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CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®
Research Note

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The monetary policy stance remains appropriate, but a full thrust towards risk-based pricing will unlock credit to private sector and solve inflationary threats in the near to medium term

"To incentivize a conversion of built-up liquidity to private sector loans will call for additional thrust towards implementation of risk-based pricing. Providing a stronger impetus for economic recovery, thereby solving inflationary threats in the near to medium term.

Highlights

We anticipate that the Central Bank of Kenya's Monetary Policy Committee decision of 28th September 2021 shall be seeking to strike a balance between three competing and interrelated phenomena:

(i) Economic recovery is underway, but remains fragile, bouyed down by the adverse effects of the pandemic;

(ii) Inflationary pressure that has been building up, largely driven by supply-side factors, may in the near-term break the upper bound target of 7.5 percent on account of the recent significant domestic fuel pump price hikes;

(iii) With the credit market still at an inflection point and the need to support the fragile economic recovery through extension of private sector credit stronger now than in the recent past, the present trade-off is between supporting economic recovery and mitigating any price instability threats.

With the credit risk remaining elevated on the back of a protracted uncertainty and a gradual (rather than sharper) recovery in household and business earnings - as the effects of the pandemic continue to bite, the incentives for the banking sector to grow private sector loans remain low. This scenario, that has resulted in a build-up in liquidity in the system, will continue in the near to medium term, unless the pricing framework is effectively recalibrated to fully reflect the risk in the market; a developement that would see a sharper growth in credit to segments perceived to more risky such the MSMEs.

In this regard, we sustain our argument as in the recent past *Research Notes* that the current monetary policy stance is appropriate and already accommodative enough. To incentivize a conversion of the built-up liquidity to private sector loans will call for a faster leap towards risk-based pricing. This would unlock private sector loans and provide a stronger impetus for economic recovery; muting inflationary pressures in the medium term.

Considerations

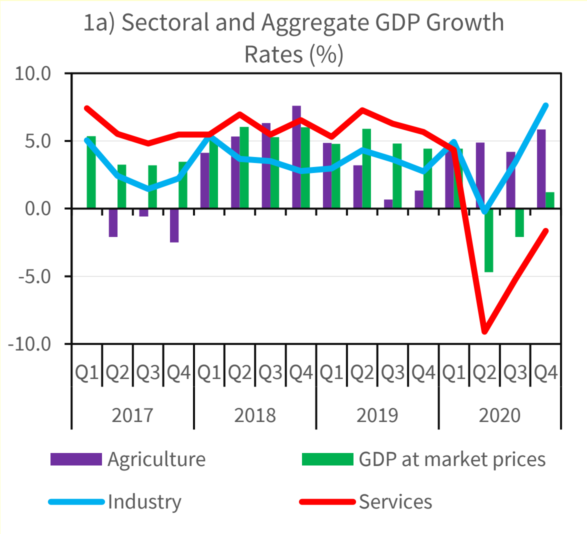
The MPC's policy scenarios, particularly amidst the fragile recovery process being witnessed, would be centred on the tight -balance between supporting economic recovery and mitigating any price instability threats. Accordingly, policy monitors will be keen to see the views adopted by the MPC on the rising inflationary threats that call for a stay on policy stance and/or signal an upward adjustment in interest rates in the near-term. In particular, the policy organ's views on whether the current inflationary pressure will be transitory or permanent will be highly anticipated.

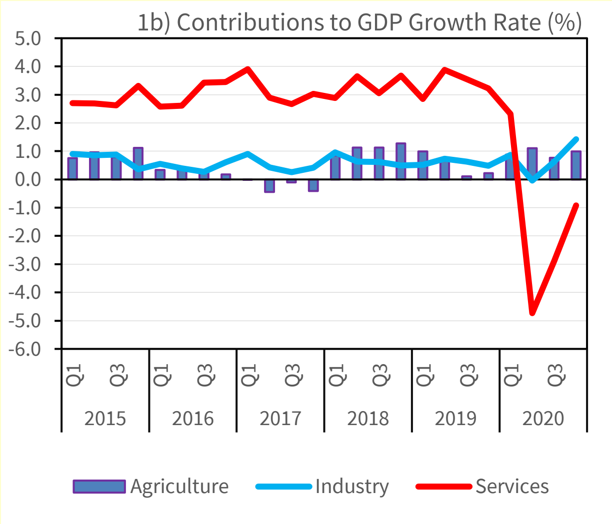
In this Research Note, we make three arguments that are likely to be at the centre of the policy decision anticipated on 28th September 2021:

First, economic recovery is underway, but remains fragile, buoyed down by the adverse effects of the pandemic. We observe that monetary policy has been accommodative, leading to lower lending rates and providing support to economic activity. In 2020, the economy was characterised by considerable slack on account of the adverse effects of COVID-19 pandemic, contracting by 0.3 percent compared to a strong growth of 5.0 percent in 2019 (see **chart 1a&b**). This represented the sharpest contraction in recent history, most of which was evident in the second quarter when the economy shrunk by 4.7 percent, as stiffer containment measures to curtail the spread of the virus were adopted. The subsequent easing of containment measures in the third and fourth quarters moderated the contraction to 2.1 percent in quarter three and supported a 1.2 percent growth in the fourth quarter.

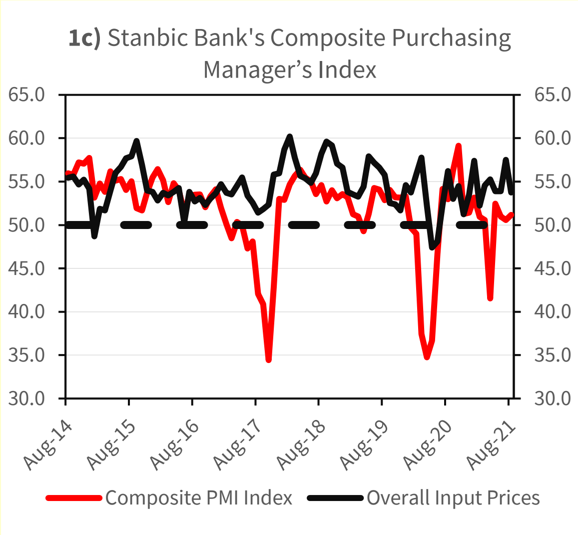
Leading economic indicators in 2021, reveal further that economic recovery is underway, but remain weak, as shown by Stanbic Bank's PMI index report for August shows (see **chart 1c&d**). The Index (PMI); a gauge of the state of the economy, edged further upwards to 51.1 in August from 50.6 in the previous month[1], signalling an improvement in economic activity for the third month running, supported by rising sales, strengthening labour market conditions, and output growth. This was, however, softened by low business confidence for the next 12 months on account of uncertainties created by the pandemic. Other high-frequency indicators, especially export growth, suggests that the economic growth momentum is gaining some traction, but overall activity remains substantially below its potential.

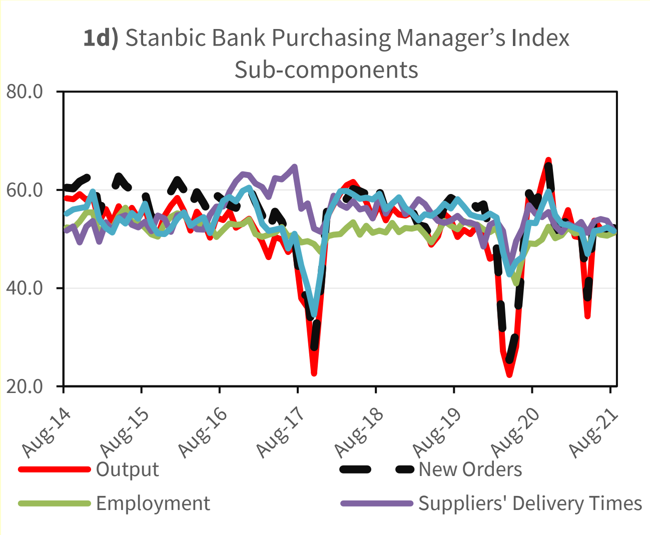
Chart 1. Economic Growth and Purchasing Manager's Index





[1] See August 2021, Stanbic Bank PMI, "New business growth picks up in August"https://www.stanbicbank.co.ke/static_file/Kenya/filedownload/KE_PMI_ENG_2109_LITE.pdf





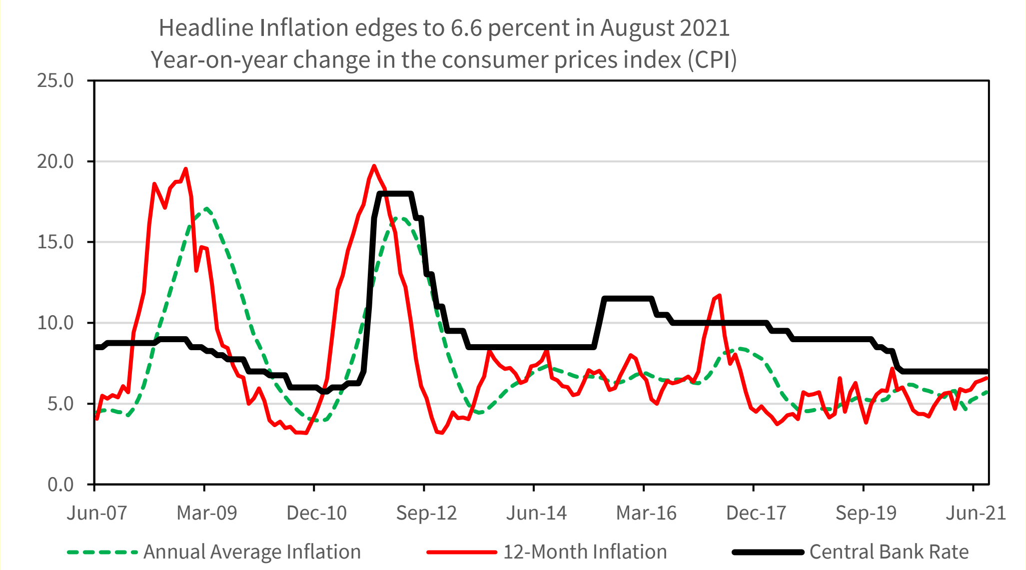
Source: KNBS, *Stanbic Bank & IHS Markit*

Second, inflationary pressure that has been building up, though largely driven by supply-side factors, may in the near-term break the upper bound target of 7.5 percent on account of the recent significant domestic fuel pump price hikes. Thus, from a price stability perspective, the continuation of the current policy stance, or even a further easing of the stance, portends some risks in two main fronts:

- **First, the move may introduce demand pressures that can exacerbate the existing supply-side-driven price pressures**. Headline inflation rate accelerated to 6.6 percent in August from 6.5 percent in July, driven largely by food inflation that rose to 10.7 percent from 8.8 percent over the same period. This was, however, moderated by fuel inflation that eased to 9.2 percent in August from 11.8 percent in July. However, this may reverse given the new hikes in local pump prices announced in mid-September. Core inflation, based on a non-food-non-fuel inflation measure that typically also reflect demand-driven pressures, also declined marginally to 2.6 percent in August from 2.9 percent in July (see **chart 2**).

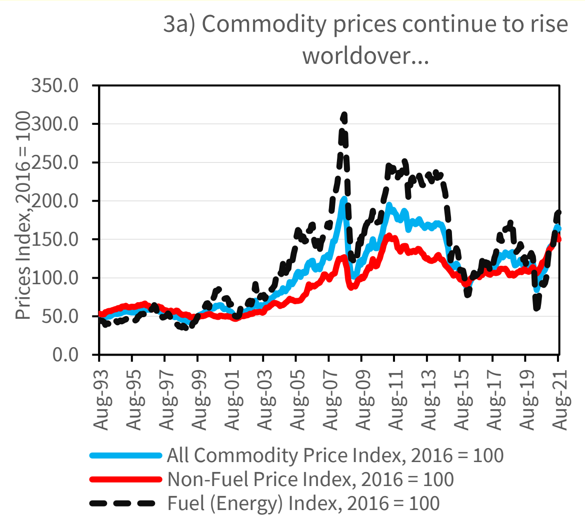
  Despite the fact that overall inflation in August was within the government's target range of 5±2.5 percent, it is rising with the risk of sustained (possibly even faster) increase stronger now than in the recent past. While we observe that the shock may be permanent given the rising global oil prices (see **chart 3a**), its impact on policy stance remains of interest. The question is, would the MPC view the pressure as permanent or transitory? The latter view would ask for a stay on policy as the former requires a signal for monetary policy tightening. In the mix of considerations would also include the view that strong economic recovery in the medium to long-term mutes inflationary pressures. But this stronger economic recovery would not require a signal for further easing of interest rates, given the elevated credit, but rather a push on the already ample liquidity through the system using the right price incentives.

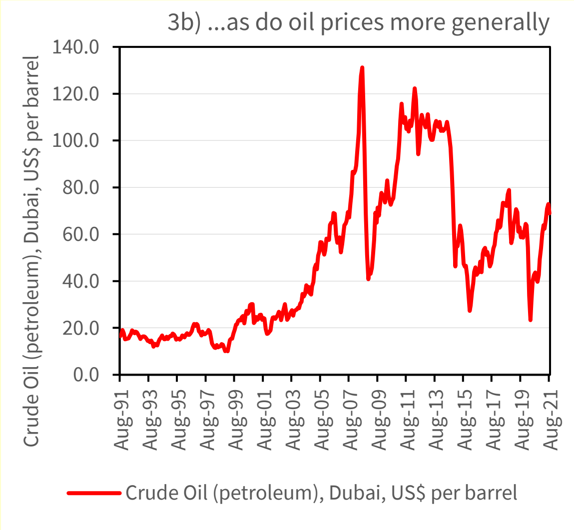
Chart 2. Inflation trends and monetary policy stance



Source: Central Bank of Kenya

Chart 3. Global commodity and oil price developments



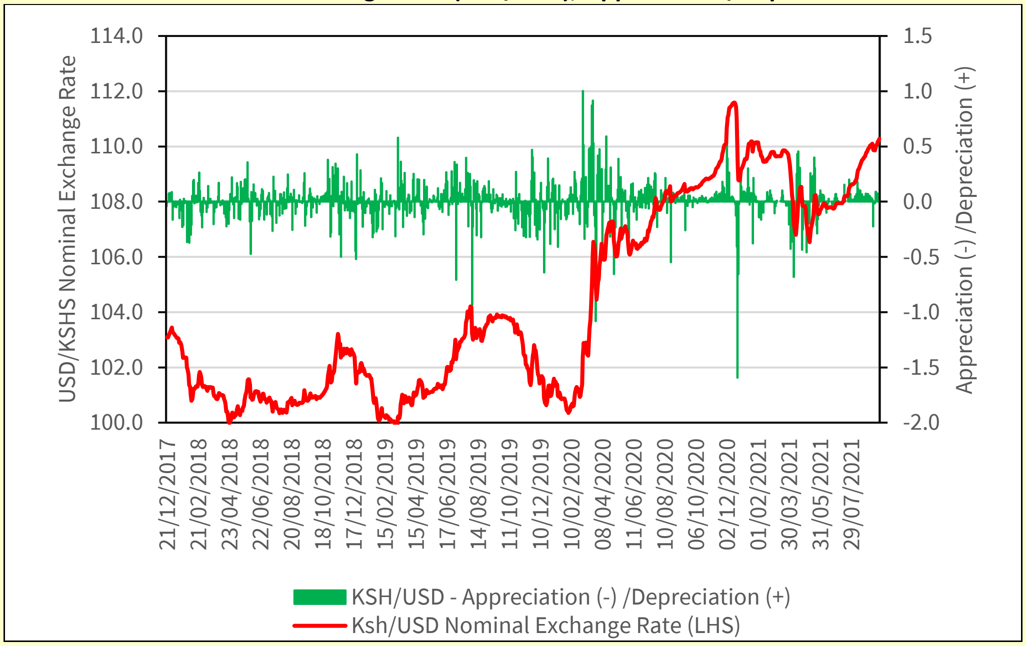


Source: IMF Global Commodity Database

- **Second, the implication of a further easing of stance on the exchange rate-effects on inflation**. The shilling since mid-July has depicted a weakening bias (see **chart 4**). Despite this, the official foreign exchange reserves have remained strong, at USD9.62 billion, equivalent to 5.88 months of imports as at 16th September 2021[2], on account of increased remittance inflows, which rose to USD 312.9 million in August 2021 compared to USD 274.1 million in August 2020. The weaker exchange rate also reflects a widening current account deficit that stood at 5.4 percent of GDP in the 12-months to July 2021 compared to 4.9 percent of GDP in the 12 months to July 2020. The widening current account was on account of lower service receipts amidst rising import bill, which more than offset the growth in receipts from agricultural exports and remittances.

[2] See 2056431405_Weekly CBK Bulletin September 17, 2021.pdf (centralbank.go.ke)

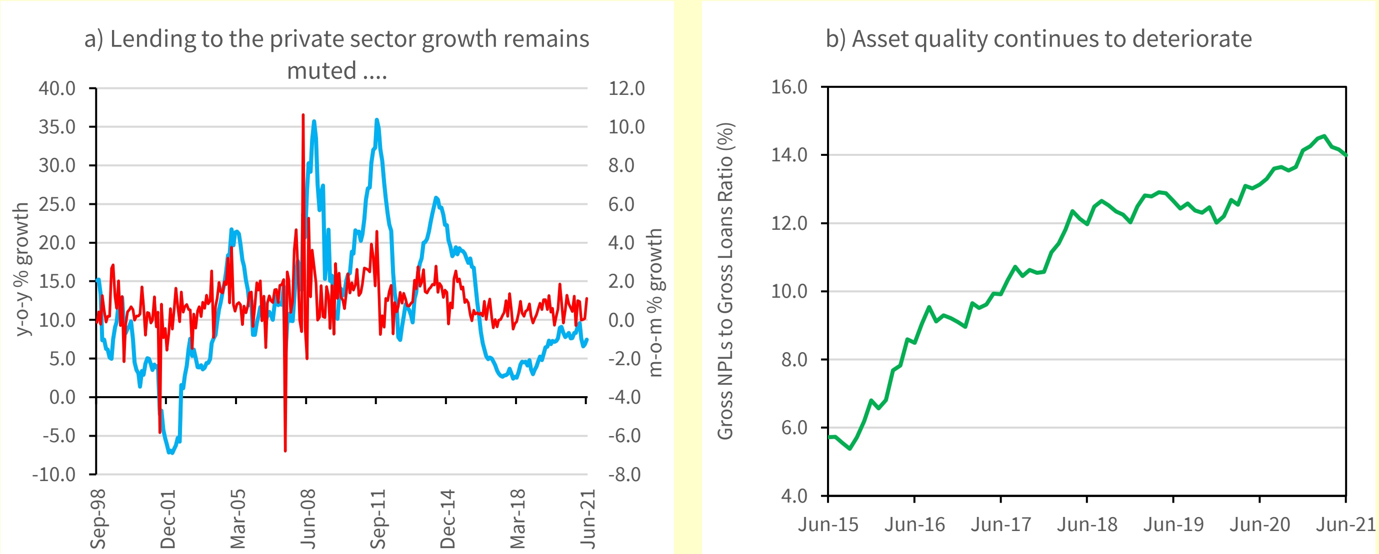
Chart 4. Exchange Rate (KSH/USD), Appreciation/Depreciation Bias



Source: Central Bank of Kenya

Third, with the credit risk remaining elevated on the back of a gradual (rather than sharper) recovery in household and business earnings - as the effects of the pandemic continue to bite- the incentives for the banking sector to grow private sector loan book remain low. The private sector credit growth trajectory has seen little change since the onset of the pandemic and remains stuck at a single-digit level (see **chart 5a**), on the back of a weakening asset quality base (see **chart 5b**). Credit to the private sector expanded by 7.5 percent in June from 6.8 percent in May 2021. Despite this improvement, the growth remains sub-optimal to deliver stronger economic recovery. Without adequate growth in credit has meant a buildup in liquidity in the system. This is expected to continue in the near to medium term, unless the pricing framework is effectively recalibrated to fully reflect the risk in the market; a development that would see a sharper growth in credit to segments perceived to be riskier such as the MSMEs.

Chart 5. Credit to the Private Sector Growth and Banking Sector Asset Quality



Source: Central Bank of Kenya

Conclusion

The much-anticipated Monetary Policy Committee's decision of 28th September 2021 is expected to reflect a tight balance between three somewhat competing and interrelated phenomena. First, noting that the economic recovery is underway, it remains fragile, buoyed down by the adverse effects of the pandemic. Second, inflationary pressure that has been building up, largely driven by supply-side factors, may in the near-term break the upper bound target of 7.5 percent on account of the recent significant domestic fuel pump price hikes. Third, with the credit market still at an inflection point and the need to support the fragile economic recovery through extension of credit to households and enterprises stronger now than in the recent past, the present trade-off is between supporting economic recovery and mitigating any price instability threats. We note that credit risk remains elevated on the back of a gradual (rather than sharper) recovery in household and business earnings as the effects of the pandemic continue to bite, and thus the incentives for the banking sector to grow private-sector loan book remain low.

In this scenario, we argue that the current accommodative monetary policy stance has caused a build-up in liquidity in the same, that will continue in the near to medium term, unless the pricing framework is effectively recalibrated to fully reflect the risk in the market; a development that would see a sharper growth in credit to segments perceived to more risky such the MSMEs.

In this regard, we sustain our argument as in the recent past *Research Notes* that the current monetary policy stance is appropriate and already accommodative enough. To incentivise conversion of liquidity to private sector loans will call for a faster leap towards risk-based pricing. This would unlock private sector loans and provide a stronger impetus for economic recovery.

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Comments on this *Research Note* can be forwarded to research@kba.co.ke