifth, there are minimal threats to exchange rate stability with the external sector performance depicting resilience buoyed by the current account deficit remaining within sustainable bounds. The Kenya Shilling

demonstrated relative stability, trading at KSh 129.24/USD as of August 1, 2025 (**Figure 7a**), supported by strong external sector buffers, including a sustainable current account deficit, strong official foreign exchange reserves, which stood at USD 10.7 billion (equivalent to 4.7 months of import cover) as of July 31, 2025, and sustained diaspora remittances. With waning dollar dominance and more balanced global financial conditions (**Figure 7b**), this has further alleviated external pressures on the Shilling. Despite remaining sustainable, the current account deficit widened in Q1 2025 to US\$66.6 million from US\$42.0 million in Q1 2024. The wider deficit reflected a temporary dip in services exports and subdued primary income inflows. Nonetheless, this was partially offset by a recovery in key agricultural exports, particularly tea and horticulture, and a significant reduction in petroleum import costs amid declining global prices.

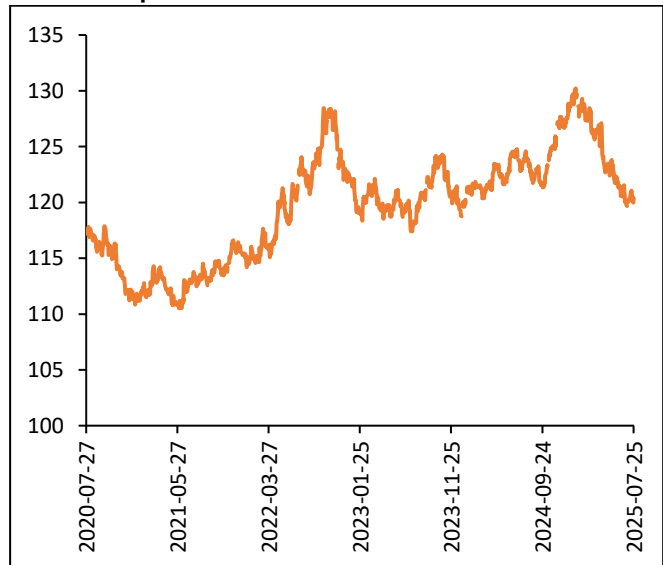
Figure 7: Exchange Rate movement and its drivers

7a: Trends in KES/USD exchange rate



Source: CBK

7b: Developments on the U.S. Dollar Index



Source: Intercontinental Exchange (ICE)

Conclusion

In view of a low and stable inflation and minimal threats on exchange rate stability, favourable external interest rate differential, we view that there is scope to cut the Central Bank Rate (CBR) to support credit growth and anchor economic growth. This will complement the structured efforts to resolve the long-standing Government pending bills that are expected to improve NPL ratios in the market.

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