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Research Note

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Monetary policy is already too accommodative, given the elevated credit risk, protracted uncertainty and rising inflationary pressures

Highlights

The **July 28, 2021** meeting of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) is expected to provide a clear signal that monetary policy is aimed at ensuring price stability, in an environment of rising inflation and growing uncertainty. Based on our analyses, the CBR should be held at 7.00 percent, on account of a number of considerations:

- First, with the delay in the release of the official economic performance statistics, there is limited clarity on the performance of the economy in 2020 and the first quarter of 2021, thus worsening the uncertainty among market players and delaying the execution of business plans.
- Second, inflationary pressures are tilted on the upside, albeit remaining within the 5±2.5 percent target range in the short term.
- Third, the growth in credit to the private sector continues to dampen, and any effort to further stimulate it by way of further easing may be counterproductive given the rising inflationary pressures. Efforts should be directed at ensuring the available liquidity is absorbed to generate economic activity and mitigate any inflationary pressure in the medium term.
- Fourth, interest rates four quarters after the reduction in the CBR have responded less-than- proportionately, reflecting stickiness that is anchored on elevated credit risk and protracted uncertainty on the economy.
- Lastly, while the Government is committed to a fiscal consolidation path mainly through enhanced revenue mobilisation, the fiscal policy's support to economic recovery remains highly constrained.
- In the light of this, caution is called in monetary policy making, because of the risk of perverse outcomes of fueling demand-driven inflationary pressure in the event monetary policy decision seeks to support growth with a further easing of stance.

On account of the outlined factors, and particularly with the inflationary risks present, monetary policy should focus on its primary role of price stability. If anything, accomodating a readiness to limit the buildup in inflationary pressure through a tightening of the stance should be seen as a viable option. But with the overaching pursuit of supporting economic recovery, a hold on the CBR at 7.00 percent would infact imply an implicit enhanced accomodative stance.

Amidst the elevated credit risk, the economic recovery underway runs the risk of being less-credit-driven and, thus unanchored and unsustainable.

While arguing for maintaining the policy rate at 7.00 percent, we reiterate that the prevailing loan pricing conditions are restrictive for the banking sector to absorb risk and support credit growth, which helps mitigate the inflationary pressure in the medium term.

Background

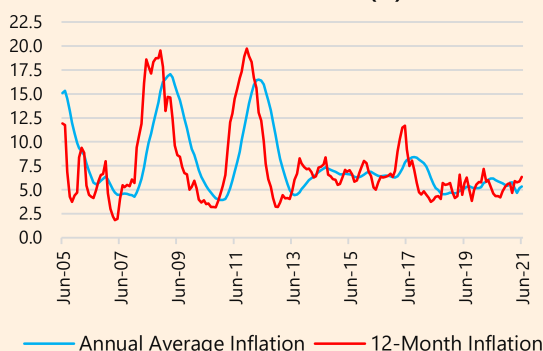
Monetary policy making during periods of great uncertainty remains a challenge the worldover. But in all cases, caution among policymakers is called for. Since April 2020, the economy has gone through bumps of different sizes, characterized by closures of different magnitudes and forms affecting almost all sectors heterogenously. These developments have heightened uncertainty in the economy and its outlook. Besides the the uncertainty caused by the pandemic, we expect a number of developments to shape the decision of the MPC in its meeting on July 28, 2021.

- **First, with the delay in the release of the official economic performance statistics, there is limited clarity on the performance of the economy in 2020 and the first half of 2021.** This continues to aggravate the uncertainty among market players, and thus delay the execution of business plans. A hold on resumption of economic activity, would not only avoid a V-shaped recovery path , but rather elongate the trough in the U-shaped recovery of the economy that is likely to be recorded. This has adverse implications on employment creation and survival of MSMEs whose structures are not so well-anchored. Amidst all these, however, statistics on the performance of the global economy show better outturn in 2021 over 2020 on the back of resumption of activity aided by mass rollout of vaccinations. But global commentators have cautioned against rising demand-driven inflationary pressures as economies show early signs of overheating from the stimulus packages; with most advanced countries reconsidering a gradual withdrawal of their economic stimulus packages.

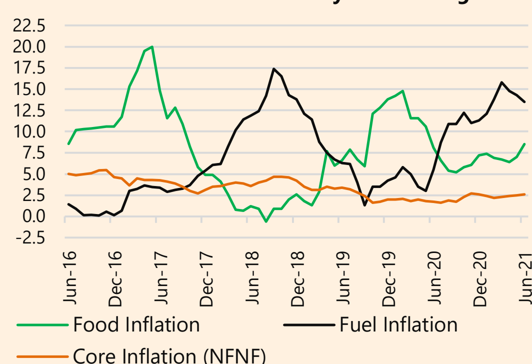
- **Second, inflationary pressures are tilted on the upside, albeit remaining within the 5±2.5 percent target range in the short term.** As shown in **Chart 1** and **Chart 2**, the 12-month inflation rate peaked in June 2021 at 6.32 percent from 5.87 percent in May; the fastest increase since March 2020 picking the attention of market players. The question is whether the increase is transitory or permanent. In this Note, we argue that the observed increase in inflation is on account of three main factors: i) a mere base effect, ii) food price increases, and iii) some core inflationary pressure. Food inflation rose to 8.5 percent in June from 7.0 percent in May 2021, while core inflation posted an increase, though marginal, to 2.6 percent in June from 2.5 percent in May 2021 reflecting some build up in demand as economic activity recovers. Fuel inflation, however, eased slightly to 13.5 percent in June from 14.3 percent in May 2021, thus moderating the overall inflation position given the importance of oil as an intermediate good.

  However, there are some imminent risks to inflation worth our attention. First, is the persistent rise in global prices of both fuel and non-fuel commodities (**Chart 3** & **4**). While these changes reflect the recovery in global demand from the adverse effects of the pandemic, their strong pass-through to domestic prices (with oil being an intermediate good) portend greater inflationary pressure going forward. Other risks include the additional excise taxes to be implemented since July 2021 as outlined in the 2021/22 budget statement.

  On account of these outlined developments, we argue that any further cuts on the policy rate (to signal a further easing monetary policy stance) runs the risk of fueling demand-driven inflationary pressures particularly when aggregate demand is building up with the incipient recovery of economic activity. If anything, policy considerations as far as inflation is concerned would be leaning more towards increased vigilance and a readiness to signal an upward adjustment in interest rates to contain the imminent inflationary risks that have a higher likelihood of materializing.



Source: CBK



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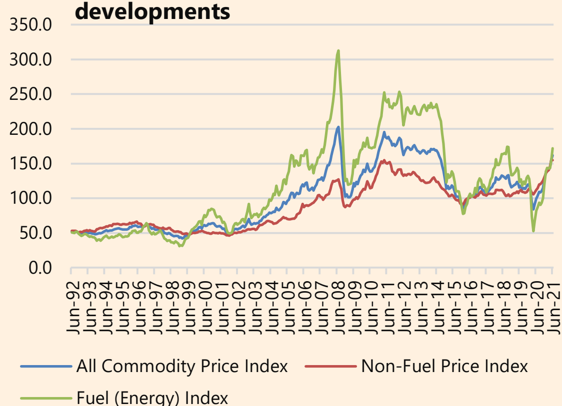

Source: IMF

Source: World Bank Commodity Prices

- **Third, the growth in credit to the private sector continues to dampen, and any effort to further stimulate it by way of further easing may be counterproductive given the rising inflationary pressures.** Growth in bank lending to the private sector has continued to ease, to 6.8 percent in May from 7.6 percent in March (**Chart 6**), tempering the expectation of stronger -possibly double digit-growth needed to revamp economic recovery. While the deceleration is largely attributed to uncertainty[1], it also reflects the less-than-proportionate decline in lending rates that followed the reduction in the CBR in April 2020 (even after allowing 15 months for transmission of the signal), as shown in **Chart 5**. The disproportinate reduction in lending rate is attributed to rising credit risk in the market and uncertainty on the path of economic performance due to the effects of the pandemic.

  In our view, to revamp credit growth amidst elevated credit risk, the efforts should be directed at ensuring the banking sector is incentivised to absorb risk to ensure that the available liquidity is absorbed to generate economic activity. In any case, this will deliver the dual benefit of mitigating inflationary pressure in the medium term. Otherwise, bank lending will continue to be depressed as banks adopt more cautious lending approaches, that typically exclude the risky borrowers.

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[1] See arguments by Alessandri, P., & Bottero, M. (2020). Bank lending in uncertain times. *European Economic Review*, *128*, 103503. https://doi.org/10.1016/j.euroecorev.2020.103503

Chart 5: Interest rates (%)

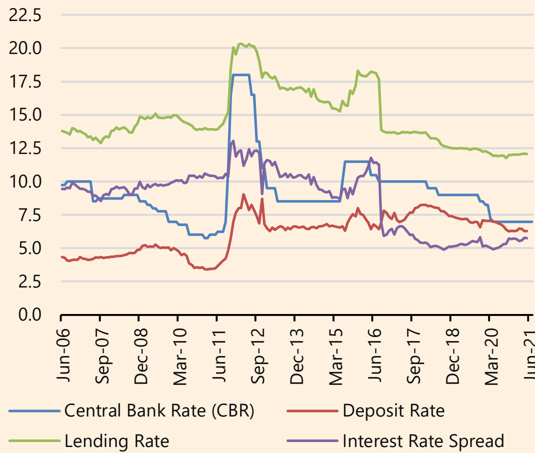
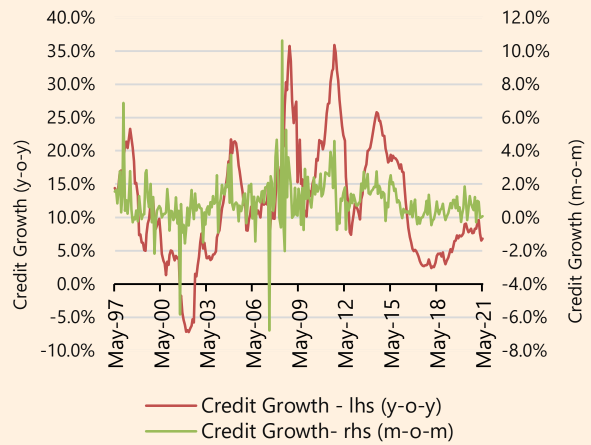


Chart 6: Growth in Claims on Private Sector



Source: CBK

- **Fourth, the Shilling exchange rate against major global currencies remained stable, but on a long-term depreciating path.** As shown in Chart 7, the exchange rate assumed a weakening trend from mid-2016 but reporting periodic strengthening from time to time. Nonetheless, the developments in the global financial markets would filter through to the domestic market given that the CBK implements a market driven exchange rate policy. The official foreign exchange reserves, that signal the capacity of CBK to deal with any emergent heightened instabilities in the market were equivalent to 5.81 months' worth of imports by end June 2021 (**Chart 8**), above the statutory minimum of 4 months of import cover. The current stability in the exchange rate implies lower threat to overall inflation coming from imported inflation.

Chart 7: Exchange Rate Developments

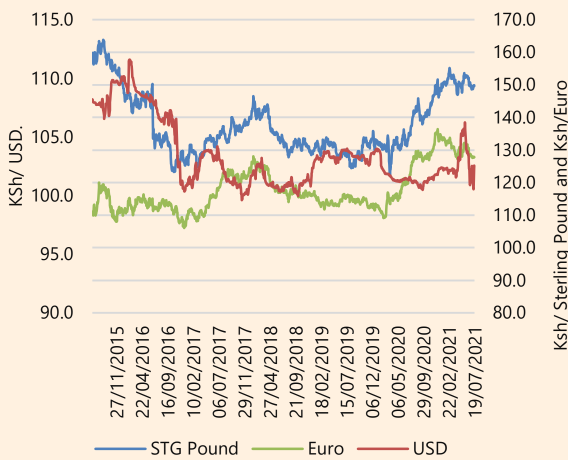
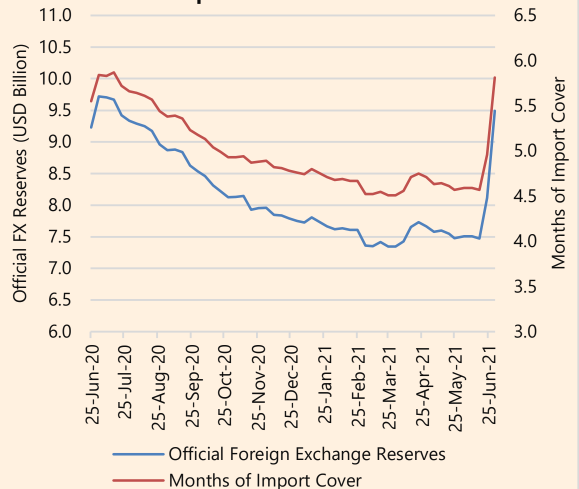
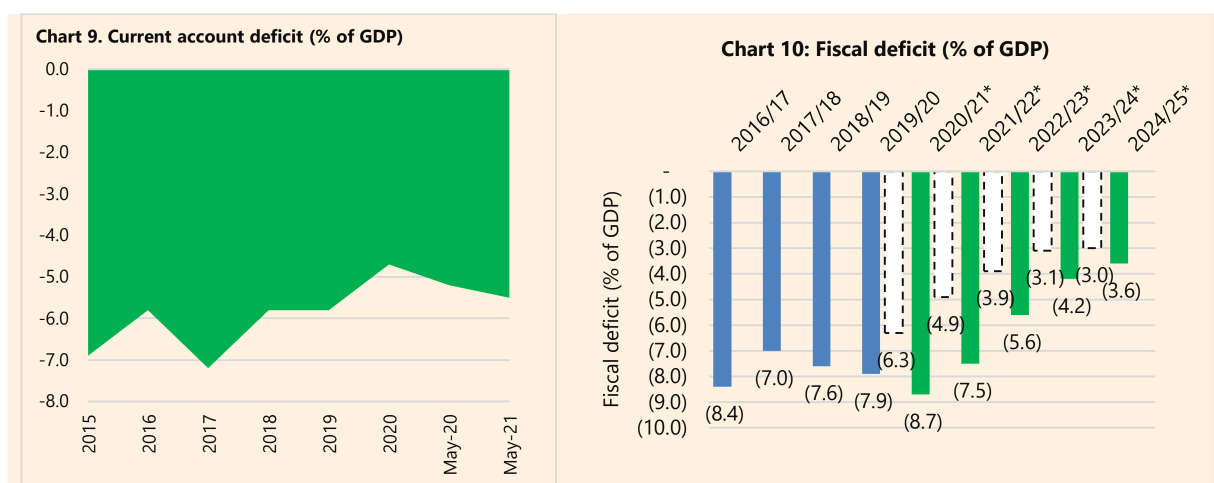


Chart 8: Foreign Exchange Reserves & Months of Imports Cover



Source: CBK

- **Fifth, the economy faces the risk of dual imbalances in the near to medium term, with potential of widening current account and fiscal deficits**. For the external imbalance, the current account deficit appears stable at about 5 percent of GDP (**Chart 9**), but there are imminent risks of this balance widening as global oil prices rise. The moderating effects of growth in exports remain vulnerable to the pace of global recovery and the attendant risks at destination countries. On the domestic front, the Government has outlined its committment to a fiscal consolidation path (**Chart 10**) leaning more on revenue mobilisation. In particular, the Government projects its fiscal deficit to decline from 8.7 percent in FY 2020/21 to 7.5 percent in FY 2021/22 and further to 3.6 percent of GDP by FY 2024/25. This implies a limited headroom for deployment of fiscal stimulus to support economic recovery. While this is dependent on the pace of economic recovery, the onus of delivering economic recovery is squarely on monetary policy and most-importantly a resolution of market strains that continue to limit credit supply.



Source: CBK and The National Treasury

Conclusion

In this *Research Note*, we argue that the current monetary policy stance remains accommodative enough, given the elevated credit risk without a reciprocating change in lending rates. In this regard, further easing would potentially exacerbate inflationary pressure in an environment where demand-driven inflation is edging upwards. Uncertainty has been aggravated by not only the effects of the pandemic, but also delays in the release of official data on domestic performance. The need to mainstream uncertainty in lending- by appropriately pricing risk- amid elevated credit risk is stronger now than before. On the hindsight, credit absorption in economic activity will deliver dual benefits; anchored growth of the economy and a medium-term solution to the incipient inflationary pressure.

In line with arguments in our previous *Notes*[2], ensuring a flow of credit to the private sector that supports the budding economic recovery would be strongly anchored on a faster leap towards a fully-fledged risk-based pricing environment. Otherwise, amidst the elevated credit risk, the economic recovery currently underway runs the risk of being less-credit-driven[3], which will be unanchored and thus unsustainable.

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[2] See https://www.kba.co.ke/downloads/Research%20Note%20No.%203%20of%202021.pdf

[3] See Sugawara, N., & Zalduendo, J. (2013). Credit-less recoveries: neither a rare nor an insurmountable challenge. *Policy Research Working Paper;No. 6459. World Bank, Washington, DC. © World Bank. https://openknowledge.worldbank.org/handle/10986/15597. See also,* Corrado, L., & Rossi, I. (2019). Anatomy of credit-less recoveries. *Journal of Macroeconomics, 62*, 103152. *https://doi.org/10.1016/j.jmacro.2019.103152*

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