KENYA BANKERS ASSOCIATION
One Industry. Transforming Kenya.

POLICY BRIEF

PB/06/22

January 2022

THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Spurring Bank Lending to Support Economic Growth in Kenya

Executive Summary

There is concern over the persistent limited bank lending which causes dismal economic growth with boomerang effects on bank lending. The problem would continue indefinitely with devastating impact on human welfare unless it is checked. To break the vicious circle of bank credit and economic growth, the government and the Central Bank of Kenya should formulate and implement coordinated fiscal and monetary policies to enhance fiscal space as a means of spurring bank credit and economic growth. The government should re-examine the current fiscal year budget and reset project priorities.

– Authored by: Benjamin Maturu

1. Context and Importance

Except for the period June 2011-August 2012 when growth in bank credit fell below 8 percent per annum hitting 3 percent in December 2011, bank lending grew by at least 8 percent between February 2010 and April 2016. Meanwhile, economic growth grew by at least 5 percent, but was below the 10 percent envisaged in Kenya's Vision 2030. Since February 2016, however, real bank lending decelerated from 13.25 percent in February 2016 to a low of -5.68 percent in April 2017[1]. Within about a year, that was followed by deceleration of economic growth from 7.6 percent in May 2017 to 1.94 percent in May 2018. As **Figure. 1** shows, recovery in bank lending and economic growth to their April 2017 and May 2018 levels was nowhere in sight as at the end of December 2019. The situation was exacerbated by the arrival of the Covid-19 pandemic in Kenya in March 2020.

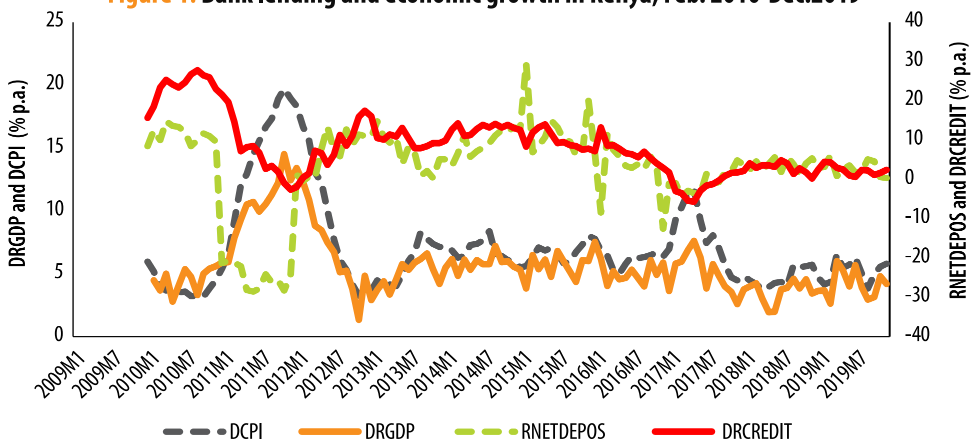
The relationship between bank credit and economic growth cannot be over-emphasized. Available evidence in a recent study by Maturu (2021) on *"The Finance-economic Growth Nexus in Kenya"* shows that bank lending and economic growth are interdependent. Low levels of bank lending cause low levels of economic growth with boomerang effects on bank lending. There is therefore a problem of bank lending and economic growth being trapped at low levels. That raises concerns on whether bank lending and economic growth can be revamped.

2. Methods

The study applies mathematical tools to specify and estimate how banks mobilize deposits and lend, and how business enterprises produce goods and services. The interdependency between bank deposits, bank lending

1 Real bank credit is nominal credit to the private sector deflated using the GDP deflator.

Figure 1: Bank lending and economic growth in Kenya, Feb. 2010-Dec.2019



Notes: DCPI = consumer price index rate of inflation; DRGDP = real economic growth rate; RBETDEPOS = growth in real bank deposits net of period loan disbursement; and DRCREDIT = growth in real bank credit.

Unless the downward spiral in bank lending and economic growth is checked and turned into an upward spiral using socio-economic policies, it would continue indefinitely and cause losses in employment, wages and consumption among domestic households for a long period

and production of goods and services is considered. For the ease of evaluation of the effectiveness and appropriateness of fiscal and monetary policies, the specified model includes fiscal and monetary policy instruments, namely, the central bank rate for monetary policy and government expenditure, direct and indirect government taxation rates for fiscal policy.

3. Study Findings

From the policy front, analysis of the effectiveness of fiscal and monetary policies shows that the policies are partly effective. While the channels through which changes in the policies affect intended variables such as bank lending and economic growth are operational, the policies are constrained by inadequate public financial resources. Because of the lack of financial resources, the central government cannot formulate and implement a sufficiently large and sustained fiscal stimulus. Similarly, inadequate disposable incomes and poor cash flows not only inhibit households' and firms' effective demand for new bank credit but also cause failure of households and firms to repay existing bank loans with adverse implications for their creditworthiness. It is also shown that COVID-19 increases the human capital depreciation rate thereby impairing economic growth and households' wage incomes.

4. Conclusions and Policy Implications

The interdependence between bank lending and economic growth has profound implications for Kenya's economy. When it materializes as a persistent downward spiral, it has potential to indefinitely hurt human welfare through loss of employment and wages. Well-coordinated socio-economic policies to mitigate this thus is important.

To break the vicious circle of bank credit and economic growth, the government and the central bank of Kenya should formulate and implement coordinated fiscal and monetary policies to, first and foremost, enhance fiscal space as a means of spurring bank credit and economic growth. To enhance fiscal space, the government:

- Should re-examine the current fiscal year budget and reset project priorities.
- Should seek for enhanced official project grants and improved terms of external loans including debt cancellation, debt rescheduling and reduced interest cost;
- Formulate and implement an appropriate fiscal stimulus package using savings from the budget rationalization where leakages of the stimulus package through non-essential imports should be minimized if not eliminated it to ensure maximum economic impact; and
- Intensify vaccination of residents against the covid-19 virus.

The Central Bank of Kenya should:

- Formulate and implement appropriate monetary policy to support the fiscal stimulus package;
- Reinforce market-based determination of bank lending and deposit interest rates by eliminating residual controls from the repealed Banking (Amendment) Act 2016 to encourage supply of credit;
- Consider a comprehensive mechanism of addressing non-performing loans to enhance effective supply of and demand for bank credit.

Reference

Maturu B. O., 2022. *"Covid-19 and the finance-economic growth nexus in Kenya",* KBA Working Paper Series (WPS/06/2022).

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY®

About the Centre for Research on Financial Markets and Policy®

The Centre for Research on Financial Markets and Policy® was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and dialogue regarding critical policy matters that impact on financial markets in Kenya. The Centre sponsors original research, provides thoughtful commentary, and hosts dialogues and conferences involving scholars and practitioners on key financial market issues. Through these activities, the Centre acts as a platform for intellectual engagement and dialogue between financial market experts, the banking sector and the policy makers in Kenya. It therefore contributes to an informed discussion that influences critical financial market debates and policies.

Kenya Bankers Association 13th Floor, International House, Mama Ngina Street | **Postal:** P.O. Box 73100– 00200 NAIROBI
Telephone: 254 20 2221704/2217757/2224014/5 | **Cell:** 0733 812770/0711 562910 | **Fax:** 254 20 2221792
Email: research@kba.co.ke | **Website:** www.kba.co.ke