CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Research Note

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Credit growth in an environment of elevated risk? A steady anchor would be lending rates that reflect the evolution of the risk.

Highlights

As we anticipate the decision of the Monetary Policy Committee (MPC) meeting scheduled for **May 26, 2021**, we parade our argument for maintaining the policy stance. Based on our analyses, the Central Bank Rate (CBR) should be kept at 7.00 percent, underpinned by a number of considerations:

- While there are prospects for better economic outturn in 2021 compared to 2020, the recovery of the domestic economy continues to face headwinds from the uncertainties created by the pandemic.
- Overall inflation is well-anchored, and the underlying inflation remains low reflecting subdued demand in the economy. Despite the decline in food prices, there are threats on overall inflation coming from the steady rise in fuel prices.
- There is a stronger committment to a fiscal consolidation path in the near term that would be achieved primarily via expenditure management to address debt vulnerabilities. During the adjustment process, the fiscal policy's room to stimulate economic activity is expected to narrow; thus, redirecting focus to the role of monetary policy and related prudential measures as key levers to support economic recovery.
- Average lending rates in the banking sector recorded less-than-proportionate decline despite the maintenance of an accommodative monetary policy stance since April 2020. The downward stickiness in interest rates reflect competiting pressure to increase lending rates as banks continue to face deteriorating credit risk due to the effects of the pandemic.
- Bank lending remains stuck in low gear, despite the sustained accommodative monetary policy stance. With the worsening of credit risk due to prolonged adverse effects of the pandemic, credit standards under the prevailing loan pricing conditions are likely to be tightened, further hurting private sector credit growth.

Efforts to re-ignite inclusive growth in private sector lending, would be strongly anchored on a faster leap towards a fully-fledged risk-based pricing environment.

Banks being economic agents respond to incentives. With greater risk, the incentive to lend would be a higher lending rate that covers the elevated risk.

Therefore, in our view, and consistent with arguments in our previous *Research Notes*, efforts to re-ignite inclusive growth in private sector lending, would be strongly anchored on a faster leap towards a fully-fledged risk-based pricing environment. *This is in recognition of the fact that banks being economic agents respond to incentives. With greater risk, the incentive to lend would be a higher lending rate that covers the elevated risk.*

Background

Since April 2020, the preceding eight meetings of the Monetary Policy Committee of the Central Bank of Kenya, have seen the monetary policy stance remain unchanged, with the Central Bank Rate (CBR) set at 7.00 percent. The MPC, in its meeting of May 26, 2021 is expected to retain the CBR at 7.00 percent largely on the back of the prevailing uncertainty in the economic environment.

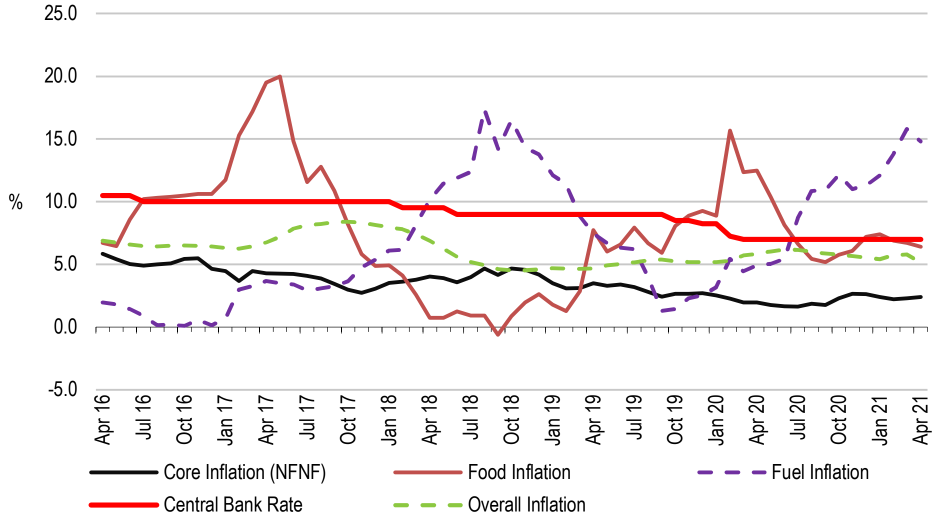
A number of developments continue to characterize the economic environment:

First, the global and domestic economic recovery is underway but continue to face headwinds from the uncertainties created by COVID-19 pandemic. At the beginning of 2021, economic recovery was starting to pick up, but the advent of the third wave of infections towards the end of the first quarter and the attendant deployment of containment measures, slowed down the pace of recovery. In fact, with persistence of the pandemic, the projected economic growth for 2021 stands at 6.3 percent, slightly lower than 7.6 percent announced in April 2021 (IMF, May 2021). Concerns are on possible resurgence of infections amidst slow roll-out of vaccinations.

Second, the Kenya Government and the IMF entered a 38-month USD 2.4 billion low-cost financing program, that besides providing access to external finance, embodied a number of economic policies. Top among the policies agreed included the adoption of a fiscal consolidation path that would ensure the Government manages its spending in the near term to secure resources to support critical economic development and to address debt vulnerabilities. During the adjustment process, the fiscal policy's room to stimulate economic activity is expected to narrow; thus, redirecting focus to the role of monetary policy and other prudential measures as key levers to support economic recovery.

Third, overall inflation is well-anchored, and the underlying (core) inflation remains subdued. In April 2021, inflation decelerated to 5.76 percent from 5.90 percent in March 2020 (**Figure 1**), on account of a decrease in both fuel and food inflation. Fuel inflation remained elevated, despite registering a decline from 15.80 percent in March to 14.80 percent in April 2021. Food inflation declined from 6.70 percent in March to 6.40 percent in April 2021 as favorable conditions continued to support food supply. Core inflation remained somewhat flat during the period, rising marginally from 2.3 percent in March to 2.4 percent in April 2021 and reflecting low demand conditions in the economy. Overall, inflationary pressures going forward will depend on the evolution of food prices that would either moderate or exacerbate the effects of the successive increases in fuel pump prices. To this end, inflationary risks are imminent.

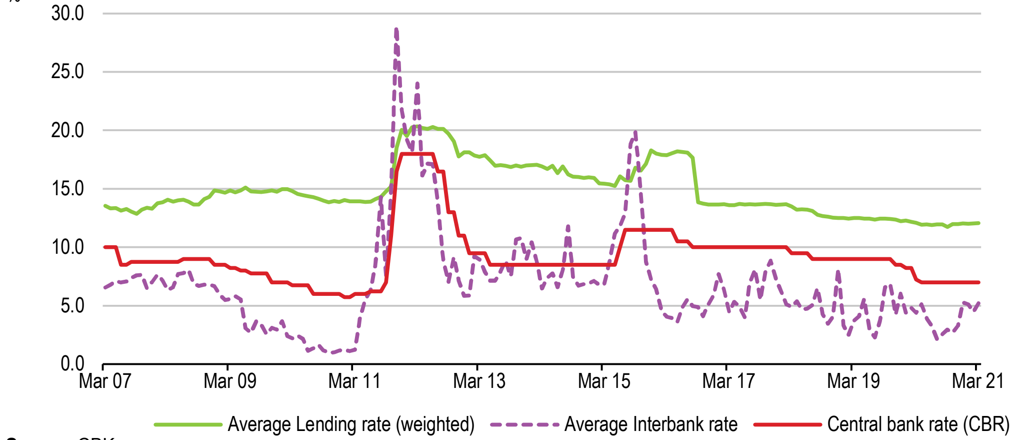
Figure 1: Trends in Inflation and the Central Bank Rate



Source: CBK & KNBS

Fourth, market interest rates have remained low and less volatile, reflective of ample liquidity in the market (Figure 2). The less-than-proportionate adjustment (stickiness) in the lending rate despite the sustained accommodative monetary policy stance adopted since April 2020, reflects two developments. First, the deterioration in credit risk as incomes of businesses and households declined due to the adverse effects of the pandemic and its containment measures. The elevated credit risk limited the extent to which banks could lower their lending rates. Second, was the enhanced need for banks to contract new loans at higher interest rates as they strived to accommodate the elevated credit risk in the market.

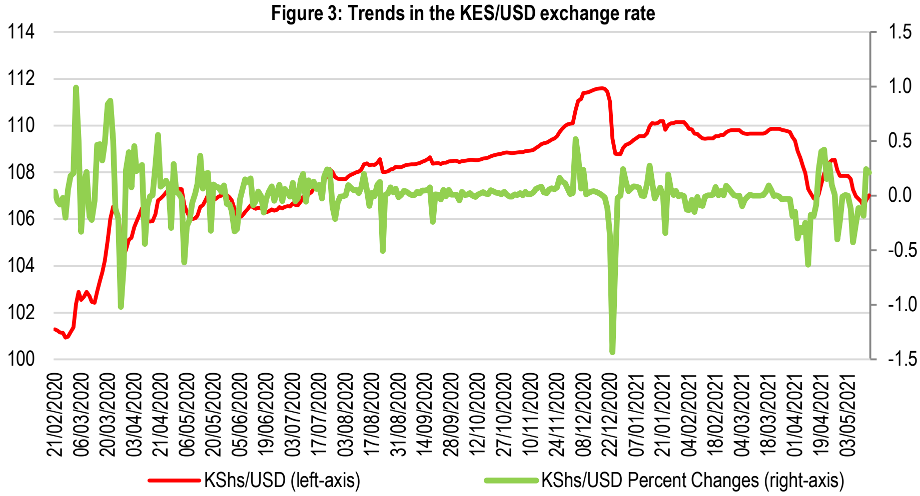
Fig. 2 Interbank rate, Lending rate and the Central bank rate



Source: CBK

Fifth, the KES/USD exchange rate has appreciated reflecting a market correction towards its long-term mean (Figure 3). The relative stability of the shilling in the last two months was buoyed by strong diaspora remittance inflows[1]; recovery in exports following the pickup in economic activity in key export destination countries in Europe; and adequate (though declined) volumes of official foreign exchange reserves (equivalent to 4.64 months of imports cover as of May 13, 2021, above the statutory minimum of 4 months). In an environment with high uncertainty, preserving the existing stability remains essential, to bolster some confidence and anchor economic recovery process. Uncertainty on the effectiveness of the interventions so far deployed to contain the pandemic continue to prolong the uneasy calm in the global foreign exchange markets. In addition, tampering with the domestic and foreign interest rate differential, through a further cut in the CBR, has the potential of distorting the current stability.

Figure 3: Trends in the KES/USD exchange rate

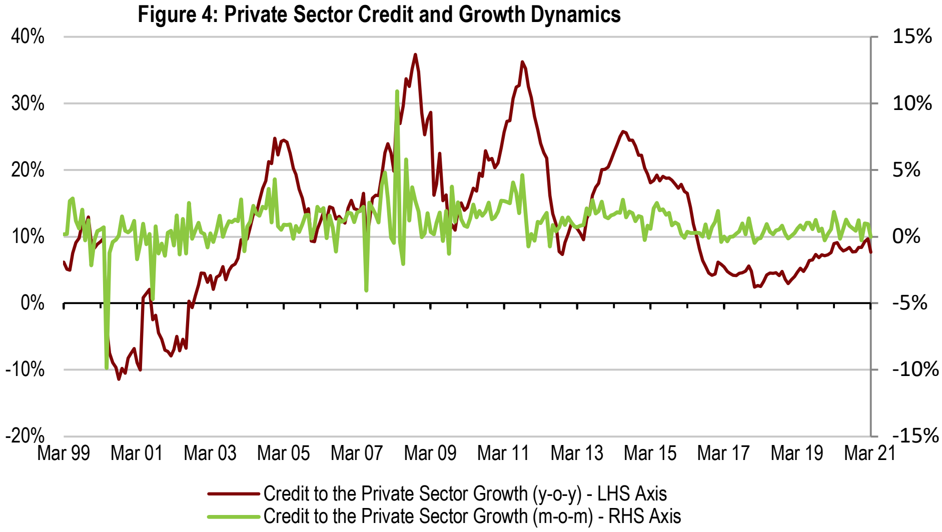


Source: CBK

[1] CBK Weekly Bulletin (May 14, 2021) reports that remittance inflows increased to USD 299.3 million in April 2021, from USD 208.2 million in April 2020, representing a 43.7 percent increase and 2.9 percent higher than the remittances in March 2021.

Sixth, bank lending has tapered off, despite the sustained accommodative monetary policy stance since April 2020(Figure 4). The annual growth in private sector lending decelerated to 7.6 percent in March compared with 9.7 percent in February 2021. The expectation of double-digit growth in private sector lending continues to be tempered by the economic uncertainty and remains largely consistent with its behaviour during periods of high uncertainty[2]. Further, with the lapse in March 2021 of the CBK emergency measures that supported lending to the private sector, and the deteriorating credit risk, commercial banks' lending standards within the existing pricing frameworks will continue to be tightened. This will further constrain the growth in private sector credit. In this regard, we argue that there is need to consider fast-tracking the implementation of credit pricing frameworks that reflect the evolution of risk in the economy. This will incentivize stronger private sector credit flows and support economic recovery.

Figure 4: Private Sector Credit and Growth Dynamics



Source: CBK

Conclusion

Therefore, in our view, and consistent with our previous *Research Notes*[3] , efforts to re-ignite growth in private sector lending, would be strongly anchored on re-engineering a faster leap into a fully-fledged risk-based pricing environment. This move will reduce the stickiness of the lending rate and mitigate any adverse effects of credit mispricing that typically leave the segments perceived to be highly risky (such as the MSMEs) heavily rationed out of the credit market. With risky business entities growing in number on account of the ongoing ravaging effects of the pandemic, their accommodation by banks with loans, sooner than later, will guarantee their existence post-pandemic. *To do this, we acknowledge that banks being economic agents respond to incentives. With greater risk, the incentive to lend would be a higher lending rate that covers the elevated risk.*

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Comments on this *Research Note* can be forwarded to the Centre's Director at research@kba.co.ke

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[2] Piergiorgio Alessandri, and Margherita Bottero (2020). Bank Lending in Uncertain Times. European Economic Review. Vol. 128, 1-19. https://www.sciencedirect.com/science/article/abs/pii/S0014292120301343

[3] See https://www.kba.co.ke/downloads/Research%20Note%20No.%201%20of%202021.pdf