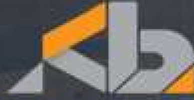

Research Note
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March 23, 2021

Sustain monetary policy stance, and re-energize appropriate pricing to '*push the liquidity in the system towards supporting economic recovery*'

Highlights

The Central Bank of Kenya Monetary Policy Committee's decisions are often keenly watched and anticipated. Ahead of the Committee's meeting on **Monday March 29, 2021**, we argue for maintaining the current monetary policy stance, and supporting a private sector-led economic recovery, based on a number of observations:

- Inflation remains within the 5±2.5 percent target range, but pressure is mounting as global oil prices increase, and a depreciated Shilling relative to its levels over a similar period in 2020.

- The domestic economy is recovering, but slowly and unevenly, weighed down by the adverse effects of the pandemic.

- Policy measures that need to be taken to place the economy on its strong growth footing lean more on monetary and its supportive measures than on fiscal policy. The latter's room to steer economic recovery remains constrained as debt build-up and debt sustainability concerns emerge. For monetary policy, revamping its effectiveness to impact economic activity will be critical.

- Private sector lending has improved, but there is more room, given the ample liquidity in the system, for its enhancement. In this *Research Note*, we argue that the recovery of the economy will not be hinged on a further policy rate cut, but on the deployment of supportive measures to '*push the liquidity in the system towards economic activity, moreso in an inclusive way'*. At the existing pricing framework, some riskier borrowers are crowded out constraining further growth in credit growth.

- In this regard, maintaining the current monetary policy stance – with the rate at 7 percent - as an anchor for supporting economic recovery is appropriately justified. But to unlock a stronger, sustainable and more inclusive growth in credit to the private sector, requires an enhancement in, not only the pace of adoption, but also the implementation of risk-based pricing.

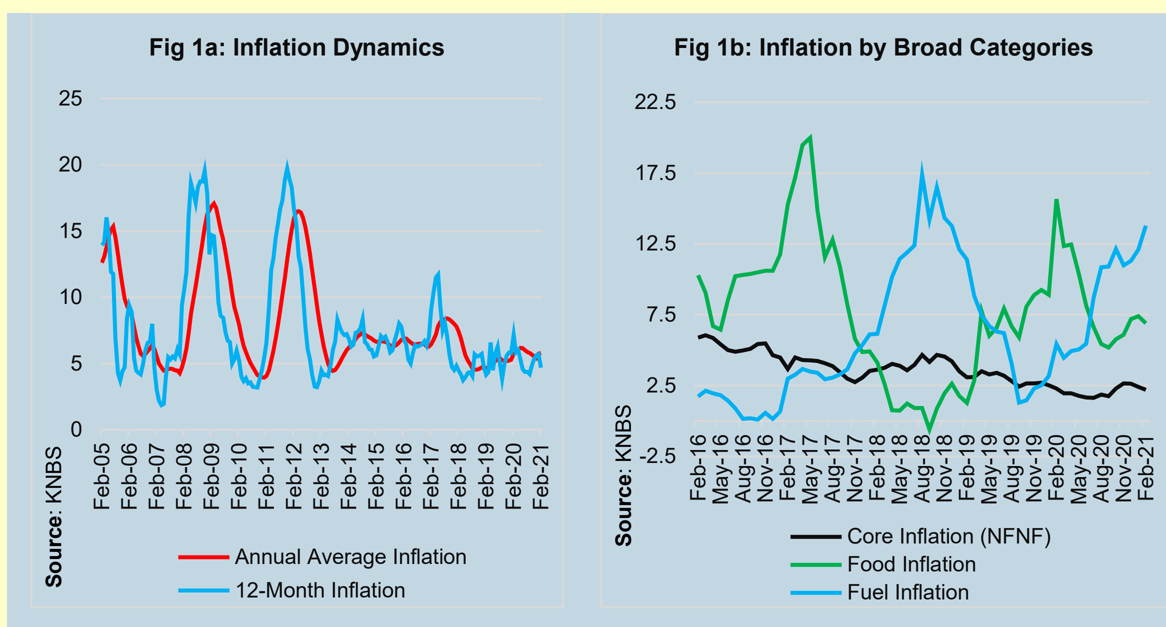
> *"To unlock a stronger, sustainable and more inclusive growth in private sector credit, will require an enhancement in, not only the pace of adopting risk-based pricing, but also its implementation.*

Background

This *Research Note* reviews the latest developments on inflation, economic activity, and external sector developments and considers the potency of the policy options available. Moreover, based on the analyses conducted, makes policy proposals.

Inflation remains within the target range (5±2.5 percent), but pressure is mounting from a steady increase in global oil prices, and a depreciated Shilling relative to its levels over a similar period in 2020. Overall inflation stood at 5.78 percent in February compared with 5.74 percent in January 2021 (**Figure 1a**); its stability largely sustained by relatively low food inflation.

The CPI's structure (**Figure 1b**) suggests emerging inflationary risks on two fronts. One, a steady increase in global oil prices, from 35.58 US dollars per barrel in March 2020 to 67.44 US dollars per barrel as at 17th March 2021. With oil being both a final consumption and an intermediate good, its price rise would directly push up inflation by increasing the local pump prices and indirectly through its influence on other manufactured goods' prices. Fuel inflation in February rose to 13.80 percent from 12.10 percent in January 2021. Pressure on inflation may be exacerbated by the depreciation in the exchange rate, with the local currency having weakened relative to the US dollar on average by 7.76 percent in the first quarter of 2021, compared to a similar period in 2020.



Additionally, despite the demand-driven inflationary pressure appearing muted in the first two months of 2021 (with core-inflation at 2.2 percent in February compared to 2.4 percent in January), there are signals of rising demand pressures in the near term, as the economy recovers from the adverse effects of the pandemic. The KBA Housing Price Index Report, published in March 2021, for instance, showed that house prices in the fourth quarter of 2020 rose for the first time after seven quarters of depressed performance, driven by a sharper increase in demand over supply.[1]

While inflationary pressure on balance appears tilted towards the upside, overall inflation has been moderated by steady food prices since the beginning of 2021, with food inflation easing to 6.90 percent in February 2021 from 7.40 percent in January 2021. Food prices, in the near term, will depend largely on the outcomes of the weather forecast for March-May 2021 published by the Kenya Meteorological Department, which, so far, looks good.[2]

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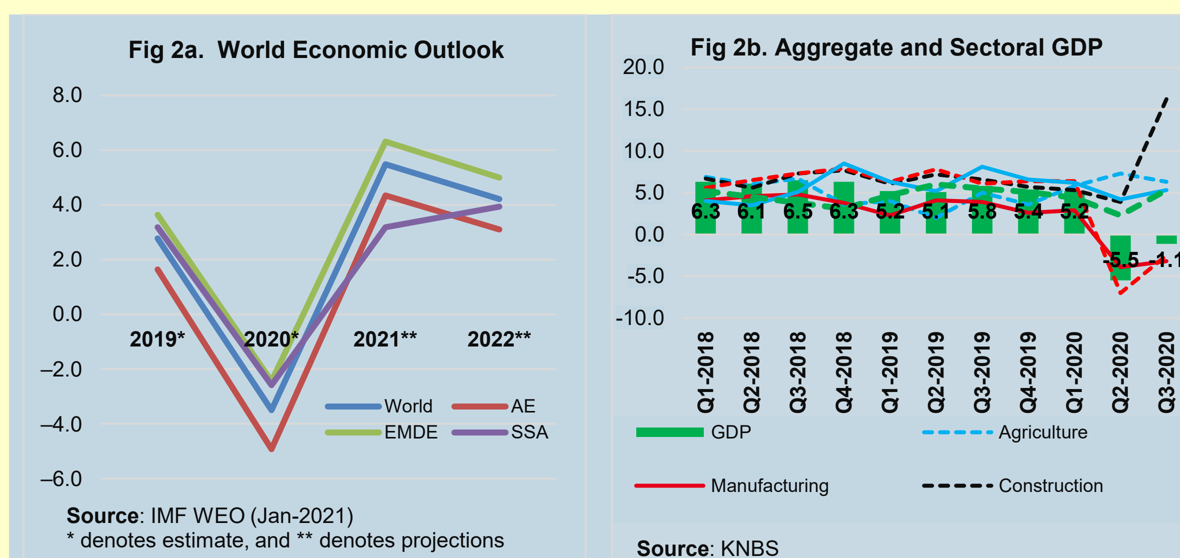
[1] See KBA-HPI 2020's fourth quarter's house price evolution trend https://www.kba.co.ke/downloads/KBA-HPI%202020_Q4.pdf

[2] For the full report of the weather forecast for March-May 2021, see http://www.meteo.go.ke/pdf/seasonal.pdf

On account of the outlined developments and inflationary risks building up, any further cuts on the policy rate (to signal a further easing monetary policy stance) would fuel inflationary pressures on the upside. 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.

The domestic economy is recovering, but at a pace slower than was anticipated, pulled back by protracted uncertainty arising from the pandemic's adverse impact. The economy, both global and domestic, entered 2021 with substantial slack. Moreover, recovery across countries and sectors remains slow and uneven. The global economy is estimated to have contracted by 3.5 percent in 2020, much of which was in the first half, with activity in the second half recovering, albeit partially. The growth forecast for 2021 has been revised upwards, though marginally, to 5.5 percent compared to 5.2 percent reported in September 2020. Notably, Sub-Sahara Africa's (SSA) growth forecast for 2021 lags all other economic blocks in 2021 (**Figure 2a**). The non-synchronized recoveries are attributable to differences in access to medical interventions, the effectiveness of policy support, exposure to cross-country spillovers, and the non-homogenous structural characteristics of economies as they entered the crisis (IMF WEO, Jan 2021)[3].



Source: IMF WEO (Jan-2021)
* denotes estimate, and ** denotes projections

Source: KNBS

Similarly, the domestic economy's recovery remains partial and uneven, with substantial slack (**Figure 2b**). Our analyses on the impact of the pandemic show that the more contactless sectors, such as the agriculture sector, depicted more resilience in 2020 compared to the services sectors that require more human-to-human contact, which were adversely affected by the pandemic's containment measures. While some of these service-oriented activities, such as tourism, hotels, and accommodation, for instance, have extensively reopened, the level of activity in these sectors is yet to pick momentum as global travel still is restricted by lockdowns in major tourist source countries/regions, such as Europe.

The story is somewhat different for the manufacturing sector. According to *Stanbic Bank's PMI Report* for February 2021, the manufacturing sector's business conditions sustained a month-after-month improvement since July 2020, although at a decelerating rate. Notably, demand (depicted by new orders) has risen, prompting an improvement in employment. However, the build-up in demand faces an adverse risk of rising input and output prices on account of higher costs of raw materials and fuel. Looking ahead, the report highlights a dip in business sentiment for the rest of the year, but the sentiments are better than those reported in the second half of 2020[4].

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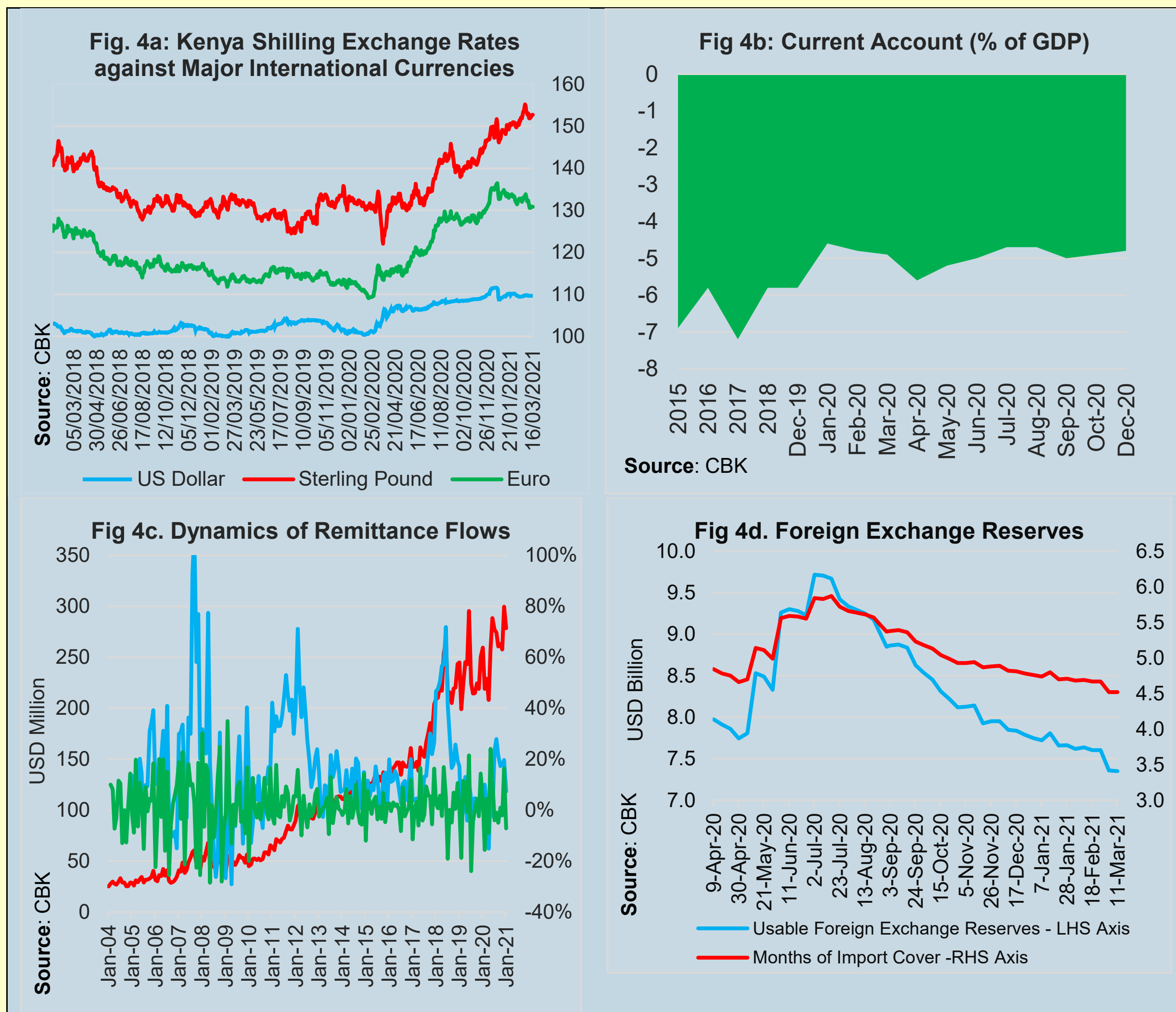
[3]See *IMF's World Economic Outlook (WEO) Update (Jan-2021)* https://www.imf.org/-/media/Files/Publications/WEO/2021/Update/January/English/text.ashx

[4]The Stanbic Bank's PMI report for February 2021 https://www.standardbank.co.ao/static_file/Kenya/filedownload/KE_PMI_ENG_2103_LITE.pdf

The domestic economy is estimated to have contracted by 0.1 percent in 2020 and projected to recover by 7.6 percent in 2021 on the back of reduced COVID-19 containment measures and reopening of schools - even as some sectors of the economy continue to face some headwinds (IMF, 2021). However, concerns emerge on the risks to economic recovery following the roll-back of the supportive tax, economic and banking sector measures that provided some reprieve to households and businesses.

Other risks to the growth of the economy include the uncertainty created by the pace of vaccine's rollout, dwindling confidence in the efficacy of some vaccines, and any delay or even failure to deploy measures that are supportive to the economy. With the overall real economic output growth estimated at below 1 percent in 2020 (IMF, 2021[5]), compared to an average of 5.6 percent growth over the last five years (2015-2019), an output gap of more than 5 percent calls for drastic and decisive measures to close or at least narrow the gap.

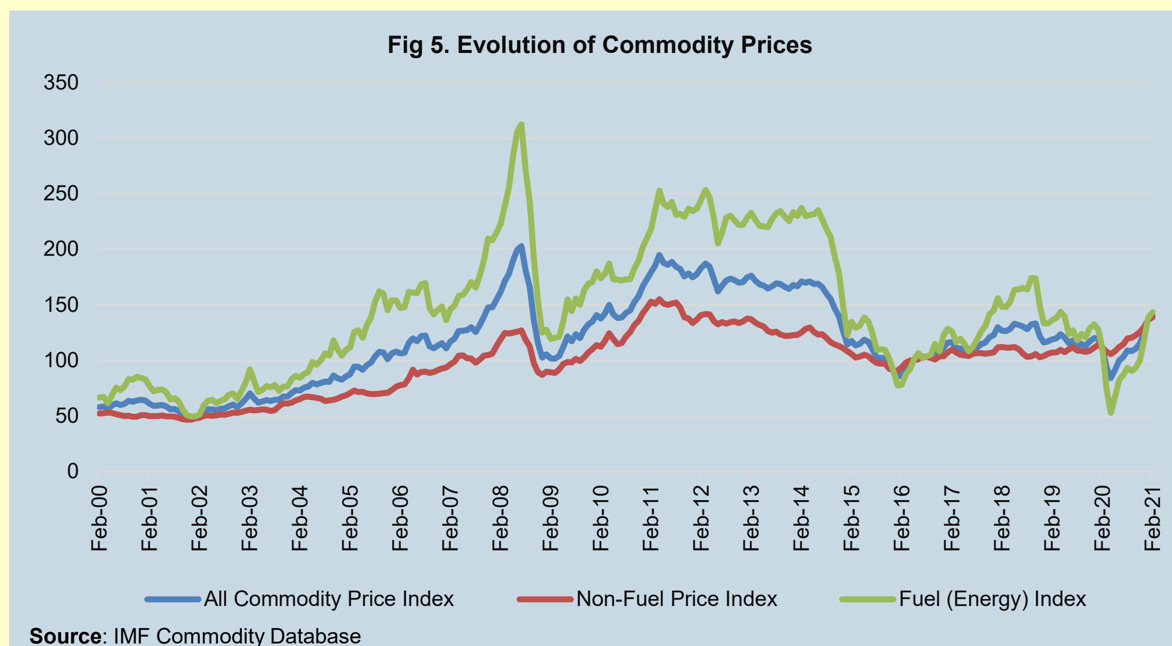
The exchange rate has stabilized but remains vulnerable to the uncertainty in the global economy. Data shows relative stability in the exchange rate (**Figure 4a**) after a depreciation that was largely attributed to a strengthening of the US dollar in the global markets. The adjustment in the U.S dollar largely reflected improved sentiments following the change in leadership in the U.S, which was expected to stabilize U.S economic and trade policies going forward. However, a narrower current account deficit (**Figure 4b**) continued to moderate the pressure on the exchange rate.



[5] 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

The current account deficit for 2020 was estimated at 4.8 percent of GDP, compared to 5.8 percent in 2019, mainly supported by a smaller oil import bill due to lower global prices, ongoing recovery in exports, especially agricultural products with a pickup in demand in global markets, and continued resilience of remittances (**Figure 4c**). Further, while foreign exchange reserves have been declining in stocks, the decline was slower in terms of months of import coverage which, at 4.5 months in mid-March 2021, was above the statutory minimum limit of 4 months (**Figure 4d**).

Going forward, risks to the exchange rate would typically be drawn from the interaction between supply and demand in the foreign exchange market, and largely include: (i) any further cuts in the policy rate that would adversely affect the interest rate differentials in favour of foreign exchange outflows; (ii) a faster pickup in global oil prices than other commodity prices (**Figure 5**) that would bulge the import bill; (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, and; (iv) any worsening of market sentiments due to delays in instituting fiscal policy adjustments to stabilize debt.



Source: IMF Commodity Database

Against the above development, the question then is, what is the potency of monetary/ fiscal policy to deliver the much-needed recovery of the economy? Typically, fiscal policy is argued empirically to deliver stronger support for the economy under distress conditions, as monetary policy -due to its reliance on the structure and level of development of the financial sector- remains a short-term macroeconomic stabilization tool. Despite this, fiscal policy is extensively constrained as debt build-up rises and debt sustainability concerns emerge.

Kenya in mid-February engaged the IMF for a 38-month US$ 2.4 billion financing programme, under the Extended Fund Facility (EFF) and Extended Credit Facility (ECF) that, besides providing resource support to the country to deliver a strong, sustainable and inclusive growth, also embodied some economic and structural reforms.

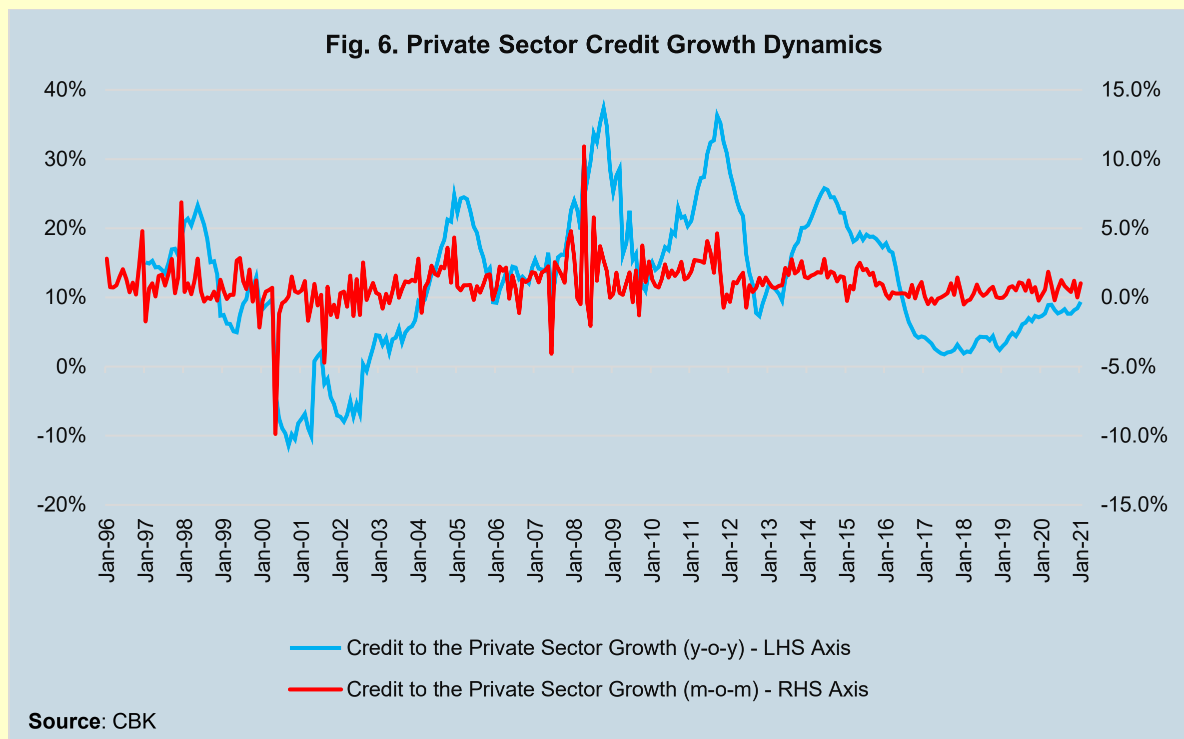
A critical deliverable under the programme is establishing a clear path to reducing the vulnerabilities crystalized by the pandemic. This would typically be achieved by implementing fiscal consolidation to stabilize and reduce its debt levels relative to GDP. The IMF/National Treasury's agreed fiscal consolidation would target to place the economy on a strong footing by freeing-up resources for private investment (IMF, February 2021).[6] This highlights the need to establish a private sector-led economic recovery.

[6] See https://www.imf.org/en/News/Articles/2021/02/15/pr2140-imf-and-kenyan-authorities-reach-staff-level-agreement

Given fiscal policy's constrained role, monetary policy support to private sector lending would be critical in anchoring a strong and sustainable economic recovery. This bestows upon the banking sector a central and increasing role in delivering the much-needed economic turnaround going forward. In January 2021, lending to the private sector grew by 9.3 percent from 8.3 percent in December 2020 (**Figure 6**). Despite this improvement, growth in credit to the private sector remains sub-optimal (below pre-interest rate capping levels), notwithstanding the sustained accommodative monetary policy stance.

Going forward, the much-needed monetary policy support would be seeking to unlock more credit to the private sector from an existing adequate pool of resources in the banking sector.[7] In particular, re-energizing the banking sector's pursuit of risk-based pricing to accommodate some risk would support sustainable and inclusive credit growth, particularly to the Micro, Small and Medium Enterprises (MSMEs).

Fig. 6. Private Sector Credit Growth Dynamics



Source: CBK

Conclusion

This note outlines several developments. First, the global and domestic economy is recovering slowly and unevenly. The sub-optimal recovery needs to be supported. Second, despite being within the target range, inflation shows signs of edging upwards in response to rising oil prices. On the back of this, and more binding constraints on the fiscal policy's ability to drive the recovery, monetary policy and other measures will be handy. Nonetheless, we argue that the recovery of the economy will not be hinged on a further policy rate cut, but rather a deployment of measures to 'push the liquidity in the system towards economic activity, more so in an inclusive way'. Private-sector lending has improved, but there is more room, given the ample liquidity in the system, for an enhancement in credit supply to the private sector.

In this *Research Note*, we argue that faster credit growth is currently constrained by the existing pricing framework, which continues to crowd out some borrowers that appear riskier. In this regard, the current monetary policy stance's sustenance at 7 percent as an anchor for supporting economic recovery is appropriately justified. But to unlock a stronger, sustainable, and more inclusive growth in credit to the private sector requires an enhancement in, not only the pace of adoption, but also the implementation of risk-based pricing.

[7] Liquidity ratio as at December 2020 stood at over 53%, which is more than double the statutory minimum of 20%.

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