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Sustain Monetary Policy Stance for Longer, but Enhance Risk-Based Pricing of Credit.

"Fiscal policy's room for manoeuvre to steer the economy out of the depressed state is limited in an environment of announced fiscal consolidation and rising concerns of debt build-up and its sustainability. With public sector-led economic recovery out of the picture, this bestows the onus of economic recovery to monetary policy and most importantly its support to private sector lending.

Highlights

- The economy enters 2021 with substantial slack, calling for additional policy support to close the output gap.

- As the Government targets a quicker economic recovery, and taking cognisance of the narrowing room for fiscal policy to steer the recovery, the onus is on monetary policy. The critical question is, how should monetary policy do the trick particularly under the existing uncertainty?

- The growth in bank lending that had picked up in August 2020 has tapered off, at below levels required to support a strong economic recovery. This also reflects an incomplete response to the strong accomodative monetary policy signal provided in March and augmented in April 2020. Under this scenario, re-energizing credit growth would be necessary and somewhat sufficient to forestall a delayed recovery of the economy.

- In this *Research Note*, we argue that the much-needed monetary policy support to grow credit, would not be anchored on the policy rate adjustment, but rather enhancing the effectiveness of previous monetary policy actions to support higher credit extension to the private sector.

- In our view, there is need to maintain the policy rate at 7 percent but re-energize the process of easing credit flows, particularly by fast-tracking the implementation of risk-based pricing. This would support a more inclusive growth in credit, particularly to the Micro, Small and Medium-sized Enterprises (MSMEs).

SUMMARY

In its meeting of **Wednesday, January 27, 2021**, the Central Bank of Kenya's (CBK) Monetary Policy Committee (MPC) is faced with the need to balance between supporting economic recovery and sustaining macroeconomic stability. The economy has shown signs of a recovery, but the recovery remains fragile and uneven, largely due to the continued uncertainty with regard to the extent of the impact of the pandemic and how long it would take for it to be contained. Options for re-engineering a strong economic recovery would focus on a number of considerations, key among them being:

- **First, the economy enters 2021 with substantial slack, and thus requiring enhanced accommodative policy support to narrow the output gap**. With projected real GDP growth of below 1 percent for 2020 weighed against a potential growth of about 6 percent, the resultant output gap that faces policymakers in 2021 calls for the deployment of measures that would revamp economic activity.

- **Second, the 12-month overall inflation rate that rose slightly to 5.6 percent in December from 5.3 percent in November remains within the medium-term target range of 5±2.5 percent.** However, the rising global oil prices, an uptick in domestic demand that comes with the resumption of economic activity, and a relatively weaker shilling may exert upward pressure on inflation towards the band's upper limit. Nonetheless, this will be moderated by expected minimal pressure on food prices in the near term.

- **Third, the shilling has exhibited overall stability, albeit with some weakening bias, largely on account of uncertainty created by the pandemic**. Several other factors continue to exert pressure on the local currency, including the strengthening of the US dollar in the international market particularly following the conclusion of the change of leadership in the US that is expected to stabilize U.S economic and trade policies, going forward. In addition, the current account deficit is expected to widen on account of a faster build-up in imports bill due to the rising global oil prices than the growth in export earnings. However, resilient diaspora remittances will continue to provide some reprieve in enhancing foreign exchange inflows in the market.

- **Fourth, the unwinding of tax measures may provide some revenue boost, but only if there is a strong recovery in economic activity**. Otherwise, this move may constrain the economy's slow and fragile recovery, given the precarious state of businesses reeling out the pandemic's challenges and containment measures. This, coupled with concerns of build-up in Government debt and its sustainability, continue to limit the fiscal policy's flexibility to support a strong economic turnaround.

- **Lastly, in light of the above, the onus is on monetary policy to steer the economy towards its potential growth rate.** Bank lending has recovered, but its pace remains stuck in low gear despite very strong accommodative monetary policy signal provided in March and augmented in April 2020. The sustenance of a private sector lending growth at below-single digits, no doubt, will support only slower recovery in the economy. The question then is, what should be done to push the liquidity in the banking system to the private sector to finance economic activity?

In this *Research Note*, we argue that as Government targets a quicker recovery in the economy and in recognition of the limited fiscal policy's limited role in steering the economic recovery, the MPC would need to explore the options available for monetary policy to revitalize credit growth. Further, we argue that to re-ignite private sector lending, the much-needed monetary policy support with the protracted uncertainty would not be anchored on the policy rate adjustment, as this option is unlikely to move the bank lending needle. In our view, a feasible option would be to maintain the policy rate at 7 percent but re-energizing the process of easing credit flow to the private sector, particularly by fast-tracking

the implementation of risk-based pricing. This would support a more inclusive growth in credit, particularly to the MSMEs.

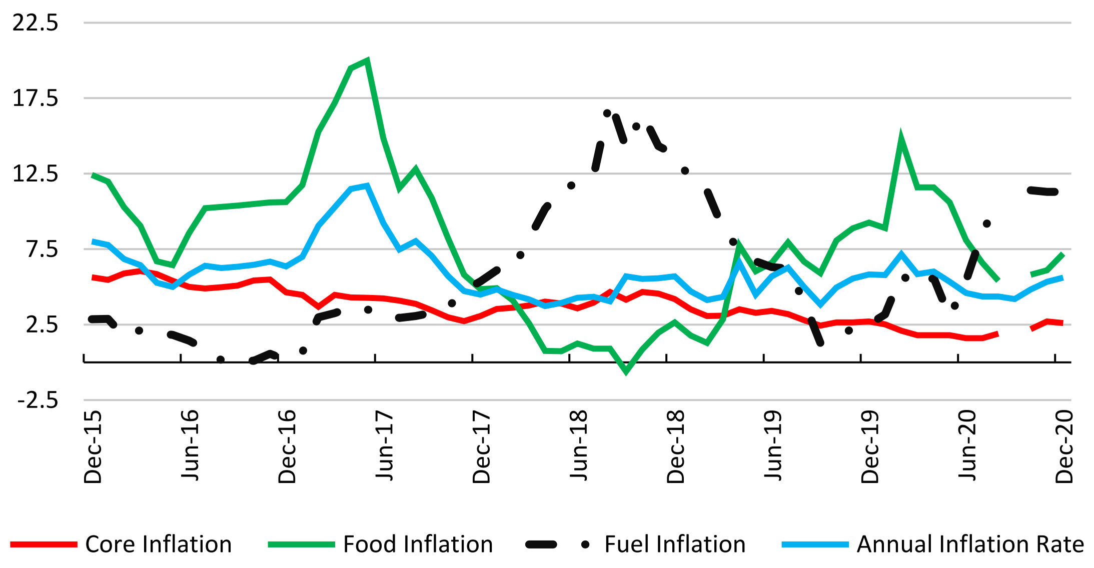
This argument is made against a review of several factors and developments, subsequently explored further below.

Overall inflation remains within the target band, but continues to face upward pressure from food and fuel price increases.

As **Figure 1** shows, price pressures have remained modest keeping inflation around the midpoint of its target range given as 5±2.5 percent. The 12-month (annual) inflation rate rose to 5.6 percent in December 2020 from 5.3 percent in November 2020, mainly on account of a sustained rise in global oil prices and an uptick in food inflation during the festive season. In particular, food inflation rose to 7.2 percent in December compared to 6.1 percent in November, as fuel inflation stood at 11.30 percent in December, slightly above 11.0 percent reported in November. The core inflation (excludes food and fuel inflation), that reflects demand conditions in the economy, however remained somewhat flat at 2.6 percent over the period.

Looking ahead, the rising global oil prices will continue to exert upward pressure on overall inflation, via its direct effects on fuel inflation and indirectly on other products dependent on oil as an intermediate good. The risk of imported inflation is also real with shilling at a relatively weaker level compared to levels reported over a similar period in early 2020.

Figure 1: Inflation Dynamics

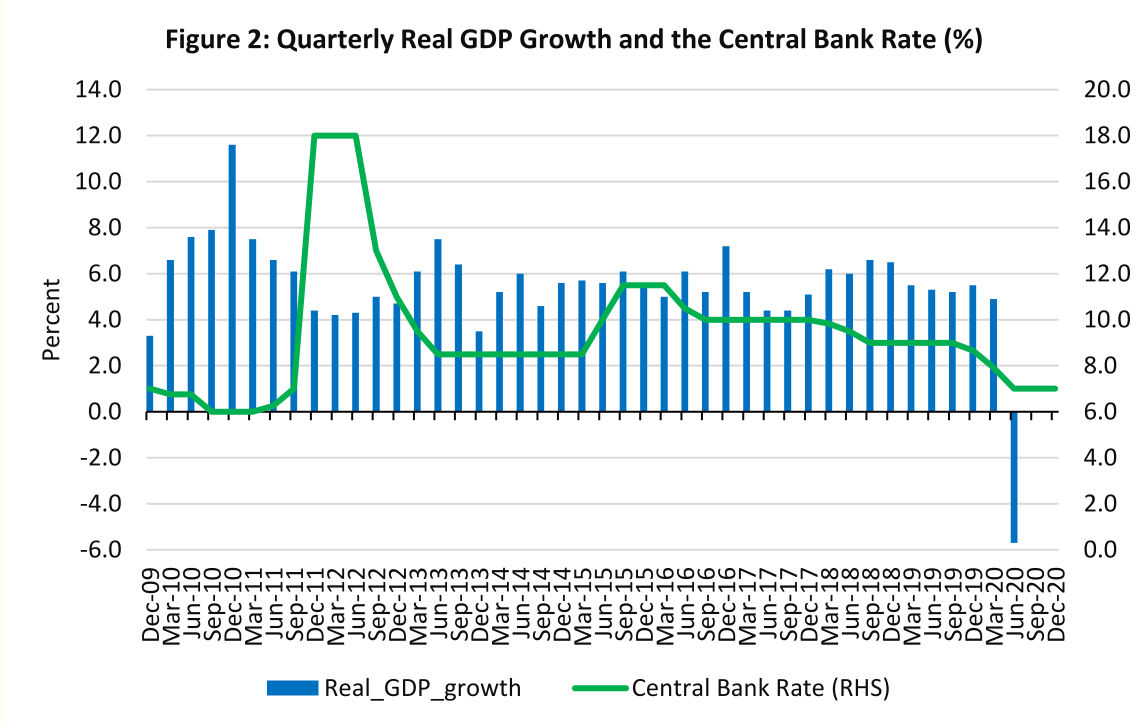


Source: CBK

In view of the above developments and expectations of a further rise in inflation, a further cut in the policy rate may introduce additional pressure on inflation particularly via a weaker exchange rate.

The current economic situation, despite showing signs of economic recovery, remains weak, fragile, and uneven.

As **Figure 2** shows, economic activity, particularly in the second quarter of 2020 suffered a significant downturn, largely attributed the adverse effects of the pandemic's containment measures. In particular, real economic activity contracted by 5.7 percent, more-than-offsetting the 5.3 percent growth that had been realized over a similar period in 2019. The impact of the pandemic was more severe in the service sectors of the economy, especially the tourism and hotel sectors, and transport following disruptions in transport and trade channels, and reduction of operating hours in line with COVID-19 containment measures.



Source: CBK and KNBS

Consistent with an almost quarter-on-quarter slowdown in economic activity since the first quarter of 2018, it can be argued that the pandemic disrupted the economic activity from finding a strong footing. The economy that was facing a transformation away from a strong dependence on agriculture in favour of services has automatically reverted to rely on agriculture. The challenge is, agricultural activity is highly uncertain, particularly when it is extensively rain-fed. Due to this, credit to agriculture remains highly volatile. In essence, the reprieve that the economy is currently enjoying based on the support from agricultural activity is extremely fragile.

With overall real economic output growth estimated to grow below 1 percent in 2020 (IMF[1]), compared to an average of 5.6 percent growth over the last five years (2015-2019), reflects a widening output gap. With the global economy depressed and far from stabilizing, this calls for continuity of monetary policy stabilization measures. As the government targets a quicker recovery in the economy, the question then is, which levers will need to be moved to steer a strong and sustainable recovery of the economy?

In view of the above, and with fiscal policy extremely constrained, the onus of delivering a strong and sustainable recovery of the economy is a monetary policy supported – growth in banking sector credit.

Fiscal policy remains strongly constrained in at least three fronts:

- First, the announced fiscal consolidation will impede public sector-led economic recovery.

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[1] https://www.imf.org/en/Publications/CR/Issues/2020/05/11/Republic-of-Kenya-Request-for-Disbursement-under-the-Rapid-Credit-Facility-Press-Release-49405

- Second, while the reversal of corporate tax measures may provide some revenue boost in the short term, it may discourage a stronger recovery in the medium term. It is highly likely that higher taxes will be sourced from sectors that continue to support the economy during the pandemic. Given the precarious state of businesses reeling out the constraints imposed by the pandemic, an increase in taxes, with the protracted pandemic's containment measures, would be akin to 'pruning out fresh shoots instead of the weak branches and expecting the tree to bear much fruit'. In essence, this is likely to delay the economic recovery process; and
- Third, increasing concerns of debt build-up and its sustainability will constrain fiscal policy's room to deploy a stronger stimulus package that would directly support economic recovery.

Against the above scenario, a monetary policy-supported private sector credit-led recovery will be inevitable. The role of bank loans in financing economic activity cannot be overemphasized. This coupled with the demonstrated resilience of the banking sector during the pandemic, in terms of the adequacy of capital and liquidity buffers, strongly positions the sector to act as an effective driver of economic recovery; determining the speed and magnitude of the recovery.

Bank lending remains stuck in low gear, despite the sustained accommodative monetary policy stance (Figure 3). In November 2020, private sector lending grew 8.2 percent compared to October's 7.7 percent growth, below expectations of over 10 percent growth in early 2020 following the interest rate caps' repeal in November 2019. The expectation of double-digit growth in private sector lending was tempered, as economic uncertainty due to the pandemic's effects affected both the demand and supply side of credit markets. This was, however, consistent with expected behaviour during periods of high uncertainty[2]. However, we argue that more credit can be supplied if only it can be effectively priced in line with prevailing risk conditions.

But concerns have emerged with the slight deterioration in asset quality of the banking sector. This has been driven mainly by a decline in business prospects and activity during the pandemic and job losses across most sectors of the economy. As a result, banks have tightened credit standards under the prevailing pricing conditions.

In this regard, we argue that ensuring that the banking sector is unconstrained to effectively price credit, would allow the sector to strongly respond to monetary policy signals and facilitate the much-needed credit flows to the private sector.

In our view, to re-ignite growth in private sector lending, much-needed monetary policy support would not be fully anchored on the policy rate adjustment. If anything, an easing stance is unlikely to move the bank lending needle. Under the circumstances, providing a more conducive environment to allow effective pricing of risk will support credit allocation and boost economic activity.

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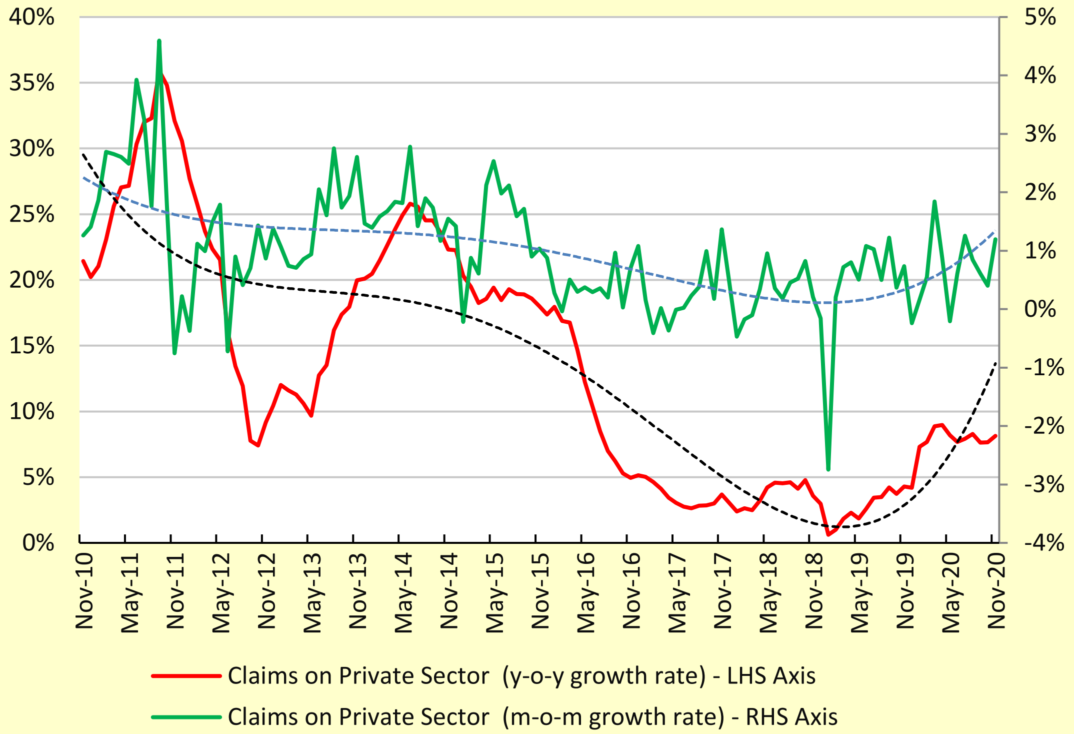
[2]Piergiorgio Alessandri, and Margherita Bottero (2020). Bank lending in uncertain times. *European Economic Review. Vol. 128, 1-19.* https:/ . /www.sciencedirect.com/science/article/abs/pii/S0014292120301343

Figure 3: Private Sector Credit and Growth Dynamics



Source: CBK

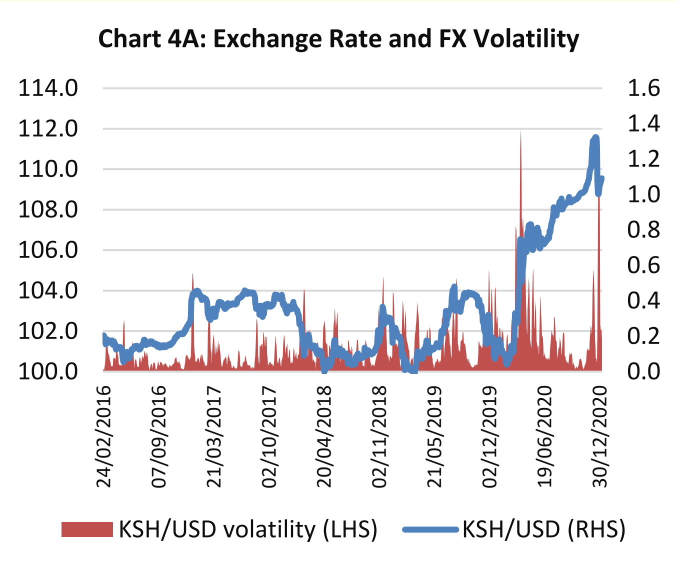
The Shilling's stability will be important to support macroeconomic stability, going forward

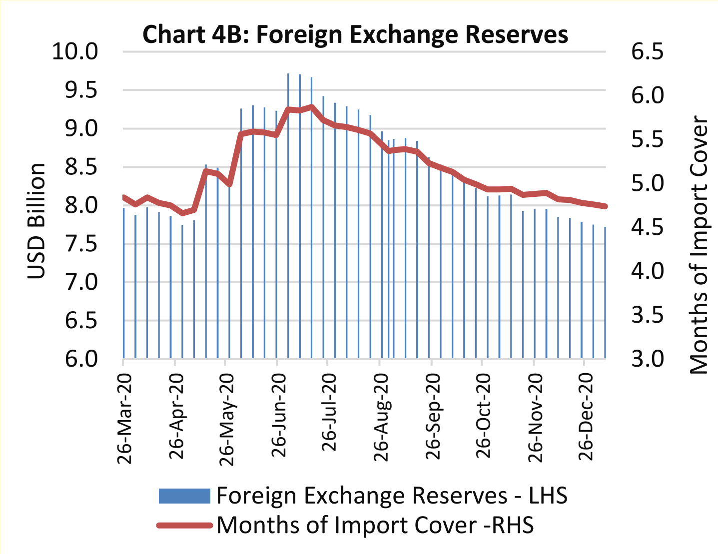
In recognizing that the exchange rate responds to both changes in fundamentals as well as market sentiments, we anticipate some fragility reflecting the uncertainty in global markets. Figure 4 shows that the Shilling weakened considerably in the second half of 2020, largely on the uncertainty created by the pandemic that triggered some volatilities in the global financial markets. The Shilling was, however, buoyed by adequate (though on a declining trend) volumes of official foreign exchange reserves that was equivalent to 4.8 months of imports cover by end December 2020 (compared to the statutory minimum of 4 months) (Figure 4B), and resilient inflows of diaspora remittances. These coupled with a narrowing current account deficit (**Figure 5**) eased pressure on the exchange rate even as the Central Bank sustained its accommodative monetary policy stance.

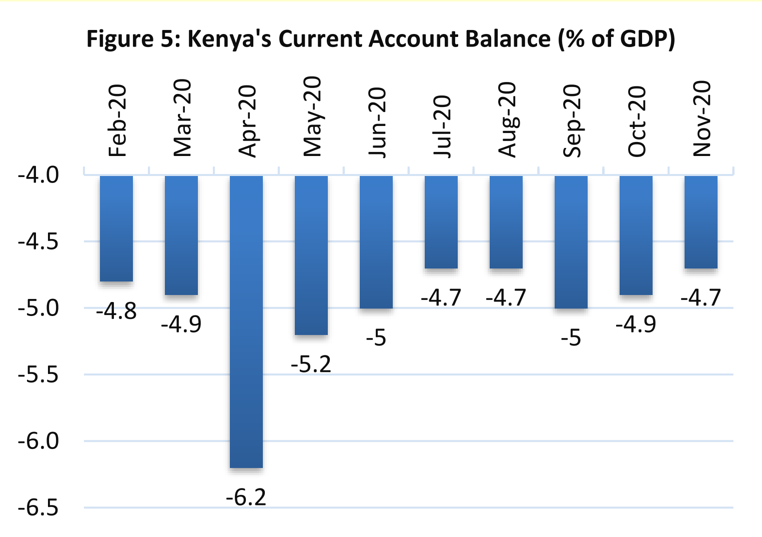
Going forward, risks on the exchange rate would stem from both the demand and supply of foreign exchange dynamics in the market as well as any changes in the interest rates. In particular, the main risks include: (i) a further cut in the policy rate that would worsen the interest rate differential for the economy; (ii) a further rise in the global oil prices that would increase the demand for foreign exchange to finance a higher oil import bill; and (iii) a widening of the current account deficit on account of slower recovery of exports (due to slower global growth) compared to the growth in imports. In addition, a further decline in the stock of foreign exchange reserves towards (or even beyond the statutory minimum), may raise concerns of the country's ability to deal with any emerging shocks that affect the foreign exchange market and exert pressure on the local currency to depreciate or remain weak.

From the above discussion, a further cut in the policy rate will have adverse implications on the exchange rate, particularly with the prevailing uncertainty in the global financial markets due to the pandemic, and the possibility of a strengthening of the US dollar with the change of leadership in the U.S.

Figure 4: Exchange Rate and Foreign Reserves Dynamics







Source: CBK

Conclusion

The economy enters 2021 with substantial slack, and a continuation of uncertainty. As the MPC considers its policy options and decisions, the focus will be on supporting macroeconomic stability while at the same time steering a stronger recovery of economic growth. Inflation remains within the target band, albeit with some moderate upward pressure; the foreign exchange market has stabilized, but uncertainty prevails; and credit to the private sector tapered off at below market expectations.

As the Government targets a quicker recovery of the economy, room for fiscal policy manoeuvre to support the recovery has narrowed, leaving the onus to monetary policy. But more importantly, focusing on enhancing the effectiveness of previous monetary policy actions to support higher credit extension to the private sector in the continuing environment of uncertainty. In our view, what would be feasible would be a maintenance of the policy rate at 7 percent but re-energizing the process of reducing the obstacles to credit flows, particularly via fast-tracking the implementation of risk-based pricing. This would support more inclusive growth in credit, particularly to the MSMEs.

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